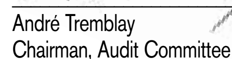
Consolidated Balance Sheets

(in thousands of US dollars)
The accompanying notes are an integral part of these consolidated financial statements.

As at August 31,		**2004**		2003
Assets				
Current assets				
Cash	**$**	**5,159**	$	5,366
Short-term investments (notes 8 and 17)		**83,969**		52,010
Accounts receivable (notes 8 and 17)				
Trade		**12,080**		9,639
Other		**1,532**		834
Income taxes and tax credits recoverable (notes 4 and 8)		**7,836**		6,003
Inventories (notes 4, 5 and 8)		**15,371**		15,602
Prepaid expenses		**1,513**		2,041
		127,460		91,495
Income taxes and tax credits recoverable (notes 4 and 8)		**449**		1,377
Property, plant and equipment (notes 4, 6 and 8)		**15,442**		21,862
Long-lived asset held for sale (note 4)		**1,600**		-
Intangible assets (notes 4, 7 and 8)		**9,447**		13,847
Goodwill (notes 4 and 7)		**18,393**		17,673
	$	**172,791**	$	146,254
Liabilities				
Current liabilities				
Accounts payable and accrued liabilities (note 9)	**$**	**11,393**	$	12,026
Income taxes payable		**-**		1,803
Deferred revenue		**805**		148
Current portion of long-term debt		**121**		110
		12,319		14,087
Deferred revenue		**1,123**		352
Deferred grants (note 14)		**1,690**		1,536
Long-term debt (note 10)		**332**		453
		15,464		16,428
Commitments (note 11)				
Contingencies (note 12)				
Shareholders' equity				
Share capital (note 13)		**521,733**		492,452
Contributed surplus		**1,986**		1,519
Cumulative translation adjustment		**13,820**		7,643
Deficit		**(380,212)**		(371,788)
		157,327		129,826
	$	**172,791**	$	146,254

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,	2004	2003	2002
Sales (note 18)	**$ 74,630**	$ 61,930	$ 68,330
Cost of sales [1,2]	**34,556**	36,197	52,366
Gross margin	**40,074**	25,733	15,964
Operating expenses			
Selling and administrative [1]	**25,890**	26,991	33,881
Net research and development [1] (notes 4 and 14)	**12,390**	15,879	12,782
Amortization of property, plant and equipment	**4,935**	5,210	5,096
Amortization of intangible assets	**5,080**	5,676	12,451
Impairment of long-lived assets and goodwill (note 4)	**620**	7,427	23,657
Restructuring and other charges (note 4)	**1,729**	4,134	2,880
Total operating expenses	**50,644**	65,317	90,747
Loss from operations	**(10,570)**	(39,584)	(74,783)
Interest and other income	**1,438**	1,245	1,456
Foreign exchange loss	**(278)**	(1,552)	(458)
Loss before income taxes and amortization and write-down of goodwill (note 15)	**(9,410)**	(39,891)	(73,785)
Income taxes (note 15)	**(986)**	15,059	(25,451)
Loss before amortization and write-down of goodwill	**(8,424)**	(54,950)	(48,334)
Amortization of goodwill (note 2)	**-**	-	38,021
Write-down of goodwill (note 4)	**-**	-	222,169
Net loss for the year	**$ (8,424)**	$ (54,950)	$ (308,524)
Basic and diluted loss per share			
Loss before amortization and write-down of goodwill	**$ (0.13)**	$ (0.87)	$ (0.80)
Net loss	**$ (0.13)**	$ (0.87)	$ (5.09)
Basic weighted average number of shares outstanding (000's)	**66,020**	62,852	60,666
Diluted weighted average number of shares outstanding (000's) (note 16)	**66,615**	63,317	60,966

(1) Stock-based compensation costs included in: (note 2)

	2004	2003	2002
Cost of sales	**$ 62**	$ -	$ -
Selling and administrative	**265**	-	-
Net research and development	**122**	-	-
	$ 449	$ -	$ -

(2) Including inventory write-offs of nil, $4,121 and $18,463 for the years ended August 31, 2004, 2003 and 2002, respectively (note 4). The cost of sales is exclusive of amortization, shown separately.

Consolidated Statements of Deficit and Contributed Surplus

(in thousands of US dollars)
The accompanying notes are an integral part of these consolidated financial statements.

Deficit

Years ended August 31,	**2004**	2003	2002
Balance – Beginning of year	**$ (371,788)**	$ (316,838)	$ (8,314)
Add			
Net loss for the year	**(8,424)**	(54,950)	(308,524)
Balance – End of year	**$ (380,212)**	$ (371,788)	$ (316,838)

Contributed Surplus

Years ended August 31,	**2004**	2003	2002
Balance – Beginning of year	**$ 1,519**	$ 1,487	$ 1,457
Add			
Premium on resale of share capital	**18**	32	30
Stock-based compensation costs (note 2)	**449**	-	-
Balance – End of year	**$ 1,986**	$ 1,519	$ 1,487

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,	2004	2003	2002
Cash flows from operating activities			
Net loss for the year	**$ (8,424)**	$ (54,950)	$ (308,524)
Add (deduct) items not affecting cash			
Discount on short-term investments	**197**	(96)	197
Stock-based compensation costs	**449**	-	-
Inventory and tax credit write-offs	**-**	6,418	18,463
Amortization	**10,015**	10,886	55,568
Impairment of long-lived assets and goodwill	**620**	7,427	245,826
Restructuring and other charges	**1,261**	512	741
Future income taxes	**-**	10,138	(13,397)
Deferred revenue	**1,404**	(24)	(106)
Deferred grants	**154**	817	(335)
	5,676	(18,872)	(1,567)
Change in non-cash operating items			
Accounts receivable	**(2,677)**	3,957	15,406
Income taxes and tax credits	**(2,464)**	13,489	(19,736)
Inventories	**1,016**	7,925	4,332
Prepaid expenses	**(449)**	(569)	356
Accounts payable and accrued liabilities	**(351)**	(349)	(7,470)
	751	5,581	(8,679)
Cash flows from investing activities			
Additions to short-term investments	**(653,348)**	(401,105)	(506,228)
Proceeds from disposal of short-term investments	**624,722**	395,699	531,733
Additions to property, plant and equipment and intangible assets	**(851)**	(2,652)	(5,245)
Business combinations	**(241)**	(1,867)	(9,756)
	(29,718)	(9,925)	10,504
Cash flows from financing activities			
Repayment of long-term debt	**(109)**	(133)	(106)
Net proceeds of offering (note 13)	**29,164**	-	-
Share issue expenses	**(137)**	-	(14)
Exercise of stock options	**254**	45	-
Redemption of share capital	**(5)**	(16)	(6)
Resale of share capital	**23**	48	36
	29,190	(56)	(90)
Effect of foreign exchange rate changes on cash	**(430)**	638	(336)
Change in cash	**(207)**	(3,762)	1,399
Cash – Beginning of year	**5,366**	9,128	7,729
Cash – End of year	**$ 5,159**	$ 5,366	$ 9,128
Supplementary information			
Interest paid	**$ 408**	$ 417	$ 269
Income taxes paid (recovered)	**$ 120**	$ (10,351)	$ 4,172

Notes to Consolidated Financial Statements

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

1 • Nature of Activities

EXFO Electro-Optical Engineering Inc. ("EXFO") designs, manufactures and markets a comprehensive suite of test and measurement solutions for the global telecommunications industry. The Telecom Division, which represents the company's main business activity, offers integrated test solutions to network service providers, system vendors and optical component manufacturers. The Photonics and Life Sciences Division mainly leverages core telecom technologies to offer value-added solutions in high-tech industrial manufacturing and research sectors. EXFO sells its products in approximately 70 countries around the world.

2 • Summary of Significant Accounting Policies

Basis of presentation

These consolidated financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") in Canada and significant differences in measurement and disclosure from U.S. GAAP are set out in note 20. 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.

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 the disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting years. Actual results could differ from those estimates.

Reporting currency

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 on 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 on the date of the balance sheet, 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 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 on the date of the balance sheet. 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 such 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.

The company's forward exchange contracts, which are used to hedge anticipated US-dollar-denominated sales, qualify for hedge accounting; therefore, foreign exchange translation gains and losses on these contracts are recognized as an adjustment of the revenues when the corresponding sales are 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. All investments with original maturity of three months or less that are not required for the purposes of meeting short-term cash commitments are classified as short-term investments.

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:

	Term
Land improvements	5 years
Buildings	25 years
Equipment	2 to 10 years
Leasehold improvements	Remaining lease term

Intangible assets, goodwill and amortization
Intangible assets primarily include the cost of core technology and software, net of accumulated amortization. Core technology represents the existing technology acquired in business combinations that has reached technological feasibility. Intangible assets are amortized on a straight-line basis over their estimated useful lives of five years for core technology and four and ten years for software.

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. Goodwill impairment exists when the carrying value of the reporting unit exceeds its fair value. The fair value of a reporting unit is determined based on a combination of discounted future cash flows and a market approach. The amount of impairment loss, if any, represents the excess of the carrying value of goodwill over its fair value and this loss is 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 and recorded impairment charges for goodwill in fiscal 2002 and 2003 (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 assesses fair value and intangible assets based on discounted future cash flows. The company recorded impairment charges for long-lived assets in fiscal 2002, 2003 and 2004 (note 4).

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

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 post-contract customer support (PCS) revenues, based upon vendor-specific objective evidence of fair value. Product revenues for these sales are recognized as described above. PCS revenues are deferred and recognized ratably over the years of the support arrangement. PCS revenues are recognized at the time the product is delivered when provided within one year of delivery; the 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 handed over to a transporter for shipment.

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.

Revenue for extended warranties is recognized on a straight-line basis over the warranty period.

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. Research and development expenses are mainly comprised of salaries and related expenses, material costs as well as fees paid to third-party consultants.

As at August 31, 2004, 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. Since 2003, the company has recorded a full valuation allowance against future income tax assets (notes 4 and 15).

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 such as the company's stock options and restricted stock awards. 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 and pronouncements
On September 1, 2003, the company implemented the documentation required by Accounting Guideline 13 of the Canadian Institute of Chartered Accountants (CICA) handbook, "Hedging Relationship", which establishes new rules for designating, documenting and assessing the effectiveness of hedging relationships, such as the company's forward exchange contracts. Hedge accounting can only be applied if these new rules are met. Consequently, the company's forward exchange contracts, which are used to hedge anticipated US-dollar-denominated sales, continue to qualify for hedge accounting; foreign exchange translation gains and losses on these contracts continue to be recognized as an adjustment of the revenue when the corresponding sales are recorded.

On September 1, 2003, the company prospectively adopted the amendments made to handbook section 3870, "Stock-Based Compensation and Other Stock-Based Payments". These amendments require an expense to be recognized in the financial statements for all forms of employee stock-based compensation using a fair value-based method. In fiscal 2004, the company granted 536,500 stock options to its employees with a weighted average exercise price of $3.94. The weighted average fair value of these stock options amounted to $2.73. The corresponding stock-based compensation costs were amortized using the graded vesting method, resulting in stock-based compensation costs of $449,000 in fiscal 2004.

The company is required to disclose pro forma information with respect to net loss and net loss per share as if stock-based compensation costs were recognized in the financial statements using the fair value-based method for options granted in fiscal 2003. However, if the fair value-based method had been used to account for these costs, there would have been no impact on the net loss per share in fiscal 2004 and the pro forma net loss per share would have been $0.01 higher than the net loss per share in 2003.

The fair value of options granted in fiscal 2004 was estimated using the Black-Scholes options valuation model with the following weighted average assumptions:

	Year ended August 31, 2004
Risk-free interest rate	2.7%
Expected volatility	100%
Dividend yield	Nil
Expected life	49 months

In July 2003, the CICA issued handbook sections 1100 and 1400, "Generally Accepted Accounting Principles" and "General Standards of Financial Statement Presentation", which are effective for fiscal years beginning on or after October 1, 2003. Among other things, these new sections define generally accepted accounting principles (GAAP), establish the relative authority of various types of CICA Accounting Standards Board pronouncements and clarify the role of "industry practice" in applying GAAP. The company will adopt these new standards on September 1, 2004, and it does not expect any significant impact on its financial statements.

Comparative figures
Certain comparative figures were reclassified to conform to the current-year presentation.

3 • Business Combinations

In fiscal 2002 and 2003, the company completed business combinations in which it acquired significant intangible assets. The fair value allocated to these assets was based upon valuations performed in conjunction with these business combinations. Acquired goodwill, except the one from *gnubi communications L.P.*, was 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 settled for a total consideration valued at $4,904,000 including acquisition-related costs of $162,000. The consideration paid consisted in $2,108,000 in cash (including a cash contingent consideration of $241,000, paid in fiscal 2004, based on EXFO Gnubi sales volume for the twelve months following the acquisition) and in the issuance of 1,479,290 subordinate voting shares, valued at $2,796,000.

The cash contingent consideration was accounted for as an additional acquisition cost and was recognized as an additional cost of acquired core technology.

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 was 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.

During fiscal 2004, EXFO Gnubi's operations were consolidated with the parent company's operations in Montreal, Canada.

The purchase price, including acquisition-related costs, was 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		75
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 on the date of acquisition	$	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 in $9,756,000 in cash, net of cash and cash equivalents acquired of $25,571,000, and in 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 was 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.

As of September 1, 2003, EXFO Protocol was merged with the parent company.

The purchase price, including acquisition-related costs, was 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

4 • Special Charges

Impairment of long-lived assets and goodwill

2002

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 Products Group Inc. ("EXFO Burleigh"), EXFO Photonic Solutions Inc. ("EXFO Photonic Solutions") and EXFO Protocol Inc. ("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 the then-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%.

2003

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 of 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 was related to EXFO Burleigh for goodwill and acquired core technology, and $555,000 was 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 future 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.

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

2004

In fiscal 2004, the company reviewed the carrying value of one of its buildings that was put up for sale and it concluded that the building was impaired. The company recorded an impairment charge of $620,000, representing the excess of the net carrying value of the building over its expected selling price. The building did not meet the criteria of CICA handbook section 3475, "Disposal of Long-Lived Assets and Discontinued Operations", because it was not available for immediate sale in its existing condition. Consequently, it was not shown as a long-lived asset held for sale in the balance sheet as at August 31, 2004. This building reports to the Telecom Division.

Restructuring and other charges and inventory write-offs

During fiscal 2002, the company implemented restructuring plans to reduce its costs. Under these plans, the company recorded 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 impaired 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.

During fiscal 2003, the company implemented an additional restructuring plan to realign its cost structure to 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 impaired 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.

During fiscal 2004, the company approved a restructuring plan to consolidate EXFO Burleigh's operations, transferring them mainly to EXFO Photonic Solutions' facilities in Toronto. The consolidation process started in August 2004 and should extend into the first two quarters of fiscal 2005. EXFO Burleigh's operations and assets reported to the Photonics and Life Sciences Division and all expenses related to this consolidation process also report to this division.

Management estimates that the overall costs to be incurred under this plan should amount to $2,700,000. From this amount, $772,000, representing severance expenses, was recorded in fiscal 2004 for the layoff of all employees of EXFO Burleigh. In addition, in fiscal 2004, the company recorded an impairment charge of $1,261,000, mainly for the building. Management expects to incur the remaining $667,000 during the first two quarters of fiscal 2005 for different types of consolidation expenses such as training, recruiting and other special termination benefits.

The EXFO Burleigh building is for sale in its present condition and management expects to sell the property within the next twelve months. Consequently, in accordance with section 3475 of the handbook, it was shown in the balance sheet as a long-lived asset held for sale. The fair value used to determine the impairment charge for the building represents the company's best estimate of its selling price based upon the municipal valuation. Starting September 1, 2004, the building will cease to be amortized.

In fiscal 2004, the company incurred expenses totaling $2,033,000 in relation to this plan. This amount was recorded in the restructuring and other charges in the statement of earnings for the year ended August 31, 2004.

The following table summarizes the restructuring charges payable activity since August 31, 2001:

Year ended August 31, 2004

	Balance as at August 31, 2003	Additions	Payments	Adjustments	Balance as at August 31, 2004
Fiscal 2004 plan					
Severance expenses	$ -	$ 772	$ (305)	$ -	$ 467
	-	772	(305)	-	467
Fiscal 2003 plan					
Severance expenses	1,233	-	(870)	(254)	109
Exited leased facilities	748	-	(362)	-	386
Other	295	-	(90)	(8)	197
	2,276	-	(1,322)	(262)	692
Fiscal 2002 plans					
Other	68	-	(68)	-	-
	68	-	(68)	-	-
Fiscal 2001 plan					
Exited leased facilities	124	-	(72)	(42)	10
	124	-	(72)	(42)	10
Total for all plans (note 9)	$ 2,468	$ 772	$ (1,767)	$ (304)	$ 1,169

Year ended August 31, 2003

	Balance as at August 31, 2002	Additions	Payments	Adjustments	Balance as at August 31, 2003
Fiscal 2003 plan					
Severance expenses	$ -	$ 2,767	$ (1,534)	$ -	$ 1,233
Exited leased facilities	-	855	(107)	-	748
Other	-	512	(217)	-	295
	-	4,134	(1,858)	-	2,276
Fiscal 2002 plans					
Severance expenses	231	-	(231)	-	-
Other	68	-	-	-	68
	299	-	(231)	-	68
Fiscal 2001 plan					
Exited leased facilities	483	-	(359)	-	124
	483	-	(359)	-	124
Total for all plans (note 9)	$ 782	$ 4,134	$ (2,448)	$ -	$ 2,468

Year ended August 31, 2002

	Balance as at August 31, 2001	Additions	Payments	Adjustments	Balance as at August 31, 2002
Fiscal 2002 plans					
Severance expenses	$ -	$ 2,012	$ (1,781)	$ -	$ 231
Other	-	868	(800)	-	68
	-	2,880	(2,581)	-	299
Fiscal 2001 plan					
Severance expenses	372	-	(372)	-	-
Exited leased facilities	858	-	(375)	-	483
	1,230	-	(747)	-	483
Total for all plans	$ 1,230	$ 2,880	$ (3,328)	$ -	$ 782

Future income tax assets and research and development tax credits

During fiscal 2003, the company reviewed the carrying value of its future income tax assets and its research and development tax credits. Considering market conditions and because the company recorded losses in fiscal 2002 and 2003, it concluded that it was more likely than not that its future income tax assets and some of its non-refundable research and development tax credits were not recoverable and that a full valuation allowance and a write-off were required. Accordingly, the company recorded a full valuation allowance of $28,385,000 against its future income tax assets, mainly related to the parent company, EXFO Protocol and EXFO Burleigh and wrote off $2,297,000 in non-refundable research and development tax credits related to EXFO Protocol. The valuation allowance was included in the income taxes in the statement of earnings for the year ended August 31, 2003 (note 15). Research and development tax credit write-offs were 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,	2004	2003
Raw materials	**$ 7,244**	$ 8,188
Work in progress	**1,370**	1,022
Finished goods	**6,757**	6,392
	$ 15,371	$ 15,602

6 • Property, Plant and Equipment

As at August 31,		**2004**		2003
	Cost	**Accumulated amortization**	Cost	Accumulated amortization
Land and land improvements	**$ 2,868**	**$ 558**	$ 3,323	$ 350
Buildings	**8,311**	**1,699**	11,177	1,784
Equipment	**29,110**	**23,422**	27,800	19,099
Leasehold improvements	**2,110**	**1,278**	1,837	1,042
	42,399	**$ 26,957**	44,137	$ 22,275
Less: Accumulated amortization	**26,957**		22,275	
	$ 15,442		$ 21,862	

As of August 31, 2003 and 2004, unpaid purchases of property, plant and equipment amounted to $156,000 and $358,000, respectively.

The net carrying value of property, plant and equipment as at August 31, 2003, included $2,867,000 for the EXFO Burleigh building shown as a long-lived asset held for sale as at August 31, 2004 (note 4).

7 • Intangible Assets and Goodwill

The net carrying value of intangible assets is comprised of the following:

As at August 31,	2004	2003
Software, net of accumulated amortization of $3,482 ($2,691 in 2003)	**$ 2,365**	$ 3,069
Core technology, net of accumulated amortization of $25,733 ($20,986 in 2003)	**7,082**	10,778
	$ 9,447	$ 13,847

Amortization expenses for intangible assets in each of the next five fiscal years will be $4,550,200 in 2005, $2,825,600 in 2006, $735,600 in 2007, $315,900 in 2008 and $296,200 in 2009.

Changes in the net carrying value of goodwill are as follows:

As at August 31,	2004	2003
Balance – Beginning of year	**$ 17,673**	$ 17,576
Business combination (note 3)	**-**	2,958
Write-down (note 4)	**-**	(4,505)
Foreign currency translation adjustment	**720**	1,644
Balance – End of year	**$ 18,393**	$ 17,673

8 • Credit Facilities

The company has a line of credit which provides for advances of up to Cdn$10,000,000 (US$7,595,000). This line of credit, which is renewable annually, bears interest at prime rate (prime rate in 2003). Short-term investments, accounts receivable, inventories and all tangible and intangible assets of the company were pledged as collateral against this line of credit. As at August 31, 2004, an amount of Cdn$3,737,000 (US$2,838,000) is reserved from this line of credit for letters of guarantee and forward exchange contracts.

9 • Accounts Payable and Accrued Liabilities

As at August 31,	2004	2003
Trade	**$ 4,484**	$ 4,227
Salaries and social benefits	**3,932**	3,462
Warranty	**390**	687
Restructuring charges (notes 4 and 19)	**1,169**	2,468
Other	**1,418**	1,182
	$ 11,393	$ 12,026

Changes in the warranty provision are as follows:

As at August 31,		**2004**		2003
Balance – Beginning of year	**$**	**687**	$	849
Provision		**564**		520
Settlement		**(889)**		(749)
Foreign currency translation adjustment		**28**		67
Balance – End of year	**$**	**390**		687

10 • Long-Term Debt

As at August 31,		**2004**		2003
Loans collateralized by equipment, bearing interest at 9.6%, repayable in monthly instalments of $13,000 including principal and interest, maturing in 2008	**$**	**453**	$	563
Less: Current portion		**121**		110
	$	**332**	$	453

As at August 31, 2004, minimum principal repayments required in each of the next four years will amount to $121,000 in 2005, $135,000 in 2006, $146,000 in 2007 and $51,000 in 2008.

11 • Commitments

The company entered into operating leases for certain of its premises and equipment, which expire at various dates through May 2011. As at August 31, 2004, minimum rentals payable under these operating leases in each of the next five years will amount to $938,000 in 2005, $875,000 in 2006, $780,000 in 2007, $484,000 in 2008 and $467,000 in 2009. As at August 31, 2004, the total commitment under these operating leases amounts to $4,382,000.

For the years ended August 31, 2002, 2003 and 2004, rental expenses amounted to $1,936,000, $1,718,000 and $1,219,000, 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. Approximately 300 other issuers and their underwriters have had similar suits filed against them, all of which are included in a single coordinated proceeding in the Southern District of New York (the "IPO Litigations"). 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 two amended complaints: one containing master allegations against all of the underwriters in the IPO Litigations, and the other 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. The Court granted the company's motion to dismiss the claims against it under Section 11 of the Securities Act. The Court denied the company's motion to dismiss the claims against it under Rule 10b-5. In October 2002, the claims against its officers were dismissed without prejudice pursuant to the terms of the Reservation of Rights and Tolling Agreements entered into with the plaintiffs.

In June 2003, a committee of the company's Board of Directors conditionally approved a proposed settlement between the issuer defendants, the individual defendants, and the plaintiffs. On June 25, 2004, the Plaintiffs moved for Preliminary Approval of the settlement, and the Underwriter defendants have opposed that motion. If approved, the settlement would provide, among other things, a release of the company and of the individual defendants for the conduct alleged in the action to be wrongful in the amended complaint. The company would agree to undertake other responsibilities under the settlement, including agreeing to assign away, not assert, or release certain potential claims the company may have against its underwriters. 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 at August 31, 2004.

As at August 31, 2004, the company has outstanding letters of guarantee of Cdn$1,273,000 (US$967,000), which expire at various dates through fiscal 2008 and that were reserved from the line of credit.

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, 2001:

	Multiple voting shares		**Subordinate voting shares**		
	Number	**Amount**	**Number**	**Amount**	**Total amount**
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	-	-	-	(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
Public offering (1)	-	-	5,200,000	29,164	29,164
Exercise of stock options	-	-	111,071	254	254
Exercise of stock awards	-	-	89,504	-	-
Redemption	-	-	(5,340)	(5)	(5)
Resale	-	-	5,340	5	5
Share issue expenses	-	-	-	(137)	(137)
Balance as at August 31, 2004	37,900,000	$ 1	30,540,483	$ 521,732	$ 521,733

(1) On February 12, 2004, pursuant to a Canadian public offering, the company issued 5,200,000 subordinate voting shares for net proceeds of $29,164,000 (Cdn$38,438,400), after deduction of underwriting commission of $1,215,000 (Cdn$1,601,000). The net proceeds of this offering were invested in commercial paper that is presented in the short-term investments in the balance sheet (note 17).

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. All 707,264 shares issued under that plan, which were restricted as to sale and transferability for a period of at least five years from the date of acquisition, were released in fiscal 2004.

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 6,306,153 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. 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, 2001:

Years ended August 31,		**2004**		2003		2002
	Number	**Weighted average exercise price**	Number	Weighted average exercise price	Number	Weighted average exercise price
Outstanding – Beginning of year	**3,176,613**	**$ 15**	2,597,574	$ 22	2,414,231	$ 28
Granted	**536,500**	**4**	1,268,450	2	1,039,805	10
Exercised	**(111,071)**	**(2)**	(25,498)	(2)	-	-
Forfeited	**(667,524)**	**(15)**	(663,913)	(17)	(856,462)	(25)
Outstanding – End of year	**2,934,518**	**$ 14**	3,176,613	$ 15	2,597,574	$ 22
Exercisable – End of year	**1,331,707**	**$ 21**	1,068,595	$ 22	512,161	$ 28

The following table summarizes information about stock options as at August 31, 2004:

	Stock options outstanding			Stocks options exercisable	
Exercise price	Number	Weighted average exercise price	Weighted average remaining contractual life	Number	Weighted average exercise price
$1.58 to $2.16	653,254	$ 1.58	8.1 years	118,900	$ 1.58
$2.59 to $3.63	436,250	3.44	9.0 years	63,208	3.39
$4.65 to $5.65	223,979	4.77	9.3 years	13,240	5.65
$9.13 to $12.69	567,396	10.10	7.2 years	283,698	10.10
$19.19 to $27.80	785,608	24.05	6.2 years	651,629	24.24
$34.07 to $45.94	216,601	44.38	6.0 years	162,459	44.38
$56.74	51,430	56.74	6.0 years	38,573	56.74
	2,934,518	$ 13.89	7.5 years	1,331,707	$ 21.43

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 August 31, 2001:

Years ended August 31,	**2004**	2003	2002
Outstanding – Beginning of year	**143,096**	215,249	359,781
Granted	**-**	-	-
Exercised	**(89,504)**	(69,935)	(144,532)
Forfeited	**-**	(2,218)	-
Outstanding – End of year	**53,592**	143,096	215,249
Exercisable – End of year	**-**	-	-

As of August 31, 2004, the weighted average remaining contractual life of the outstanding restricted stock awards was four months.

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 $4.36 as at August 31, 2004, compensation cost for those stock appreciation rights was nominal as at August 31, 2004.

The following table summarizes stock appreciation rights activity since August 31, 2001:

Years ended August 31,		**2004**		2003		2002
	Number	**Weighted average exercise price**	Number	Weighted average exercise price	Number	Weighted average exercise price
Outstanding – Beginning of year	**9,000**	**$ 24**	10,000	$ 26	22,400	$ 30
Granted	**6,000**	**5**	5,000	2	1,000	12
Forfeited	**(2,000)**	**19**	(6,000)	(9)	(13,400)	(31)
Outstanding – End of year	**13,000**	**$ 16**	9,000	$ 24	10,000	$ 26
Exercisable – End of year	**4,250**	**$ 30**	3,500	$ 30	2,250	$ 27

The following table summarizes information about stock appreciation rights as at August 31, 2004:

		Stock appreciation rights outstanding	Stock appreciation rights exercisable
Exercise price	Number	Weighted average remaining contractual life	Number
$2.10	2,000	8.6 years	500
$4.65	6,000	9.6 years	-
$22.25	2,500	6.4 years	1,875
$45.94	2,500	6.0 years	1,875
	13,000	8.1 years	4,250

14 • Other Disclosures

Net research and development expenses

Net research and development expenses comprise the following:

Years ended August 31,		2004		2003		2002
Gross research and development expenses	**$**	**15,668**	$	17,133	$	17,005
Research and development tax credits and grants		**(3,278)**		(3,551)		(4,223)
Research and development tax credit write-offs (note 4)		**-**		2,297		-
	$	**12,390**	$	15,879	$	12,782

All tax credits written off can be carried forward against future years' income taxes payable over the next nine 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$456,000) towards 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$1,686,000) 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 repayment of amounts received by the company. Since the beginning of this program, the company has received the maximum amount of Cdn$2,820,000 (US$2,142,000), of which Cdn$1,370,000 (US$1,040,000) was credited to earnings; the balance of Cdn$1,450,000 (US$1,102,000) was included in deferred grants in the balance sheet.

Furthermore, 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 based on the increase of eligible production and marketing salaries incurred in the Quebec City area at a rate of 40%. Since 2000, the company has received a total of Cdn$5,679,000 (US$4,313,000) under this program, of which Cdn$4,905,000 (US$3,725,000) was credited to earnings; the balance of Cdn$774,000 (US$588,000) was included in deferred grants in the balance sheet. The deferred grants will be recognized in the statement of earnings upon the final approval of eligible salaries by the sponsor of the program.

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

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, 2002, 2003 and 2004, is net of government grants of $546,000, $518,000 and $3,000, respectively.

Selling and administrative expenses for the years ended August 31, 2002, 2003 and 2004, are net of government grants of $213,000, $286,000 and $5,000, respectively.

Research and development expenses for the years ended August 31, 2002, 2003 and 2004, are net of government grants of $333,000, $45,000 and $80,000, 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 for the years ended August 31, 2002, 2003 and 2004, amounted to Cdn$136,000 (US$86,000), Cdn$93,000 (US$63,000) and Cdn$141,000 (US$106,000), respectively.

- 401K plan
  The company maintains a 401K plan for eligible U.S. resident employees. Under this plan, the company must contribute an amount equal to 3% of an employee's current compensation. During the years ended August 31, 2002, 2003 and 2004, the company recorded contributions totaling $317,000, $253,000 and $187,000, respectively.

15 • Income Taxes

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

Years ended August 31,	2004	2003	2002
Income tax provision at combined Canadian federal and provincial statutory tax rate (32% in 2004, 34% in 2003 and 36% in 2002)	**$ (3,011)**	$ (13,563)	$ (26,563)
Increase (decrease) due to:			
Manufacturing and processing deduction	**6**	307	525
Foreign income taxed at different rates	**(767)**	(999)	(1,101)
Non-taxable income	**(128)**	(298)	(143)
Non-deductible expenses	**1,205**	1,609	334
Tax deductions	**(169)**	(80)	(518)
Reduction of Canadian federal statutory tax rate	**274**	92	168
Effect of consolidation of subsidiaries	**(1,384)**	184	1,325
Previous year tax recovery upon a tax assessment	**(1,406)**	(645)	-
Other	**440**	67	522
Change in valuation allowance	**3,954**	28,385	-
	$ (986)	$ 15,059	$ (25,451)

The income tax provision consists of the following:	2004	2003	2002
Current			
Canadian	**$ (577)**	$ 4,829	$ (10,816)
United States	**-**	(247)	(1,232)
Other	**(409)**	339	(6)
	(986)	4,921	(12,054)
Future			
Canadian	**(1,104)**	(13,553)	(4,475)
United States	**(2,448)**	(4,307)	(8,694)
Other	**(402)**	(387)	(228)
	(3,954)	(18,247)	(13,397)
Valuation allowance			
Canadian	**1,104**	20,359	-
United States	**2,448**	7,374	-
Other	**402**	652	-
	3,954	28,385	-
	$ (986)	$ 15,059	$ (25,451)

Details of the company's income taxes:	2004	2003	2002
Loss before income taxes and amortization and write-down of goodwill			
Canadian	**$ (7,740)**	$ (20,449)	$ (47,431)
United States	**(5,879)**	(13,116)	(28,228)
Other	**4,209**	(6,326)	1,874
	$ (9,410)	$ (39,891)	$ (73,785)

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

As at August 31,	2004	2003
Future income tax assets		
Long-lived assets	**$ 3,291**	$ 2,053
Provisions and accruals	**8,755**	9,786
Government grants	**188**	185
Deferred revenue	**336**	140
Share issue expenses	**657**	1,434
Research and development expenses	**5,064**	3,621
Losses carried forward	**15,110**	13,770
	33,401	30,989
Valuation allowance	**(32,613)**	(28,846)
	$ 788	$ 2,143
Future income tax liabilities		
Long-lived assets	**$ -**	$ (1,614)
Research and development tax credits	**(788)**	(497)
Provisions and accruals	**-**	(32)
	(788)	(2,143)
Future income tax assets, net	**$ -**	$ -

As at August 31, 2004, the company had available operating losses in several tax jurisdictions, against which a full valuation allowance was established. The following table summarizes the year of expiry of these operating losses by tax jurisdiction:

	Canada		United States
Year of expiry	Federal	Provincial	and Other
2005	$ 643,000	$ 955,000	$ -
2006	199,000	199,000	-
2007	1,544,000	1,609,000	207,000
2008	4,278,000	4,313,000	1,916,000
2009	5,346,000	3,256,000	575,000
2010	3,802,000	1,996,000	-
2014	182,000	-	-
2022	-	-	9,044,000
2023	-	-	11,943,000
2024	-	-	6,225,000
Indefinite	631,000	-	1,651,000
	$ 16,625,000	$ 12,328,000	$ 31,561,000

Also, as at August 31, 2004, the company had available research and development expenses in Canada amounting to $16,110,000 at the federal level and $16,600,000 at the provincial level, against which a full valuation allowance was established. These expenses can be carried forward indefinitely against future years' taxable income in their respective tax jurisdiction.

16 • 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:

Years ended August 31,	**2004**	2003	2002
Basic weighted average number of shares outstanding (000's)	**66,020**	62,852	60,666
Dilutive effect of stock options (000's)	**502**	301	31
Dilutive effect of restricted stock awards (000's)	**93**	164	269
Diluted weighted average number of shares outstanding (000's)	**66,615**	63,317	60,966
Stock options excluded from the calculation of the diluted weighted average number of shares because their exercise price was greater than the average market price of the common shares (000's)	**2,128**	2,533	2,734

The diluted loss per share for the years ended August 31, 2002, 2003 and 2004, 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.

17 • Financial Instruments

Short-term investments

Short-term investments consist of the following:

As at August 31,	**2004**	2003
Commercial paper denominated in Canadian dollars, bearing interest at annual rates of 2.00% to 2.14% in 2004 and 2.65% to 3.10% in 2003, maturing on different dates between October 2004 and January 2005 in fiscal 2004, and October 2003 and January 2004 in fiscal 2003	**$ 65,359**	$ 52,010
Mutual funds denominated in Canadian dollars	**18,610**	-
	$ 83,969	$ 52,010

Fair value

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

The fair value of short-term investments, based on market value, amounted to $52,010,000 and $83,969,000 as at August 31, 2003 and 2004, respectively.

The fair value of forward exchange contracts, based on the current trading value, amounted to Cdn$18,550,000 and Cdn$20,371,000 as at August 31, 2003 and 2004, respectively.

Credit risk
Financial instruments that potentially subject the company to credit risk consist primarily of cash, short-term investments, accounts receivable and forward exchange contracts. The company's short-term investments consist of debt instruments issued by high-credit quality corporations and trusts. 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 $568,000 and $510,000 as at August 31, 2003 and 2004, respectively.

Interest rate risk
As at August 31, 2004, 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, 2003 and 2004, 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, 2003		
September 2003 to August 2004	$ 6,470	1.5869
September 2004 to August 2005	6,680	1.5647
As at August 31, 2004		
September 2004 to August 2005	$ 7,480	1.5427
September 2005 to March 2007	8,400	1.3622

As at August 31, 2003 and 2004, these forward exchange contracts generated deferred unrealized gains of US$1,800,000 and US$1,500,000, respectively. Deferred unrealized gains were calculated using year-end exchange rates of Cdn$1.3851 = US$1.00 for fiscal 2003 and Cnd$1.3167 = US$1.00 for fiscal 2004.

18 • Segment Information

In September 2003, the company reorganized its business under two reportable segments: the Telecom Division and the Photonics and Life Sciences Division. The Telecom Division offers integrated test solutions to network service providers, system vendors and component manufacturers throughout the global telecommunications industry. The Photonics and Life Sciences Division mainly leverages developed and acquired core telecom technologies for high-tech industrial manufacturing and research markets.

EXFO's President and Chief Executive Officer ("CEO"), as the chief operating decision-maker, assesses the performance of the two segments and allocates resources to the segments. Each reportable segment is managed separately. Earnings (loss) from operations represent the primary measure used by the CEO in assessing performance of the reportable segments. The accounting policies of the reportable segments are 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.

The following tables present information by segment:

Year ended August 31, 2004	Telecom Division	Photonics and Life Sciences Division	Total
Sales	$ 58,882	$ 15,748	$ 74,630
Loss from operations	$ (5,557)	$ (5,013)	$ (10,570)
Unallocated items:			
Interest and other income			1,438
Foreign exchange loss			(278)
Loss before income taxes			(9,410)
Income taxes			(986)
Net loss for the year			$ (8,424)
Amortization of capital assets	$ 6,643	$ 3,372	$ 10,015
Stock-based compensation costs	$ 417	$ 32	$ 449
Capital expenditures	$ 607	$ 244	$ 851

Year ended August 31, 2003	Telecom Division	Photonics and Life Sciences Division	Total
Sales	$ 48,753	$ 13,177	$ 61,930

Year ended August 31, 2002	Telecom Division	Photonics and Life Sciences Division	Total
Sales	$ 54,452	$ 13,878	$ 68,330

Comparative information for the loss from operations and related information as well as capital expenditures is not provided for each reportable segment because this information is not available and is impracticable to determine.

As at August 31,	**2004**	2003
Total assets		
Telecom Division	**$ 59,463**	$ 59,466
Photonics and Life Sciences Division	**15,915**	22,032
Unallocated assets	**97,413**	64,756
	$ 172,791	$ 146,254

Unallocated assets are comprised of cash, short-term investments and income taxes and tax credits recoverable.

As at August 31, 2004, the net carrying value of goodwill that reported to the Telecom Division and the Photonics and Life Sciences Division amounted to $14,530,000 and $3,863,000, respectively.

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

Years ended August 31,	**2004**	2003	2002
United States	**$ 40,019**	$ 31,561	$ 35,129
Canada	**5,818**	4,806	3,971
Latin America	**3,547**	4,467	2,581
	49,384	40,834	41,681
Europe, Middle East and Africa	**13,706**	11,092	13,678
Asia-Pacific	**11,540**	10,004	12,971
	$ 74,630	$ 61,930	$ 68,330

Sales were allocated to geographic regions based on the country of residence of the related customers. In fiscal 2002 and 2004, one customer represented more than 10% of sales with 10.2% of sales ($6,965,000) in fiscal 2002 and 13.8% of sales ($10,325,000) in fiscal 2004. In fiscal 2003, no single customer accounted for 10% of sales or more. For fiscal 2004, the most important customer reported to the Telecom Division.

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

As at August 31,	**2004**	2003
Canada	**$ 37,948**	$ 43,402
United States	**6,934**	9,980
	$ 44,882	$ 53,382

Long-lived assets consist of property, plant and equipment, the long-lived asset held for sale, intangible assets and goodwill.

19 • Related Party Transactions

In fiscal 2003, the company acquired a building from a company owned by the President of EXFO for a cash consideration of $930,000. This transaction was measured at the fair market value since it was not conducted during 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, 2002, 2003 and 2004, the company leased facilities from a company owned by the President of EXFO. The annual rental expense amounted to $234,000, $331,000 and nil, respectively. The rental expense for fiscal 2003 included $234,000 for future payments on an exited leased facility; this expense was recorded in the restructuring and other charges in the statement of earnings for that year (notes 4 and 9). As at August 31, 2004, restructuring charges payable included $194,000 due to the company owned by the President of EXFO in connection with this exited leased facility. In September 2004, EXFO was released from its obligations under that lease, and it paid the full amount due to the related company. These rental expenses were measured at the fair market value since they were incurred during 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 (SEC), 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). Furthermore, additional significant disclosures required under U.S. GAAP and Regulation S-X of the SEC are also provided in the accompanying financial statements and notes. The following summarizes the significant quantitative differences between Canadian and U.S. GAAP, as well as other significant disclosures required under U.S. GAAP and Regulation S-X not already provided in the accompanying financial statements.

Reconciliation of net loss to conform to 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,		**2004**	2003	2002
Net loss for the year in accordance with Canadian GAAP		**$ (8,424)**	$ (54,950)	$ (308,524)
Stock-based compensation costs related to stock option plan	a)	**146**	216	49
Stock-based compensation costs related to stock purchase plan	a)	**(611)**	(61)	(661)
Stock-based compensation costs related to restricted stock award plan	a)	**(402)**	(987)	(3,038)
Unrealized gains (losses) on forward exchange contracts	b)	**(280)**	1,645	444
Future income taxes on forward exchange contracts	b)	**-**	(543)	(212)
Future income taxes on acquired in-process research and development	d)	**-**	-	(444)
Amortization of intangible assets	e)	**-**	832	239
Future income taxes on amortization of intangible assets	e)	**-**	(279)	(80)
Amortization of goodwill	d), e)	**-**	-	(9,263)
Write-down of goodwill and intangible assets	e)	**-**	6,178	(62,557)
Future income taxes on write-down of intangible assets	e)	**-**	-	1,154
Valuation allowance on future income tax assets	f)	**-**	(252)	-
Net loss for the year in accordance with U.S. GAAP		**(9,571)**	(48,201)	(382,893)
Other comprehensive loss				
Foreign currency translation adjustment		**5,969**	15,089	(521)
Unrealized gains on forward exchange contracts	b)	**689**	-	-
Comprehensive loss		**$ (2,913)**	$ (33,112)	$ (383,414)
Basic and diluted net loss per share in accordance with U.S. GAAP	h)	**$ (0.14)**	$ (0.77)	$ (6.31)

Shareholders' equity

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

Share capital

As at August 31,		**2004**	2003	2002
Share capital in accordance with Canadian GAAP		**$ 521,733**	$ 492,452	$ 489,611
Stock-based compensation costs related to stock purchase plan	a), g)			
Current year		**(47)**	(75)	(64)
Cumulative effect of prior years		**2,403**	2,478	2,542
Reclassification from other capital upon exercise of restricted stock awards				
Current year		**1,784**	1,582	3,270
Cumulative effect of prior years		**4,852**	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		**$ 596,309**	$ 565,291	$ 560,943

Deferred stock-based compensation costs

As at August 31,		**2004**	2003	2002
Deferred stock-based compensation costs in accordance with Canadian GAAP		**$ -**	$ -	$ -
Stock-based compensation costs related to stock-based compensation plans	a), g)			
Current year		**(1,463)**	-	-
Cumulative effect of prior years		**(29,576)**	(29,576)	(29,576)
Amortization				
Current year		**1,718**	1,483	4,698
Cumulative effect of prior years		**13,095**	11,612	6,914
Reduction of stock-based compensation costs				
Current year		**84**	106	403
Cumulative effect of prior years		**15,203**	15,097	14,694
Deferred stock-based compensation costs in accordance with U.S. GAAP		**$ (939)**	$ (1,278)	$ (2,867)

Other capital

As at August 31,		**2004**	2003	2002
Other capital in accordance with Canadian GAAP		**$ -**	$ -	$ -
Stock-based compensation costs related to stock-based compensation plans	a), g)			
Current year		**1,463**	-	-
Cumulative effect of prior years		**26,894**	26,894	26,894
Reduction of stock-based compensation costs				
Current year		**(439)**	(682)	(1,387)
Cumulative effect of prior years		**(16,613)**	(15,931)	(14,544)
Reclassification to share capital upon exercise of restricted stock awards				
Current year		**(1,784)**	(1,582)	(3,270)
Cumulative effect of prior years		**(4,852)**	(3,270)	-
Other capital in accordance with U.S. GAAP		**$ 4,669**	$ 5,429	$ 7,693

Deficit

As at August 31,		**2004**	2003	2002
Deficit in accordance with Canadian GAAP		**$ (380,212)**	$ (371,788)	$ (316,838)
Stock-based compensation costs	a)			
Current year		**(867)**	(832)	(3,650)
Cumulative effect of prior years		**(11,406)**	(10,574)	(6,924)
Unrealized gains (losses) on forward exchange contracts, net of income taxes	b)			
Current year		**(280)**	1,102	232
Cumulative effect of prior years		**1,451**	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)
Cumulative effect of prior years		**(1,380)**	(1,380)	(936)
Amortization of intangible assets, net of income taxes	e)			
Current year		**-**	553	159
Cumulative effect of prior years		**712**	159	-
Write-down of goodwill and intangible assets, net of income taxes	e)			
Current year		**-**	6,178	(61,403)
Cumulative effect of prior years		**(55,225)**	(61,403)	-
Valuation allowance on future income tax assets	f)			
Current year		**-**	(252)	-
Cumulative effect of prior years		**(252)**	-	-
Amortization of goodwill	d), e)			
Current year		**-**	-	(9,263)
Cumulative effect of prior years		**(17,716)**	(17,716)	(8,453)
Deficit in accordance with U.S. GAAP		**$ (464,159)**	$ (454,588)	$ (406,387)

Accumulated other comprehensive income (loss)

As at August 31,		**2004**	2003	2002
Accumulated other comprehensive income in accordance with Canadian GAAP		**$ -**	$ -	$ -
Foreign currency translation adjustment				
Current year		**5,969**	15,089	(521)
Cumulative effect of prior years		**5,219**	(9,870)	(9,349)
Unrealized gains on forward exchange contracts				
Current year	b)	**689**	-	-
Accumulated other comprehensive income (loss) in accordance with U.S. GAAP		**$ 11,877**	$ 5,219	$ (9,870)

Balance sheets

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

		As at August 31, 2004		As at August 31, 2003	
		As reported	**U.S. GAAP**	As reported	U.S. GAAP
Goodwill	d), e)				
Cost		**$ 93,967**	**$ 102,138**	$ 91,982	$ 100,512
Accumulated amortization		**(75,574)**	**(93,753)**	(74,309)	(92,610)
		$ 18,393	**$ 8,385**	$ 17,673	$ 7,902
Shareholders' equity					
Share capital	a), d), g)	**$ 521,733**	**$ 596,309**	$ 492,452	$ 565,291
Contributed surplus		**1,986**	**1,537**	1,519	1,519
Cumulative translation adjustment	c)	**13,820**	**-**	7,643	-
Deficit	a), b), c), d), e), f)	**(380,212)**	**(464,159)**	(371,788)	(454,588)
Deferred stock-based compensation costs	a), g)	**-**	**(939)**	-	(1,278)
Other capital	a)	**-**	**4,669**	-	5,429
Accumulated other comprehensive income	c)	**-**	**11,877**	-	5,219
		$ 157,327	**$ 149,294**	$ 129,826	$ 121,592

Statements of cash flows

For the years ended August 31, 2002, 2003 and 2004, there were 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 plans

Until August 31, 2003, to conform to U.S. GAAP, the company measured stock-based compensation costs using the intrinsic value method (APB 25, "Accounting for Stock Issued to Employees"). However, since September 1, 2003, and as described in item j) below, the company accounts for stock-based compensation costs for awards granted after that date, using the fair-value based method to conform to Statement of Financial Accounting Standard (SFAS) 123, "Accounting for Stock-Based Compensation". As at August 31, 2004, deferred stock-based compensation costs related to awards accounted for under SFAS 123 amounted to $939,000.

Stock purchase plan

Under APB 25, compensation costs related to the stock purchase plan were measured as the difference between the fair value of the purchased stock and the purchase price paid by plan participants. Compensation costs were 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. As at August 31, 2004, compensation costs related to this plan were fully amortized.

Stock option plan

Until August 31, 2003, and under APB 25, compensation costs related to the stock option plan were measured as the difference between the fair value of the underlying stock at the date of grant and the exercise price of the option. These compensation costs were amortized to expense over the estimated vesting period up to a maximum of four years. As at August 31, 2004, compensation costs related to stock options granted prior to September 1, 2003, and accounted for under APB 25 were fully amortized.

Restricted stock award plan

Under APB 25, compensation costs related to the restricted stock award plan were measured as the difference between the fair value of the underlying stock at the date of grant and the exercise price, which is nil. These compensation costs were amortized to expense over the estimated vesting period up to a maximum of four years, being the acquisition period. As at August 31, 2004, compensation costs related to this plan were fully amortized.

Until August 31, 2003, no compensation costs were recognized for these stock-based compensation plans under Canadian GAAP.

b) Forward exchange contracts

On September 1, 2000, the company prospectively adopted SFAS 133, "Accounting for Derivative Instruments and Hedging Activities", 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 did not qualify for hedge accounting treatment during the years ended August 31, 2002 and 2003 under U.S. GAAP; accordingly, changes in the fair value of the derivatives were charged to earnings during these years.

However, on September 1, 2003, the company implemented the documentation required by Accounting Guideline 13 of the CICA handbook, "Hedging Relationship", for the designation, documentation and assessment of the effectiveness of its forward exchange contracts, for the purposes of applying hedge accounting, as described in note 2.

With this documentation in place, the forward exchange contracts entered into by the company after September 1, 2003, qualify for hedge accounting treatment under U.S. GAAP. Consequently, under U.S. GAAP, changes in the fair value of these contracts are charged to other comprehensive loss. Upon settlement of the forward exchange contracts, changes in fair value are reclassified in the statement of earnings.

Under Canadian GAAP, foreign exchange translation gains and losses on contracts are recognized as an adjustment of the revenue when the corresponding sales are recorded, regardless of whether the contracts were entered into before or after September 1, 2003.

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 those of 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. In the purchase price allocation process, future income taxes for that asset are recognized on the acquisition date. As at August 31, 2002, 2003 and 2004, 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, “Goodwill and Other Intangible Assets”, 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 fiscal 2002 were acquired in business combinations that were 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 reflected 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 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 fiscal 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 fiscal 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 the goodwill of EXFO Burleigh and a pre-tax charge of $377,000 to write down the 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 for the year ended August 31, 2003.

Furthermore, considering differences in the carrying value of intangible assets between Canadian GAAP and U.S. GAAP due to impairment losses, adjustments to the amortization of such assets and related future income taxes were also required in fiscal 2002 and 2003.

f) Income taxes

In fiscal 2003, 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) 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.

h) 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.

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. These tax credits amounted to $1,761,000 and $2,599,000 for fiscal 2004 and 2002, respectively. In fiscal 2003, we had a net expense of $176,000 following the write-off of tax credits. This difference had no impact on the net loss and the net loss per share figures for the reporting years.

j) New accounting standard

On September 1, 2003, the company prospectively adopted SFAS 123, "Accounting for Stock-Based Compensation", under the revised transition provisions of SFAS 148, "Accounting for Stock-Based Compensation – Transition and Disclosure". Upon the adoption of SFAS 123 and SFAS 148, the company recognized stock-based compensation costs for stock options granted to employees since September 1, 2003, using the fair value-based method. The company adopted this Statement in order to conform to the newly adopted rules under Canadian GAAP, as described in note 2. As a result of the adoption of the fair value-based method, the accounting for stock-based compensation under Canadian GAAP and U.S. GAAP is the same for awards granted after September 1, 2003.

Accounting for stock-based compensation

Under U.S. GAAP, and until August 31, 2003, the company 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, 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. If the fair value-based method had been applied, the pro forma net loss per share would have been lower than the net loss per share by $0.02 in fiscal 2004 and higher by $0.01 and $0.08 in 2003 and 2002, respectively.

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,	**2004**	2003	2002
Risk-free interest rate	**2.7%**	4.8%	4.5%
Expected volatility	**100%**	80%	80%
Dividend yield	**Nil**	Nil	Nil
Expected life	**49 months**	36 months	40 months