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

The following discussion and analysis of the consolidated financial condition and results of operations of EXFO Electro-Optical Engineering Inc. for the fiscal years ended August 31, 2002, 2003 and 2004, should be read in conjunction with our consolidated financial statements and the related notes included elsewhere in this Annual Report. Our consolidated financial statements are reported in US dollars and have been prepared in accordance with generally accepted accounting principles in Canada, or Canadian GAAP. Significant differences in measurement and disclosure from generally accepted accounting principles in the United States, or U.S. GAAP, are set out in note 20 to our consolidated financial statements.

The following discussion and analysis of financial condition and results of operations is dated September 30, 2004.

Industry Overview

Following three years of reductions in capital expenditures (CAPEX) among network service providers (NSPs), some measure of stability returned to the marketplace in 2004. Telecom carriers and cable multiple-system operators (MSOs), which fall under the NSP designation, resumed investing in their networks to ultimately gain stronger access to the consumer's pocketbook with their triple-play offering of video, data and voice services. Investments in IP networking were particularly prevalent among these groups, as this will allow them to provide more cost-effective delivery of voice services (i.e., VoIP). Telecom carriers also invested in network architectures like fiber-to-the-premises (FTTP) in order to extend their available bandwidth to the home, which will enable them to offer video services as well. These investments, however, were offset by CAPEX reductions in other areas of the network to produce relatively flat spending patterns year-over-year.

This relative stability in CAPEX spending was witnessed in multiple segments of the global telecommunications supply chain. System manufacturers benefited from NSP orders for next-generation, converged IP networks and fiber deployments in access areas. Component vendors, who had been hardest hit by the downturn, began seeing incremental demand for optical components that support IP-based systems. Some test and measurement equipment vendors, whose products enable customers to reduce CAPEX and operating expenses (OPEX), attracted the attention of NSPs, system vendors and component manufacturers, especially ones offering test solutions for VoIP and/or FTTP applications.

Company Overview

EXFO is a recognized expert in the global telecommunications industry through the design and manufacture of advanced and innovative test and measurement solutions. The Telecom Division, which represents our main business activity, offers a complete range of dedicated and integrated test solutions to NSPs, system vendors and component manufacturers in approximately 70 countries. One of our strongest competitive advantages is our modular platform design, based on a PC/Windows-centric architecture to offer a series of test solutions that maximize technology reuse across multiple market segments. The Photonics and Life Sciences Division mainly leverages core telecom technologies to offer value-added solutions for life sciences applications and high-precision assembly processes, such as those required for microelectronics and optoelectronics.

EXFO was founded in Quebec City, Canada, in 1985. Our original products were focused on the needs of installers and operators of fiber-optic networks. Customers use these field-portable testing products for the installation, maintenance, monitoring and troubleshooting of optical networks. In 1996, we supplemented our product portfolio with an extensive line of high-end products that are mainly dedicated to research and development as well as manufacturing activities.

In the last three years, we have enhanced our competitive position through the acquisition of two protocol test businesses in order to extend our product offering and address our customers' requirements more completely. In November 2001, we acquired Avantas Networks Corporation (renamed EXFO Protocol Inc.), a supplier of protocol testing and optical-network-performance management equipment for NSPs. This transaction was highly strategic because it enabled us to combine optical and protocol test modules inside a single field-portable test platform to help our customers increase revenues and reduce operating costs. In October 2002, our wholly-owned subsidiary, EXFO Gnubi, purchased substantially all the assets of *gnubi communications, L.P.*, a supplier of multi-channel telecom and datacom testing solutions for the system manufacturer market. These strategic acquisitions, which were consolidated in Montreal in fiscal 2004, enabled us to double our addressable market, as we expanded from optical testing into protocol testing applications, and to offer a more complete test solution to customers.

Previously, we had completed two acquisitions to bolster growth in the optical component manufacturing market. We acquired Burleigh Instruments, Inc. (renamed EXFO Burleigh Products Group Inc.) in December 2000 for its wavelength measurement instruments and nanopositioning alignment systems. We also added EFOS Inc. (renamed EXFO Photonic Solutions Inc.) in March 2001 for its precision light-based, adhesive spot-curing technology. We have since exited the optical component manufacturing automation business.

At the beginning of fiscal 2004, we reorganized our business under two divisions: the Telecom Division and the Photonics and Life Sciences Division. Our objectives behind this new structure were to simplify our business model, adopt a market approach rather than a product approach and increase accountability throughout the organization. Our Telecom Division, which consists of the former Portable and Monitoring and telecom-related Industrial and Scientific product lines, is focused on NSPs, telecommunication system manufacturers and optical component vendors on a global basis. Our Photonics and Life Sciences Division, which includes previous non-telecom Industrial and Scientific product lines, mainly leverages developed and acquired core telecom technologies for diverse high-precision assembly and life sciences markets.

Following this reorganization, our two divisions now have respective sales, marketing, manufacturing, research and development as well as management teams and are, therefore, presented as two corresponding reportable segments in the financial statements. We have disclosed segmented information about each of these segments in our consolidated financial statements for fiscal 2004. However, we did not provide comparative information for previous periods about each reportable segment (except for sales and long-lived assets) because this information is not available and it is impracticable to determine. Please refer to note 18 to our consolidated financial statements for detailed segment information.

Until August 31, 2003, the company was organized under one reportable segment; that is, the development, manufacturing and marketing of fiber-optic test, measurement and monitoring solutions for the global telecommunications industry.

In fiscal 2004, we launched 20 new products, including several aimed at establishing leadership in the emerging FTTP market and others dedicated to expanding our life sciences product portfolio. We also strengthened our competitive position in protocol testing through the introduction of a next-generation Fibre Channel test set for security-intensive applications and, subsequent to the year-end, we released a next-generation SONET/SDH analyzer for data-centric IP networks as well as a Gigabit Ethernet test solution with VoIP test capabilities.

In February 2004, we closed a public offering of 5.2 million subordinate voting shares to a syndicate of Canadian-based underwriters for net proceeds of $29.2 million (Cdn$38.4 million). EXFO closed the fiscal year with cash and short-term investments amounting to $89.1 million.

In May 2004, we successfully renewed our collective bargaining agreement with unionized manufacturing employees in Quebec City, Canada.

In the third quarter of fiscal 2004, we performed our annual impairment test for goodwill and reviewed the carrying value of certain acquired intangible assets for impairment. Based on our impairment tests, we concluded that goodwill and these intangible assets were not impaired.

Near the end of the fiscal year, we reached the decision to consolidate operations of our Photonics and Life Sciences Division in order to improve its market focus and efficiency. Consequently, we have begun transferring operations from Victor/Fishers, NY, mostly to Toronto. To fully implement this consolidation, we expect to incur restructuring and other charges of $2.7 million, of which $1.7 million was already recorded in the fourth quarter of fiscal 2004; the remainder will be recorded in 2005. We estimate that we will derive $1.5 million in annual savings from these streamlined operations.

Finally, in August 2004, we reviewed the carrying value of one of our buildings that has been put up for sale and we concluded that the building was impaired. We recorded an impairment charge of $620,000. This building reports to the Telecom Division.

Sales

We sell our products to a diversified customer base in approximately 70 countries through our direct sales force and, indirectly, through distribution channels. As mentioned above, our customers are comprised of NSPs, manufacturers of communication systems and optical components, as well as research and development laboratories. We have a diversified customer base, both in terms of industry sector and geographical area, which provides us with reasonable protection against concentration of credit risk.

Cost of Sales

Cost of sales includes raw materials, salaries and related expenses for direct and indirect manufacturing personnel (net of government grants) as well as overhead costs. Excess, obsolete and scrapped materials are also included in cost of sales. However, cost of sales is exclusive of amortization, which is shown separately in the statement of earnings.

Operating Expenses

We classify our operating expenses into three main categories: selling and administrative expenses, research and development expenses and amortization expenses.

Selling and administrative expenses consist primarily of salaries and related expenses for personnel (net of government grants), sales commissions, travel expenses, marketing programs, professional services, information systems, human resources and other corporate expenses.

Gross research and development expenses consist primarily of salaries and related expenses for engineers and other technical personnel, material component costs as well as fees paid to third-party consultants. We are eligible to receive research and development tax credits and government grants on research and development activities carried out in Canada. All related research and development tax credits and government grants are recorded as a reduction of gross research and development expenses. Tax credit write-offs are also included in net research and development expenses.

Operating charges related to our restructuring plans have been recorded as a separate component of operating expenses. These charges consist primarily of severance expenses, costs to exit leased facilities as well as write-offs of long-lived assets.

Our Strategy

Strategic Objectives for Fiscal 2004

In our fiscal 2003 Annual Report, we had established four strategic objectives for fiscal 2004. We planned to increase sales through market-share gains; maximize profitability and growth on a long-term basis by focusing on gross margin improvements; innovate our way out of the downturn by successfully bringing to market differentiated products that allow us to seize targeted market opportunities; and maintain a sound financial position both as a strategic and defensive asset. We had also established key performance indicators as measures to assess the realization of our objectives. The following table summarizes these objectives and key performance indicators as well as the results achieved in fiscal 2004:

Strategic objectives	Key performance indicators	Actual results	Goal achieved
Increase sales through market-share gains	10% sales growth year-over-year	20.5% sales growth year-over-year	√
Maximize profitability and growth on a long-term basis	50% gross margin	53.7% gross margin	√
Innovate our way out of the downturn	45% of our sales from new products (on the market for two years or less)	31.7% of our sales from new products	x
Maintain a sound financial position	Positive cash flows from operating activities for at least one quarter	Cash flows from operating activities at $751,000 for fiscal 2004	√

Increase sales through market-share gains
We posted our second-best sales performance in history, growing sales 20.5% to $74.6 million in fiscal 2004, compared to our KPI of 10%. Considering that the marketplace remained relatively flat in 2004, this is a clear indication that we gained market share overall. For fiscal 2004, our Telecom Division and Photonics and Life Sciences Division reported sales increases of 20.8% and 19.5%, respectively.

Maximize profitability and growth on a long-term basis
We sought to maximize profitability with a focus on raising our gross margin above 50%. In fact, for fiscal 2004, we achieved a gross margin of 53.7%. We surpassed our objective mainly due to our increased sales volume and because we paid close attention to our supply chain. We focused our R&D not only on being first to market, but also on achieving the lowest possible cost of goods required to meet the highest performance criteria. In addition, we streamlined manufacturing operations into fewer sites, while continuing to deliver superior value to customers.

Innovate our way out of the downturn
Ever since we founded EXFO in 1985, innovation strategies were focused on being first to market with unique solutions that anticipate and better address customer requirements. Our market-driven approach can be demonstrated through a long history of industry firsts. This focus on delivering a unique value proposition to the marketplace is of strategic importance to improve our gross margin. As a KPI for this strategic objective, we anticipated that sales of new products (on the market two years or less) would reach 45% of global sales for fiscal 2004. However, in fiscal 2004, new products represented 31.7% of total sales mainly because key customers in our space were more conservative than expected, as they were more active planning their future strategies than deploying them.

We remain firm believers that the 20 new products and key innovations brought to market in the last 12 months are well targeted for market opportunities and that our percentage of sales from new products is going to increase in the quarters and year to come. Incidentally, for the fourth quarter of 2004, this innovation rate was at 38%.

Maintain a sound financial position
In fiscal 2004, cash flows provided by operating activities were positive at $751,000, enabling us to meet our KPI of attaining positive cash flows from operations in at least one quarter in the fiscal year. In fact, cash flows from operating activities were positive for the last three quarters of 2004. Our solid balance sheet (including cash on hand and short-term investments amounting to $89.1 million and practically no debt) is not only reassuring to customers but, more importantly, this advantage is also a strategic asset that will help ensure our long-term development and allow for possible acquisitions.

Strategic Objectives for Fiscal 2005
For fiscal 2005, we believe general market conditions will be relatively similar to 2004 as CAPEX spending is expected to remain fairly tight for wireline operators overall. However, they will spend within certain growth vectors (namely IP networking and FTTP deployments), for which we have already begun positioning ourselves.

As you might expect, our strategic directions, and therefore our KPIs, will not be radically different from those of 2004. Since we are highly focused on creating value for our shareholders, providing the highest degree of profitable growth is at the heart of our actions. We intend to maintain our long-term focus on profitable growth by increasing sales through further market-share gains; maximize profitability through proper execution and efficiency of our cost-reduction programs; and focus on innovation to positively position the organization for the long-term growth opportunities that exist in our space.

Increase sales through market-share gains
In fiscal 2005, we will focus on continued market-share gains to achieve growth, assuming the stability or slight growth of our addressable telecommunications market. We expect the CAPEX environment to be relatively stable with a few clear shifts made by carriers towards their key strategic initiatives. In fiscal 2004, our 20.5% sales growth in a stable market clearly indicated that we gained market share. For fiscal 2005, we intend once again to grow sales faster than the market by leveraging our sustained R&D investments in areas such as next-generation Internet protocol (IP) and fiber-to-the-premises (FTTP) testing, by intensifying our sales and marketing efforts, both domestic and international, as well as by strengthening and expanding our business relationships with major accounts.

Maximize profitability
Returning to profitability remains a top priority at EXFO. Our expected sales growth combined with a series of internal initiatives will bring us to profitability on a pro-forma basis in fiscal 2005. At EXFO, pro forma net earnings represent GAAP net earnings excluding stock-based compensation costs, amortization of intangible assets, restructuring charges and other unusual items. Recent consolidation efforts of our protocol activities in Montreal and our life sciences operations in Toronto are expected to bear fruit in fiscal 2005. We also applied strategies to maximize supply chain efficiency, overall execution, as well as R&D (focusing on cost of goods, rather than strictly on being first to market).

Focus on innovation
In fiscal 2005, innovation will continue to be a key driver for us. Although we fell short of this strategic objective for fiscal 2004, we remain convinced that our commitment to innovation will pay off in the long term and support our growth and profitability targets. We have maintained a significant level of R&D investment since the telecom peak in 2001 and brought 20 new products to the marketplace in fiscal 2004—several of which were released in the second half of the fiscal year and have therefore not yet reached their market potential. For fiscal 2005, we intend to invest a similar amount in R&D compared to fiscal 2004. These initiatives should enable our new products to continue gaining traction with customers and lead to further market-share gains in the coming years.

Key Performance Indicators

As measures to assess the realization of our strategic plan and its objectives, we have set out three consolidated key performance indicators for fiscal 2005. They are summarized as follows:

Strategic objectives	Key performance indicators
Increase sales through market-share gains	20% sales growth year-over-year, assuming a stable telecommunications market
Maximize profitability	Profitability on a pro-forma basis
Focus on innovation	45% of sales from new products (on the market two years or less)

Capability to Deliver Results

At EXFO, we believe that we have the capabilities to deliver expected results thanks to outstanding products, an excellent reputation in the marketplace, a sound financial position, as well as an experienced workforce and management team.

Critical Accounting Policies and Estimates

Management's discussion and analysis of financial conditions and results of operations is based on our consolidated financial statements included elsewhere in this Annual Report. As previously mentioned, they have been prepared in accordance with Canadian GAAP. The preparation of financial statements in accordance with GAAP 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. On an ongoing basis, we evaluate these estimates and assumptions, including those related to revenue recognition, allowance for doubtful accounts, allowance for excess and obsolete inventories, research and development tax credits and government grants, impairment of long-lived assets and goodwill, valuation allowance of future income tax assets, warranty obligations, restructuring charges as well as contingencies and other obligations. We base our estimates and assumptions on historical experience and on other factors that we believe to be reasonable under the circumstances, the result of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates.

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

Revenue recognition. For products in which software is incidental, we recognize 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, we use 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, we assess whether the price associated with our revenue transaction is fixed and determinable, and whether or not collection is reasonably assured. We assess whether the price is fixed and determinable based on the payment terms associated with the transaction. We assess 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 the receipt of a written customer acceptance or the 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.

Allowance for doubtful accounts. We estimate collectibility of accounts receivable on an ongoing basis by reviewing balances outstanding over a certain period of time. We determine our allowance for doubtful accounts receivable based on our historical accounts receivable collection experience and on the information that we have about the status of our accounts receivable balances. If the financial conditions of our customers deteriorate, resulting in an impairment of their ability to make required payments, additional allowance may be required, which could adversely affect our future results.

Allowance for excess and obsolete inventories. We state our inventories at the lower of cost, determined on an average cost basis and replacement cost or net realizable value, and provide reserves for excess and obsolete inventories. We determine our reserves for excess and obsolete inventories based on the quantities we have on hand versus expected needs for these inventories, so as to support future sales of our products. It is possible that additional inventory reserves may occur if future sales are less than our forecasts or if there is a significant shift in product mix compared to our forecasts, which could adversely affect our future results.

Research and development tax credits and government grants. We record research and development tax credits and government grants based on our interpretation of tax laws and grant programs, especially regarding related eligible projects and expenses, and when there is reasonable assurance that we have complied and will continue to comply with all conditions and laws. Also, our judgment and estimates are based on historical experience. It is possible, however, that the tax authorities have a different interpretation of laws and application of conditions related to the programs or that we do not comply with all conditions related to grants in the future, which could adversely affect our future results. Furthermore, a large part of our tax credits are refundable against income taxes payable, causing their ultimate realization to be dependent upon the generation of taxable income. If we obtain information that causes our forecast of future taxable income to change or if actual taxable income differs from our forecast, we may have to revise the carrying value of these tax credits, which would affect our results in the period in which the change was made. We review the recoverability of such tax credits on a quarterly basis.

Impairment of long-lived-assets and goodwill. We assess impairment of goodwill 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 a 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, is the excess of the carrying value of goodwill over its fair value.

We assess impairment of long-lived assets when events or circumstances indicate that costs may not be recoverable. Impairment exists when the carrying value of the asset is greater than the pre-tax 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. We assess fair value of intangible assets based on discounted future cash flows.

Future income taxes. We account 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. In assessing the recoverability of our future income tax assets, we consider whether it is more likely than not that some or all of the future income tax assets will not be realized. The ultimate realization of certain future income tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences will become deductible. As at August 31, 2004, we had established a full valuation allowance against our future income tax assets. The valuation allowance will be reversed once management will have concluded that realization of future income tax assets is more likely than not.

During fiscal 2004, we also adopted the following new Canadian Institute of Chartered Accountants (CICA) handbook section and guideline:

- Section 3870, “Stock-Based Compensation and Other Stock-Based Payments”
- Accounting Guideline 13, “Hedging Relationship”

On September 1, 2004, we adopted new CICA handbook sections 1100 and 1400, “Generally Accepted Accounting Principles” and “General Standards of Financial Statements Presentation”. The adoption of these new standards had no significant impact on our financial statements.

Please refer to note 2 to our consolidated financial statements included elsewhere in this Annual Report for further information about these new standards and their impact on our financial statements.

Results of Operations

The following table sets forth certain Canadian GAAP consolidated financial statements data in thousands of US dollars, except per share data, and as a percentage of sales for the years indicated:

Consolidated statements of earnings data:	**2004**	2003	2002	**2004**	2003	2002
Sales	**$ 74,630**	$ 61,930	$ 68,330	**100.0 %**	100.0 %	100.0 %
Cost of sales [1]	**34,556**	36,197	52,366	**46.3**	58.4	76.6
Gross margin	**40,074**	25,733	15,964	**53.7**	41.6	23.4
Operating expenses						
Selling and administrative	**25,890**	26,991	33,881	**34.7**	43.6	49.6
Net research and development	**12,390**	15,879	12,782	**16.6**	25.6	18.7
Amortization of property, plant and equipment [2]	**4,935**	5,210	5,096	**6.6**	8.4	7.4
Amortization of intangible assets [2]	**5,080**	5,676	12,451	**6.8**	9.2	18.3
Impairment of long-lived assets and goodwill	**620**	7,427	23,657	**0.8**	12.0	34.6
Restructuring and other charges	**1,729**	4,134	2,880	**2.3**	6.7	4.2
Total operating expenses	**50,644**	65,317	90,747	**67.8**	105.5	132.8
Loss from operations	**(10,570)**	(39,584)	(74,783)	**(14.1)**	(63.9)	(109.4)
Interest and other income	**1,438**	1,245	1,456	**1.9**	2.0	2.1
Foreign exchange loss	**(278)**	(1,552)	(458)	**(0.4)**	(2.5)	(0.7)
Loss before income taxes and amortization and write-down of goodwill	**(9,410)**	(39,891)	(73,785)	**(12.6)**	(64.4)	(108.0)
Income taxes	**(986)**	15,059	(25,451)	**(1.3)**	24.3	(37.3)
Loss before amortization and write-down of goodwill	**(8,424)**	(54,950)	(48,334)	**(11.3)**	(88.7)	(70.7)
Amortization of goodwill	**-**	-	38,021	**-**	-	55.7
Write-down of goodwill	**-**	-	222,169	**-**	-	325.1
Net loss for the year	**$ (8,424)**	$ (54,950)	$ (308,524)	**(11.3) %**	(88.7) %	(451.5) %
Basic and diluted net loss per share	**$ (0.13)**	$ (0.87)	$ (5.09)			
Segment information [3]						
Sales:						
Telecom Division	**$ 58,882**	$ 48,753	$ 54,452	**78.9 %**	78.7 %	79.7 %
Photonics and Life Sciences Division	**15,748**	13,177	13,878	**21.1 %**	21.3 %	20.3 %
	$ 74,630	$ 61,930	$ 68,330	**100.0 %**	100.0 %	100.0 %
Operating loss:						
Telecom Division	**$ (5,557)**	$ -	$ -	**(7.4) %**	- %	- %
Photonics and Life Sciences Division	**(5,013)**	-	-	**(6.7)**	-	-
	$ (10,570)	$ -	$ -	**(14.1) %**	- %	- %
Research and development data:						
Gross research and development	**$ 15,668**	$ 17,133	$ 17,005	**21.0 %**	27.7 %	24.9 %
Net research and development	**$ 12,390**	$ 15,879	$ 12,782	**16.6 %**	25.6 %	18.7 %
Other statements of earnings data (unaudited): [4]						
Pro forma net loss	**$ (1,952)**	$ (10,879)	$ (10,702)	**(2.6) %**	(17.6) %	(15.7) %
Basic and diluted pro forma net loss per share	**$ (0.03)**	$ (0.17)	$ (0.18)			
Consolidated balance sheets data:						
Total assets	**$ 172,791**	$ 146,254	$ 177,926			

(1) Including inventory write-offs of nil, $4,121 and $18,463 for the years ended August 31, 2004, 2003 and 2002, respectively, and an unusual gain of $473 for the year ended August 31, 2003. Excluding inventory write-offs and the unusual gain, gross margin would have reached 47.4% for the year ended August 31, 2003. Excluding inventory write-offs, gross margin would have reached 50.4% for the year ended August 31, 2002. This latter information is unaudited and is a non-GAAP measure. The cost of sales is exclusive of amortization, shown separately.

(2) Certain comparative figures were reclassified to conform to the current-year presentation.

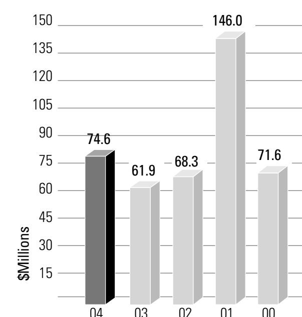
(3) Comparative information for the loss from operations is not available and is impracticable to determine.

(4) Net loss excluding stock-based compensation costs, amortization and write-down of goodwill, unusual tax recovery, future income tax assets valuation allowance and the after-tax effect of amortization of intangible assets, impairment of long-lived assets, restructuring and other charges, inventory and tax credit write-offs and unusual grants recovery. This information may not be comparable to similarly titled measures reported by other companies because it is non-GAAP information. Please refer to page 20 of this Annual Report for a detailed quantitative reconciliation.

Sales

Fiscal 2004 vs. 2003

In fiscal 2004, our global sales increased 20.5% to $74.6 million from $61.9 million in 2003, with a 79%-21% split in favor of our Telecom Division.



Telecom Division

In fiscal 2004, sales of our Telecom Division increased 20.8% to $58.9 million from $48.8 million in 2003. In 2004, despite a relatively stable carrier spending environment, compared to the previous year, we continued to gain market share, which helped us increase our sales year-over-year. We believe these market-share gains are mainly attributable to our optical field-testing products, which represent our traditional core business, since sales of our protocol-layer test solutions represented just over 10% of our Telecom sales in fiscal 2004. In addition, we benefited from a slight recovery in the telecom system and optical manufacturing markets. Finally, revenues from FTTP test solutions were higher than expected, especially with a tier-one customer, which contributed to our sales increase.

The current protocol-layer test market proves to be highly competitive as it prepares for deployment of next-generation SONET/SDH and new IP-intensive architectures. We remain confident that the solid product portfolio we are building for this crucial end-market will lead to long-term growth for EXFO.

Over the last few months, we have also been offering new and enhanced extended-warranty programs, which have significantly increased extended-warranty sales. Revenues from these sales are deferred and recognized over the warranty period, causing our deferred revenue to increase year-over-year.

Photonics and Life Sciences Division

In fiscal 2004, sales of our Photonics and Life Sciences Division increased 19.5% to $15.7 million from $13.2 million in 2003. The increase in sales is due to the greater demand for our high-tech industrial manufacturing solutions.

Overall, for the two divisions, net accepted orders increased 34.6% to $75.0 million in fiscal 2004 from $55.7 million in 2003. Our net book-to-bill ratio rose to 1.00 in fiscal 2004, from 0.90 in 2003.

For the upcoming quarters, we expect the sales split between the two divisions to remain in the same range as for fiscal 2004.

Fiscal 2003 vs. 2002

In fiscal 2003, our global sales decreased 9.4% to $61.9 million from $68.3 million in 2002, with a 79%-21% split in favor of our Telecom Division.

Telecom Division

In fiscal 2003, sales of our Telecom Division decreased 10.5% to $48.8 million from $54.5 million in 2002. Most of the decrease is attributable to the collapsed market for optical components and the resulting gray market. Also, increased pricing pressure by vendors and the continued slowdown in the global telecommunications industry affected our sales. However, despite depressed spending levels in the telecommunications industry, our sales of field-testing products increased 3%, compared to 2002, mainly because of heightened traction in the protocol-layer testing sector.

Photonics and Life Sciences Division

In fiscal 2003, sales of our Photonics and Life Sciences Division decreased 5.1% to $13.2 million from $13.9 million in 2002. The markets addressed by this division were relatively stable, thus explaining the relative stability in this division's sales year-over-year.

Geographic distribution

During fiscal 2004 and 2003, sales to the Americas, Europe-Middle East-Africa (EMEA) and Asia-Pacific (APAC) accounted for 66%, 18% and 16% of global sales, respectively. During 2002, sales to the Americas, EMEA and APAC accounted for 61%, 20% and 19% of global sales, respectively.

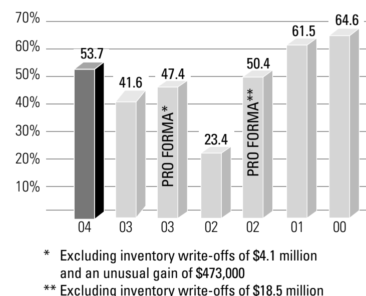
The geographic distribution of our sales remained unchanged as a percentage of sales in fiscal 2004, compared to 2003, since all geographic areas had the same growth level.

In fiscal 2003, sales to the Americas stayed relatively stable in dollars compared to 2002, while sales to the EMEA and APAC markets decreased year-over-year. The EMEA market was the most affected by the downturn in the telecommunications industry, which caused our sales to this market to decrease year-over-year. In addition, most of our sales to the APAC market are made through tenders, which may vary in number and significance from period to period. Finally, the SARS outbreak also affected our sales to this market to some extent.

Through our two divisions, we sell our products to a broad range of customers, including network service providers, optical component and system manufacturers, as well as high-tech industrial manufacturers and research and development laboratories. During fiscal 2004, we had only one customer that accounted for more than 10% of sales, representing 13.8% of sales ($10.3 million). During that same year, our top three customers accounted for 20.8% of our sales. During 2003, no customer accounted for more than 10% of our sales. In fiscal 2002, we had one customer that accounted for more than 10% of sales, with 10.2% ($7.0 million).

Gross Margin

Gross margin amounted to 53.7%, 41.6% and 23.4% of sales for fiscal 2004, 2003 and 2002, respectively.



Fiscal 2004 vs. 2003

In fiscal 2003, we recorded write-offs for excess and obsolete inventories of $4.1 million and an unusual gain of $473,000 related to a grant recovery. Excluding these special items, gross margin would have reached 47.4% of sales for that year. The increase in our gross margin in fiscal 2004, compared to 2003, can be explained by several factors. First, the rise in sales (20.5% year-over-year) undoubtedly helped increase our gross margin. Increased manufacturing activities allowed us to better absorb our fixed manufacturing costs. In addition, our cost-reduction measures, the consolidation of manufacturing sites and our enhanced efficiency further contributed to the increase in gross margin. However, a stronger Canadian dollar, compared to the US dollar year-over-year, prevented us, to some extent, from further improving our gross margin as some cost of sales elements are denominated in Canadian dollars.

Fiscal 2003 vs. 2002

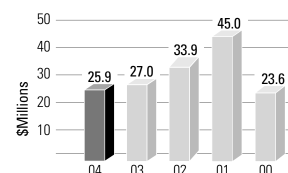
In fiscal 2002, we also recorded write-offs for excess and obsolete inventories of $18.5 million. Excluding these special charges, our gross margin would have reached 50.4% of sales. The decrease in our gross margin in fiscal 2003, compared to 2002, on an adjusted basis, is attributable to several factors. First, the market condition and competitive landscape inevitably led to increased pricing pressure. This, combined with a lower sales level in fiscal 2003, prevented a better absoption of our fixed manufacturing costs, which ultimately caused margin erosion. In addition, shift in product mix in favor of our field-testing products caused our gross margin to decrease, as these products tend to have lower margins than our modular and benchtop products. However, the decrease in our gross margin was offset in part by our increased efficiency and restructuring efforts in 2002 and 2003.

Outlook for Fiscal 2005

Considering the current state of the telecommunications industry, our recent cost-cutting measures, our tight control on operating costs as well as our expected sales growth, we believe that our gross margin will improve in fiscal 2005. However, our gross margin may fluctuate quarter-over-quarter as our sales may fluctuate. Furthermore, our gross margin can be negatively affected by increased competitive pricing pressure, increased obsolescence costs, shifts in product mix, under-absorption of fixed manufacturing costs and increases in product offerings by other suppliers in our industry. Finally, the expected increased strength of the Canadian dollar should have, to some extent, a negative impact on our gross margin in 2005.

Selling and Administrative

Selling and administrative expenses were $25.9 million, $27.0 million and $33.9 million for fiscal 2004, 2003 and 2002, respectively. As a percentage of sales, selling and administrative expenses amounted to 34.7%, 43.6% and 49.6% for fiscal 2004, 2003 and 2002, respectively.



Fiscal 2004 vs. 2003

In fiscal 2004, thanks to our restructuring actions and tight cost-control measures, we were able to reduce our selling and administrative expenses by 4% year-over-year, while our sales increased 20.5% in that same period. However, several factors prevented us from further reducing these expenses year-over-year. A higher sales volume in fiscal 2004, compared to 2003, caused our commission and marketing expenses to increase. In addition, since September 1, 2003, we account for non-cash stock-based compensation costs related to awards granted to our employees, which caused our selling and administrative expenses to increase $265,000 year-over-year. Furthermore, in fiscal 2003, we recorded an unusual gain of $239,000 related to a grant recovery. Finally, a stronger Canadian dollar, compared to the US dollar year-over-year, further increased our selling and administrative expenses, as some of these are incurred in Canadian dollars.

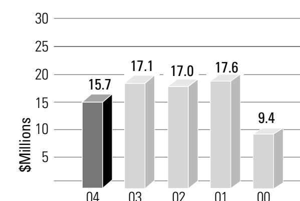
Fiscal 2003 vs. 2002

In fiscal 2003, as a result of our restructuring plans implemented in 2002 and 2003, we were able to significantly reduce our selling and administrative expenses year-over-year (20%). Also, the decrease in sales in fiscal 2003 resulted in lower commission and marketing expenses during that year. Finally, in 2003, as mentioned above, we recorded an unusual gain of $239,000 related to a grant recovery. However, this significant decrease in our selling and administrative expenses was offset in part by the impact of the acquisitions of EXFO Protocol and EXFO Gnubi in November 2001 and October 2002, respectively. Also, the increased strength of the Canadian dollar, compared to the US dollar, in fiscal 2003, prevented us from further reducing our selling and administrative expenses, as some of these are incurred in Canadian dollars.

Outlook for Fiscal 2005

For fiscal 2005, we expect our selling and administrative expenses to increase in dollars and be relatively stable as a percentage of sales. In particular, we expect our commission expenses to increase as sales volume increases. Also, considering our goal of becoming the leading player in the telecom test and measurement space, we will intensify our sales and marketing efforts, both domestic and international, which will also cause our expenses to rise. Finally, the expected increased strength of the Canadian dollar should also cause our selling and administrative expenses to increase, as some of these are incurred in Canadian dollars.

Research and Development



Gross research and development expenses totaled $15.7 million, $17.1 million, $17.0 million for fiscal 2004, 2003 and 2002, respectively. As a percentage of sales, gross research and development expenses amounted to 21.0%, 27.7% and 24.9% for fiscal 2004, 2003 and 2002, respectively.

Fiscal 2004 vs. 2003

The decrease in our gross research and development expenses in fiscal 2004, compared to 2003, both in dollars and as percentage of sales can be explained by several factors. First, our restructuring actions, the consolidation of our protocol operations in Montreal, as well as tight cost-control measures, contributed to the reduction of our gross research and development expenses year-over-year. In addition, we refocused our research and development activities in our Photonics and Life Sciences Division. Finally, mix and timing of our research and development projects, especially in our Telecom Division, caused our gross research and development expenses to decrease year-over-year. On the other hand, a stronger Canadian dollar, compared to the US dollar year-over-year, increased our gross research and development expenses, as most of these are incurred in Canadian dollars.

Although we reduced our gross research and development expenses year-over-year, we still invested significantly in R&D activities in fiscal 2004, mainly in our Telecom Division for IP-based convergence and FTTP deployments. We firmly believe that innovation and new product introductions are the key to gaining market share in the current economic environment and to ensuring the long-term growth and profitability of the company. As mentioned above, in fiscal 2004, we launched 20 new products, including several aimed at establishing leadership in the emerging FTTP market and others dedicated to expanding our life sciences product portfolio.

Fiscal 2003 vs. 2002

In fiscal 2003, our dollar-amount gross research and development expenses remained flat compared to 2002. The savings related to our restructuring actions were fully offset by the impact of the acquisitions of EXFO Protocol and EXFO Gnubi, which carried out a significant level of research and development activities, and by the strength of the Canadian dollar, compared to the US dollar, since a large portion of our R&D expenses are incurred in Canadian dollars. The percentage increase in fiscal 2003, compared to 2002, can be explained by the fact that despite challenging market conditions, we continued investing heavily in research and development, especially in the protocol-layer sector. In fact, in 2003, we launched 15 new products, most of which were telecom-related solutions.

Tax credits and grants from the Canadian federal and provincial governments for research and development activities were $3.3 million, $3.6 million and $4.2 million for fiscal 2004, 2003 and 2002, respectively. The decrease in our tax credits and government grants in fiscal 2004, compared to 2003, is mainly related to the decrease in our eligible gross research and development expenses incurred in Canada, since we were entitled to similar tax credits year-over-year. The decrease in tax credits and grants in fiscal 2003, compared to 2002, is due to several reasons. First, our government grant programs came to an end. Second, the acquisition of U.S.-based EXFO Gnubi, early in 2003, led to a larger portion of our R&D activities being conducted in the U.S., where such activities are not eligible for tax credits. Finally, we did not record Canadian federal tax credits for EXFO Protocol in the fourth quarter of 2003 because it was more likely than not that those credits would be recovered in the medium term.

Also, in fiscal 2003, we wrote off $2.3 million of Canadian federal tax credits because it was more likely than not that these credits would not be recoverable. These tax credits can be carried forward against future years' taxable income over the next nine years.

Outlook for Fiscal 2005

During fiscal 2005, we expect to continue investing significantly in research and development activities, reflecting our focus on innovation, our desire to gain market share and our goal to exceed customer needs and expectations.

Amortization of Intangible Assets

In conjunction with the business combinations we completed over the past few years, we recorded intangible assets, primarily consisting of core technology. These intangible assets resulted in amortization expenses of $5.1 million, $5.7 million and $12.5 million for fiscal 2004, 2003 and 2002, respectively. The decrease in amortization expenses in fiscal 2004, compared to 2003, is the result of the $2.9 million impairment charge recorded in the third quarter of fiscal 2003. The decrease in amortization expenses in fiscal 2003, compared to 2002, is the result of the impairment charge recorded in 2003, as discussed above, and the significant impairment charge of $23.7 million recorded in 2002. Also, acquired in-process R&D was fully amortized at the end of 2002, which reduced amortization expenses in 2003.

Outlook for Fiscal 2005

For fiscal 2005, we expect the amortization of intangible assets to approximate $1.1 million per quarter, assuming no acquisitions are made during that time.

Impairment of Long-Lived Assets and Goodwill

Fiscal 2002

In May 2002, as part of our review of financial results, we 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 our subsidiaries' industries and the decline in technology valuations. The growth prospects for our subsidiaries were significantly lower than previously expected and less than those of historical periods. In addition, the decline in market conditions affecting the subsidiaries was significant and other than temporary. As a result, we concluded that the carrying value of goodwill and certain acquired intangible assets was impaired and we recorded a charge of $222.2 million to write down a significant portion of goodwill and a pre-tax charge of $23.7 million to write down a significant portion of acquired core technology. Of the total impairment charge of $245.8 million, $125.0 million was related to EXFO Burleigh for goodwill and acquired core technology, $71.5 million was related to EXFO Photonic Solutions for goodwill and acquired core technology and $49.3 million was related to EXFO Protocol for goodwill.

The impairment charge 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 we had distinct cash flows for each of them and because they were not fully integrated into our activities. The cash flow periods used ranged from three to five years and the annual growth rates ranged between 15% and 30%.

Fiscal 2003

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

As a result of this assessment, we 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 were impaired and we recorded an impairment charge of $4.5 million to write down goodwill and a pre-tax impairment charge of $2.9 million to write down acquired core technology. Of the total impairment charge of $7.4 million, $6.9 million was related to EXFO Burleigh for goodwill and acquired core technology and $555,000 was related to EXFO Photonic Solutions for acquired core technology.

The write-down of goodwill and acquired core technology of EXFO Burleigh was required, considering that we exited the optical component manufacturing automation business, whose revenue potential represented a long-term prospect. The write-down of acquired core technology from EXFO Photonic Solutions was required because revenue potential related to this long-lived asset was less than expected in the short and medium term due to the state of the market at the time.

However, no impairment of goodwill and intangible assets was required for EXFO Protocol since we believed that revenue potential from the protocol-layer testing market would remain strong in the short and medium term.

For the purposes of estimating fair values, we 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 an annual growth rate ranging between nil and 35%. The sales multiples used in the market approach ranged between 0.7 and 2.3. The assumptions used reflected our best estimates.

Fiscal 2004

In May 2004, we performed our annual impairment test and concluded that goodwill was not impaired. Goodwill will be reviewed for impairment in May 2005, or prior to that date if events or circumstances occur that more likely than not reduce the fair value of a reporting unit below its carrying value.

Also, at the end of fiscal 2004, we reviewed the carrying value of one of our buildings that was put up for sale and we concluded that the building was impaired. We recorded an impairment charge of $620,000, representing the excess of the 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 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. The decision to sell this building was made in order to consolidate our Quebec City manufacturing operations in a single location, which will allow us to increase efficiency and reduce costs. This building reports to our Telecom Division.

After the end of fiscal 2004, we received a formal offer to buy this building; the offer is conditional upon the usual building inspections. The sale price proposed in the offer represents the fair value used by management to determine the decrease in the value of the building as at August 31, 2004.

Restructuring and Other Charges

Fiscal 2002

In fiscal 2002, we implemented restructuring plans to reduce our costs. Under these plans, we recorded charges of $2.9 million, including $2.0 million in severance expenses for the 350 employees who were terminated throughout the company and $868,000 for impaired long-lived assets.

Fiscal 2003

In fiscal 2003, we implemented an additional restructuring plan to realign our cost structure to market conditions. Under that plan, we recorded additional charges of $4.1 million, including $2.8 million 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 located around the world. Our estimation of the fair value of such future payments took into account the estimated sublease rentals over the remaining terms of the exited leases.

Fiscal 2004

In fiscal 2004, the Board of Directors 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 through the first two quarters of fiscal 2005. We estimate that the overall costs to be incurred under this plan should amount to $2.7 million during the implementation period. From this amount, $772,000, representing severance expenses, was recorded in fiscal 2004 for the layoff of all employees of EXFO Burleigh. In addition, we recorded an impairment charge of $1.3 million, mainly for the building. We expect to incur most of 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 we expect to sell the property within the next twelve months. Consequently, as per CICA handbook section 3475, "Disposal of Long-Lived Assets and Discontinued Operations", the building 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 our best estimate of its selling price based upon the municipal valuation. Since September 1, 2004, this building is no longer amortized.

Expenses incurred in relation with our restructuring plans have been recorded in the restructuring and other charges in the statements of earnings of the reporting years.

Our cost-reduction measures represented our best efforts to respond to the difficult market conditions of the past years and we expect that they will lead us to profitability on a pro-forma basis in fiscal 2005. However, these efforts may be inappropriate or insufficient. Our actions in this regard may not be successful in achieving the cost reductions or other benefits expected, may be insufficient to align our cost structure to market conditions, or may be more costly or extensive than anticipated.

Interest and Other Income

Our interest income mainly resulted from our short-term investments, less interests and bank charges. Interest and other income amounted to $1.4 million, $1.2 million and $1.5 million for fiscal 2004, 2003 and 2002, respectively. In fiscal 2004, we recorded a one-time revenue of $265,000 for the sale of non-core technologies. Without this one-time revenue, interest and other income would have been relatively flat year-over-year.

We expect our interest income to slightly increase in fiscal 2005 as our cash position increased during 2004 following our public offering in February 2004.

Foreign Exchange Loss

Foreign exchange loss amounted to $278,000, $1.6 million and $458,000 for fiscal 2004, 2003 and 2002, respectively.

Foreign exchange gains and losses are the result of the translation of operating activities denominated in currencies other than the Canadian dollar. In fiscal 2004, the Canadian dollar fluctuated less than in the previous year, resulting in a smaller foreign exchange loss during that year, compared to 2003. In fiscal 2003, the Canadian dollar value increased significantly through the year, compared to the US dollar, resulting in a significant exchange loss during that year.

We manage our exposure to currency risk with forward exchange contracts. In addition, some of our Canadian entities' operating activities are denominated in currencies other than the Canadian dollar, which further hedges this risk.

Income Taxes

Our income tax recovery was $986,000 for fiscal 2004, compared to an income tax expense of $15.1 million in 2003 and an income tax recovery of $25.5 million in 2002.

The income tax recovery recorded in fiscal 2004 is mainly due to the $1.4 million unusual income tax recovery recorded during that year, offset in part by income taxes payable in some specific tax jurisdictions. The unusual tax recovery was due to the receipt, during that period, of income taxes paid in previous periods following the reception of a tax assessment.

Since the third quarter of fiscal 2003, we have been recording a full valuation allowance against our future income tax assets. In fiscal 2003, considering market conditions as well as the fact that we recorded losses for fiscal 2002 and 2003, we concluded that it was more likely than not that these assets would not be recovered and that a full valuation allowance was required. Even though the carrying periods of our future income tax assets were very long or indefinite, we recorded a full valuation allowance against our future income tax assets, mainly related to the parent company, EXFO Protocol and EXFO Burleigh. Future income tax assets written off consisted mainly in deferred tax losses, research and development expenses, share issue expenses as well as non-deductible provisions and accruals. In fiscal 2004, we also recorded a full valuation allowance on new future income tax assets created during the year. Please refer to note 15 to our consolidated financial statements included elsewhere in this Annual Report for details about our future income tax assets and valuation allowance.

The valuation allowance will be reversed once management will have concluded that realization of future income tax assets is more likely than not. Consequently, our future periods' income tax rates will be distorted compared to statutory rates.

Amortization of Goodwill

In conjunction with the business combinations completed over the past few years, we have recorded goodwill. The goodwill related to the acquisitions of EXFO Burleigh and EXFO Photonic Solutions was amortized over five years until August 31, 2002. This resulted in amortization expenses of $38.0 million in fiscal 2002. The acquisitions of EXFO Protocol and EXFO Gnubi have been accounted for using new accounting standards contained in CICA handbook sections 1581, "Business Combinations" and 3062, "Goodwill and Other Intangible Assets" and, consequently, goodwill resulting from these acquisitions was not amortized.

Since September 1, 2002, goodwill related to the acquisitions of EXFO Burleigh and EXFO Photonic Solutions is no longer amortized under new accounting standards. Consequently, we no longer have amortization expenses for goodwill.

Net Loss and Pro Forma Net Loss

Net loss amounted to $8.4 million, $55.0 million and $308.5 million in fiscal 2004, 2003 and 2002, respectively. In terms of per share amounts, we recorded a net loss of $0.13, $0.87 and $5.09 in fiscal 2004, 2003 and 2002, respectively.

Also, as a measure to assess financial performance, we use pro forma net loss and pro forma net loss per share. Pro forma net loss represents net loss excluding stock-based compensation costs, amortization and write-down of goodwill, unusual tax recovery, future income tax assets valuation allowance and the after-tax effect of amortization of intangible assets, impairment of long-lived assets, restructuring and other charges, inventory and tax credits write-offs and unusual grants recovery.

Pro forma net loss amounted to $2.0 million, $10.9 million and $10.7 million in fiscal 2004, 2003 and 2002, respectively. In terms of pro forma per share amounts, we recorded a net loss of $0.03, $0.17 and $0.18 in fiscal 2004, 2003 and 2002, respectively.

Pro forma net loss is reconciled as follows:

Years ended August 31,	**2004** **(unaudited)**	2003 (unaudited)	2002 (unaudited)
Net loss according to GAAP	**$ (8,424)**	$ (54,950)	$ (308,524)
Pro forma adjustments:			
Stock-based compensation costs	**449**	-	-
Amortization and write-down of goodwill	**-**	4,505	260,190
Amortization of intangible assets	**5,080**	5,676	12,451
Tax effect on amortization of intangible assets	**-**	(2,031)	(4,296)
Impairment of long-lived assets	**620**	2,922	23,657
Tax effect on impairment of long-lived assets	**-**	(1,046)	(8,161)
Restructuring and other charges and inventory and tax credit write-offs	**1,729**	10,549	21,343
Tax effect on restructuring and other charges and inventory and tax credit write-offs	**-**	(3,777)	(7,362)
Unusual tax and grants recovery	**(1,406)**	(1,357)	-
Tax effect on unusual grants recovery	**-**	245	-
Future income tax assets valuation allowance	**-**	28,385	-
Pro forma net loss	**$ (1,952)**	$ (10,879)	$ (10,702)
Basic and diluted net loss per share	**$ (0.13)**	$ (0.87)	$ (5.09)
Basic and diluted pro forma net loss per share	**$ (0.03)**	$ (0.17)	$ (0.18)

We disclose pro forma financial data in order to provide supplemental information regarding our results of operations and to enhance our investors' overall understanding of our core financial performance and our prospects for the future. We believe that our investors benefit from seeing our results through the eyes of management in addition to seeing the GAAP information. This non-GAAP information facilitates management's comparison of current results with the company's historical results of operations and with those of our peers. This information is not in accordance with, or an alternative to, GAAP and may not be comparable to similarly titled measures reported by other companies.

Liquidity and Capital Resources

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

In fiscal 2004, pursuant to a public offering in Canada, we issued 5.2 million subordinate voting shares for net proceeds of $29.2 million (Cdn$38.4 million) after deducting underwriting commissions of $1.2 million (Cdn$1.6 million). These net proceeds will be used for working capital and other general corporate purposes, including potential acquisitions, although we currently have no commitments or agreements regarding any acquisitions. Cash flows provided by financing activities in fiscal 2004 are attributable to the net proceeds of this offering.

One of the four main objectives of our strategic plan for fiscal 2004 was to maintain a sound financial position. We believe that such an objective is in line with a strong cash position and working capital. As at August 31, 2004, cash and short-term investments consisted of $89.1 million, while our working capital was at $115.1 million. Our cash and short-term investments increased $31.8 million in fiscal 2004, compared to 2003, mainly due to the net proceeds of the public offering of $29.2 million, the cash flows from operating activities of $751,000 as well as an unrealized foreign exchange gain of $2.9 million on cash and short-term investments. However, this increase was partially offset by the cash payment of $1.1 million for the purchase of property, plant and equipment as well as intangible assets. The unrealized foreign exchange gain resulted from the translation, in US dollars, of our Canadian-dollar-denominated cash and short-term investments and was recorded in the cumulative translation adjustment in the balance sheet.

We believe that our cash balances and short-term investments, combined with an available line of credit of $4.8 million, will be sufficient to meet our liquidity and capital requirements for the foreseeable future. However, possible additional operating losses and/or possible investment in or acquisition of complementary businesses, products or technologies may require additional financing. There can be no assurance that additional debt or equity financing will be available when required or, if available, that it can be secured on satisfactory terms. Our line of credit bears interest at prime rate.

The following table summarizes our commitments as at August 31, 2004:

Years ending August 31,	2005	2006	2007	2008	2009 and later	Total
Long-term debt	$ 121,000	$ 135,000	$ 146,000	$ 51,000	$ -	$ 453,000
Operating leases	938,000	875,000	780,000	484,000	1,305,000	4,382,000
Total commitments	$ 1,059,000	$ 1,010,000	$ 926,000	$ 535,000	$ 1,305,000	$ 4,835,000

Operating Activities

Cash flows provided by operating activities amounted to $751,000 in fiscal 2004, compared to $5.6 million in 2003 and cash flows used of $8.7 million in 2002.

Cash flows provided by operating activities in fiscal 2004 were mainly attributable to the net earnings after items not affecting cash of $5.7 million, offset in part by the net increase of our operating items of $4.9 million; that is, our accounts receivable increased by $2.7 million, our income taxes and tax credits recoverable increased by $2.5 million and our inventories decreased by $1.0 million. The increase in our accounts receivable is directly related to the significant sales growth in fiscal 2004 (20.5%). The increase in our income taxes and tax credits recoverable is mainly due to the payment during the year of income taxes and to the recognition, during the year, of R&D tax credits not yet recovered. On the other hand, our increased sales level combined with tight inventory management enabled us to reduced our inventories overall.

Cash flows provided by operating activities in fiscal 2003 were mainly the result of a decrease in some of our operating items; that is, our accounts receivable decreased by $4.0 million, our income taxes and tax credits recoverable decreased by $13.5 million and our inventories decreased by $7.9 million (excluding write-offs). These positive effects on cash were offset in part by the net loss after items not affecting cash of $18.9 million. The decrease in our accounts receivable is directly related to the reduction in our sales during that year. The decrease in our income taxes and tax credits recoverable is related to the recovery, during the year, of income taxes and research and development tax credits recoverable from previous periods. Finally, the decrease in our inventories is due to our efforts to maintain them at the lowest acceptable level considering the decrease in sales.

With positive cash flows from operating activities for three quarters in a row and for fiscal 2004, we met one of our four annual strategic objectives, which consisted in maintaining a sound financial position.

Investing Activities

Cash flows used by investing activities totaled $29.7 million in fiscal 2004, compared to $9.9 million in 2003 and cash flows provided of $10.5 million in 2002.

In fiscal 2004, we acquired $28.6 million worth of short-term investments with the net proceeds of the public offering. In addition, we paid $1.1 million for the purchase of property, plant and equipment and intangible assets.

In fiscal 2003, we acquired $5.4 million worth of short-term investments with the proceeds from the recovery of income taxes and tax credits. We also made cash payments of $1.9 million and $2.6 million for the acquisition of EXFO Gnubi and the purchases of property, plant and equipment, respectively.

Forward Exchange Contracts

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

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

As at August 31, 2004, we held contracts to sell US dollars at various forward rates, which are summarized as follows:

Expiry dates:	Contractual amounts	Weighted average contractual forward rates
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$1.8 million and US$1.5 million, respectively. Deferred unrealized gains were calculated using year-end exchange rates of Cdn$1.3851 = US$1.00 for fiscal 2003 and Cdn$1.3167 = US$1.00 for fiscal 2004.

Related-Party Transactions

In fiscal 2003, we 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 independent appraisal.

In addition, for the years ended August 31, 2002, 2003 and 2004, we 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. 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.

Contingency

As discussed in note 12 to our consolidated financial statements, in November 2001, the company was named as a defendant in a U.S. securities class action related to its initial public offering (IPO) in June 2000. The complaints allege that the prospectus and the registration statement for the IPO failed to disclose that the underwriters allegedly received excessive commissions and that the underwriters and some investors collaborated in order to inflate the price of EXFO's stock in the aftermarket.

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.

Share Capital and Stock-Based Compensation Plans

Share capital

As at November 3, 2004, EXFO had 37,900,000 multiple voting shares outstanding, entitling to ten votes each, and 30,581,696 subordinate voting shares outstanding. The multiple voting shares and the subordinate voting shares are unlimited as to number and without par value.

Stock option plan

The aggregate number of subordinate voting shares covered by options granted under the stock option plan was 2,934,518 as at August 31, 2004. The weighted average exercise price of those stock options was $13.89 compared to the market price of $4.36 per share as at August 31, 2004. The maximum number of subordinate voting shares issuable under the plan cannot exceed 6,306,153 shares. The following table summarizes information about stock options granted to the members of the Board of Directors and to Management and Corporate Officers of the company and its subsidiaries as at August 31, 2004:

	Number	% of issued and outstanding	Weighted average exercise price
Chairman of the Board, President and CEO (one individual)	150,482	5.1 %	$ 9.91
Board of Directors (five individuals)	194,375	6.6	6.23
Management and Corporate Officers (seven individuals)	315,300	10.7	15.03
	660,157	22.5 %	$ 11.27

Restricted stock award plan

In addition to the stock option plan, we maintain a restricted stock award plan for some U.S.-based employees. The aggregate number of subordinate voting shares covered by restricted stock awards was 53,592 as at August 31, 2004. Each restricted stock award entitles employees to receive one subordinate voting share at a purchase price of nil.

Risks and Uncertainties

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

Firstly, we are exposed to currency risks due to the export of our Canadian-manufactured products, the large majority of which are denominated in US dollars for sale. These risks are partially hedged by operating expenses denominated in US dollars, the purchase of raw materials in US dollars and forward exchange contracts. The increased strength of the Canadian dollar, compared to the US dollar, over the last two years caused our operating expenses, as well as our foreign exchange loss, to increase. Any further increase in the value of the Canadian dollar in the coming months will negatively affect our results of operations.

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

In addition, given our strategic goals for growth and competitive positioning in our industry, we are continuously expanding into international markets. This exposes us to certain risks and uncertainties related to changes in local laws and regulations, multiple technological standards, protective legislation and pricing pressure.

Furthermore, while strategic acquisitions, like those we have made in the past and possibly others in the future, are essential to our long-term growth, they also expose us to certain risks and uncertainties related to the rapid and effective integration of these businesses as well as their products, technologies and personnel.

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

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

Quarterly Summary Financial Information (unaudited)

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

	1st quarter	2nd quarter	3rd quarter	4th quarter	Years ended August 31,
2004					
Sales	$ 15,962	$ 16,880	$ 20,456	$ 21,332	$ 74,630
Cost of sales	$ 7,815	$ 7,528	$ 9,637	$ 9,576	$ 34,556
Gross margin	$ 8,147	$ 9,352	$ 10,819	$ 11,756	$ 40,074
Loss from operations	$ (3,145)	$ (3,485)	$ (1,888)	$ (2,052)	$ (10,570)
Net loss	$ (2,008)	$ (2,885)	$ (1,188)	$ (2,343)	$ (8,424)
Pro forma net earnings (loss) (1)	$ (2,124)	$ (1,510)	$ 273	$ 1,409	$ (1,952)
Basic and diluted net loss per share (1)	$ (0.03)	$ (0.04)	$ (0.02)	$ (0.03)	$ (0.13)
Basic and diluted pro forma net earnings (loss) per share (1)	$ (0.03)	$ (0.02)	$ 0.00	$ 0.02	$ (0.03)
2003					
Sales	$ 17,748	$ 14,753	$ 15,103	$ 14,326	$ 61,930
Cost of sales	$ 8,031	$ 7,939	$ 10,460	$ 9,767	$ 36,197
Gross margin	$ 9,717	$ 6,814	$ 4,643	$ 4,559	$ 25,733
Loss from operations	$ (3,562)	$ (6,085)	$ (18,924)	$ (11,013)	$ (39,584)
Net loss	$ (2,158)	$ (4,246)	$ (38,427)	$ (10,119)	$ (54,950)
Pro forma net loss (1)	$ (1,217)	$ (3,289)	$ (3,922)	$ (2,485)	$ (10,879)
Basic and diluted net loss per share (1)	$ (0.03)	$ (0.07)	$ (0.61)	$ (0.16)	$ (0.87)
Basic and diluted pro forma net loss per share (1)	$ (0.02)	$ (0.05)	$ (0.06)	$ (0.04)	$ (0.17)
2002					
Sales	$ 20,138	$ 14,601	$ 16,348	$ 17,243	$ 68,330
Cost of sales	$ 13,008	$ 13,172	$ 17,429	$ 8,757	$ 52,366
Gross margin (loss)	$ 7,130	$ 1,429	$ (1,081)	$ 8,486	$ 15,964
Loss from operations	$ (10,893)	$ (16,612)	$ (43,396)	$ (3,882)	$ (74,783)
Net loss	$ (19,055)	$ (22,675)	$ (263,826)	$ (2,968)	$ (308,524)
Pro forma net loss (1)	$ (1,830)	$ (3,948)	$ (3,786)	$ (1,038)	$ (10,702)
Basic and diluted net loss per share (1)	$ (0.33)	$ (0.37)	$ (4.29)	$ (0.05)	$ (5.09)
Basic and diluted pro forma net loss per share(1)	$ (0.03)	$ (0.06)	$ (0.06)	$ (0.02)	$ (0.18)

(1) Pro forma net earnings (loss) and per share data are calculated independently for each of the quarters presented. Therefore, the sum of this quarterly information may not equal the corresponding annual information. Pro forma net (earnings) loss represents net loss excluding stock-based compensation costs, amortization and write-down of goodwill, unusual tax recovery, future income tax assets valuation allowance and the after-tax effect of amortization of intangible assets, restructuring and other charges, inventory and tax credit write-offs, unusual grants recovery and impairment of long-lived assets. This information may not be comparable to similarly titled measures reported by other companies because it is non-GAAP information.