

## Consolidated Balance Sheets

(in thousands of US dollars)

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

As at August 31,	2005	2004
<b>Assets</b>		
<b>Current assets</b>		
Cash	\$ 7,119	\$ 5,159
Short-term investments (notes 8 and 18)	104,883	83,969
Accounts receivable (notes 8 and 18)		
Trade	13,945	12,080
Other	2,007	1,532
Income taxes and tax credits recoverable (notes 4 and 8)	2,392	7,836
Inventories (notes 4, 5 and 8)	17,749	15,371
Prepaid expenses	1,112	1,513
	<b>149,207</b>	<b>127,460</b>
<b>Income taxes and tax credits recoverable</b> (notes 4 and 8)	<b>459</b>	<b>449</b>
<b>Property, plant and equipment</b> (notes 4, 6 and 8)	<b>13,719</b>	<b>15,442</b>
<b>Long-lived asset held for sale</b> (note 4)	<b>1,600</b>	<b>1,600</b>
<b>Intangible assets</b> (notes 4, 7 and 8)	<b>5,602</b>	<b>9,447</b>
<b>Goodwill</b> (notes 4 and 7)	<b>20,370</b>	<b>18,393</b>
	<b>\$ 190,957</b>	<b>\$ 172,791</b>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities (note 9)	\$ 12,201	\$ 11,393
Deferred revenue	1,584	805
Current portion of long-term debt	134	121
	<b>13,919</b>	<b>12,319</b>
<b>Deferred revenue</b>	<b>1,568</b>	<b>1,123</b>
<b>Government grants</b> (note 15)	<b>1,872</b>	<b>1,690</b>
<b>Long-term debt</b> (note 10)	<b>198</b>	<b>332</b>
	<b>17,557</b>	<b>15,464</b>
<b>Commitments</b> (note 11)		
<b>Contingencies</b> (note 12)		
<b>Shareholders' Equity</b>		
Share capital (note 13)	521,875	521,733
Contributed surplus	2,949	1,986
Deficit	(381,846)	(380,212)
Cumulative translation adjustment	30,422	13,820
	<b>173,400</b>	<b>157,327</b>
	<b>\$ 190,957</b>	<b>\$ 172,791</b>



**Germain Lamonde** |  
Chairman, President and CEO



**André Tremblay** |  
Chairman, Audit Committee

On behalf of the Board

## 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,	2005	2004	2003
<b>Sales</b> (note 19)	\$ <b>97,216</b>	\$ 74,630	\$ 61,930
<b>Cost of sales</b> <sup>(1,2)</sup>	<b>44,059</b>	34,556	36,197
<b>Gross margin</b>	<b>53,157</b>	40,074	25,733
<b>Operating expenses</b>			
Selling and administrative <sup>(1)</sup>	<b>31,782</b>	25,890	26,991
Net research and development <sup>(1)</sup> (notes 4 and 15)	<b>12,190</b>	12,390	15,879
Amortization of property, plant and equipment	<b>4,256</b>	4,935	5,210
Amortization of intangible assets	<b>4,836</b>	5,080	5,676
Impairment of long-lived assets and goodwill (note 4)	<b>–</b>	620	7,427
Restructuring and other charges (note 4)	<b>292</b>	1,729	4,134
<b>Total operating expenses</b>	<b>53,356</b>	50,644	65,317
<b>Loss from operations</b>	<b>(199)</b>	(10,570)	(39,584)
Interest and other income	<b>2,524</b>	1,438	1,245
Foreign exchange loss	<b>(1,336)</b>	(278)	(1,552)
<b>Earnings (loss) before income taxes</b> (note 16)	<b>989</b>	(9,410)	(39,891)
<b>Income taxes</b> (notes 4 and 16)	<b>2,623</b>	(986)	15,059
<b>Net loss for the year</b>	\$ <b>(1,634)</b>	\$ (8,424)	\$ (54,950)
<b>Basic and diluted net loss per share</b>	\$ <b>(0.02)</b>	\$ (0.13)	\$ (0.87)
<b>Basic weighted average number of shares outstanding (000's)</b>	<b>68,526</b>	66,020	62,852
<b>Diluted weighted average number of shares outstanding (000's)</b> (note 17)	<b>68,981</b>	66,615	63,317
<b>(1) Stock-based compensation costs included in:</b> (note 14)			
Cost of sales	\$ <b>143</b>	\$ 62	\$ –
Selling and administrative	<b>626</b>	265	–
Net research and development	<b>194</b>	122	–
	\$ <b>963</b>	\$ 449	\$ –

(2) The cost of sales is exclusive of amortization, shown separately. The cost of sales for the year ended August 31, 2003, includes inventory write-offs of \$4,121 (note 4).

## Consolidated Statements of Deficit and Contributed Surplus

(in thousands of US dollars)

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

<b>Deficit</b>			
Years ended August 31,	2005	2004	2003
<b>Balance – Beginning of year</b>	\$ (380,212)	\$ (371,788)	\$ (316,838)
<b>Add</b>			
Net loss for the year	(1,634)	(8,424)	(54,950)
<b>Balance – End of year</b>	\$ (381,846)	\$ (380,212)	\$ (371,788)
<b>Contributed surplus</b>			
Years ended August 31,	2005	2004	2003
<b>Balance – Beginning of year</b>	\$ 1,986	\$ 1,519	\$ 1,487
<b>Add</b>			
Premium on resale of share capital	–	18	32
Stock-based compensation costs	963	449	–
<b>Balance – End of year</b>	\$ 2,949	\$ 1,986	\$ 1,519

## 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,	2005	2004	2003
<b>Cash flows from operating activities</b>			
Net loss for the year	\$ (1,634)	\$ (8,424)	\$ (54,950)
Add (deduct) items not affecting cash			
Discount on short-term investments	(302)	197	(96)
Stock-based compensation costs	963	449	–
Inventory and tax credit write-offs	–	–	6,418
Amortization	9,092	10,015	10,886
Impairment of long-lived assets and goodwill	–	620	7,427
Restructuring and other charges	–	1,261	512
Future income taxes	–	–	10,138
Deferred revenue	977	1,404	(24)
Government grants	–	154	817
	<b>9,096</b>	<b>5,676</b>	<b>(18,872)</b>
Change in non-cash operating items			
Accounts receivable	(838)	(2,677)	3,957
Income taxes and tax credits	6,096	(2,464)	13,489
Inventories	(699)	1,016	7,925
Prepaid expenses	544	(449)	(569)
Accounts payable and accrued liabilities	(164)	(351)	(349)
	<b>14,035</b>	<b>751</b>	<b>5,581</b>
<b>Cash flows from investing activities</b>			
Additions to short-term investments	(585,665)	(653,348)	(401,105)
Proceeds from disposal and maturity of short-term investments	574,207	624,722	395,699
Additions to property, plant and equipment and intangible assets	(1,501)	(851)	(2,652)
Business combination	–	(241)	(1,867)
	<b>(12,959)</b>	<b>(29,718)</b>	<b>(9,925)</b>
<b>Cash flows from financing activities</b>			
Repayment of long-term debt	(121)	(109)	(133)
Net proceeds of offering (note 13)	–	29,164	–
Share issue expenses	(6)	(137)	–
Exercise of stock options	148	254	45
Redemption of share capital	–	(5)	(16)
Resale of share capital	–	23	48
	<b>21</b>	<b>29,190</b>	<b>(56)</b>
<b>Effect of foreign exchange rate changes on cash</b>	<b>863</b>	<b>(430)</b>	<b>638</b>
<b>Change in cash</b>	<b>1,960</b>	<b>(207)</b>	<b>(3,762)</b>
<b>Cash – Beginning of year</b>	<b>5,159</b>	<b>5,366</b>	<b>9,128</b>
<b>Cash – End of year</b>	<b>\$ 7,119</b>	<b>\$ 5,159</b>	<b>\$ 5,366</b>
<b>Supplementary information</b>			
Interest paid	\$ 30	\$ 408	\$ 417
Income taxes paid (recovered)	\$ (669)	\$ 120	\$ (10,351)

## 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 line 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, cable operators, system vendors and optical component manufacturers. The Life Sciences and Industrial Division mainly leverages core telecom technologies to offer value-added solutions life sciences applications and high-precision assembly processes, such as those required for microelectronics, optoelectronics and medical devices. EXFO's products are sold 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 21. 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. Significant estimates include the allowance for doubtful accounts receivable, tax credits recoverable, provision for excess and obsolete inventories, useful lives of capital assets, valuation of intangible assets and goodwill, future income taxes valuation allowance, certain accrued liabilities and stock-based compensation costs. Actual results could differ from those estimates.

#### **Reporting currency**

The functional currency of the company is the Canadian dollar. 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 from the functional currency to 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, and 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, unless such assets and liabilities are carried at market, in which case, they are translated at the exchange rate in effect on the date of the balance sheet. 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 to manage 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 hedged 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 and that are not required for the purposes of meeting short-term cash requirements 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.

**Property, plant and equipment and amortization**

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

	<b>Term</b>
Land improvements	5 years
Buildings	25 years
Equipment	2 to 10 years
Leasehold improvements	The lesser of useful life and 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. Amortization is provided on a straight-line basis over the 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 is not amortized but must be tested for impairment on an annual basis or more frequently if events or circumstances indicate that it might be impaired. Recoverability of goodwill is determined at the reporting unit level using a two-step approach. First, the carrying value of a reporting unit is compared to its fair value, which is determined based on a combination of discounted future cash flows and a market approach. If the carrying value of a reporting unit exceeds its fair value, the second step is performed. In this step, the amount of impairment loss, if any, represents the excess of the carrying value of goodwill over its fair value and the loss is charged to earnings in the period in which it is incurred. For the purposes of this impairment test, the fair value of goodwill is estimated in the same way as goodwill is determined in business combinations; that is, the excess of the fair value of a reporting unit over the estimated fair value of its net identifiable assets.

The company elected to perform its annual impairment test in May of each fiscal year for all its existing reporting units and it recorded an impairment charge for goodwill in fiscal 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 an asset or group of assets is greater than the undiscounted future cash flows expected to be provided by the asset or group of assets. The amount of impairment loss, if any, is the excess of the carrying value over the fair value.

The company assesses fair value of long-lived assets based on discounted future cash flows. The company recorded impairment charges for long-lived assets in fiscal 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 separately priced 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, when a sales arrangement does include 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**

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 during which the created job must be maintained or training provided. Grants are included in earnings or deducted from the related assets, provided there is reasonable assurance that the company has complied and will comply with all the conditions related to the grant.

**Research and development expenses**

All expenses related to research, as well as development activities that do not meet generally accepted criteria for deferral are expensed as incurred, net of related tax credits and government grants. Development expenses that meet generally accepted criteria for deferral, in accordance with the Canadian Institute of Chartered Accountants (CICA) handbook Section 3450, "Research and Development", are capitalized, net of related tax credits and government grants, and are 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, 2005, 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 records a full valuation allowance against future income tax assets (notes 4 and 16).

**Earnings per share**

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

Diluted earnings per share are determined using the weighted average number of common shares outstanding during the year, plus the effect of dilutive potential common shares outstanding during the year. This method requires that diluted earnings per share be calculated (using the treasury stock method) as if all dilutive potential common shares had been exercised at the latest at the beginning of the year or on the date of issuance, as the case may be, and that the funds obtained thereby (plus an amount equivalent to the unamortized portion of related stock-based compensation costs) be used to

purchase common shares of the company at the average market price of the common shares during the year.

**Stock-based compensation costs**

Since September 1, 2003, the company accounts for all forms of employee stock-based compensation using the fair value-based method. Stock-based compensation costs are amortized to expense over the vesting periods.

Prior to fiscal 2004, no stock-based compensation costs were recognized for employee stock-based compensation. However, 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 outstanding stock options granted prior to September 1, 2003 (note 14).

**New accounting standards and pronouncements***Adopted in fiscal 2005*

On September 1, 2004, the company prospectively adopted the CICA handbook Sections 1100 and 1400, "Generally Accepted Accounting Principles" and "General Standards of Financial Statement Presentation". 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 adoption of these new standards had no impact on the financial statements of the company.

*To be adopted after fiscal 2005*

In January 2005, the CICA issued four new accounting standards in relation to financial instruments: Section 3855, "Financial Instruments – Recognition and measurement"; Section 3865, "Hedges"; Section 1530, "Comprehensive Income"; and Section 3251, "Equity".

Section 3855 expands on Section 3860, "Financial Instruments – Disclosure and Presentation", by prescribing when a financial instrument is to be recognized on the balance sheet and at what amount. It also specifies how financial instrument gains and losses are to be presented in the financial statements.

Section 3865 provides an alternative to Section 3855 for entities that choose to designate qualifying transactions as hedges for accounting purposes. It replaces and expands on Accounting Guideline 13, "Hedging Relationships", and on the hedging guidance in Section 1650, "Foreign Currency Translation", by specifying how hedge accounting is applied and what disclosures it requires.

Section 1530, "Comprehensive Income", introduces a new requirement to temporarily present certain gains and losses outside net income.

Consequently, Section 3250, "Surplus", has been revised as Section 3251, "Equity".

Sections 1530, 3251, 3855 and 3865 apply to fiscal years beginning on or after October 1, 2006. The company will adopt these new standards on September 1, 2007. While the company is currently assessing the effects of these new standards, impacts consistent with the adjustments described under note 21 item b) of these consolidated financial statements are expected.

### 3 | Business Combination

*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 of \$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 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 allocated to 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	750
Current liabilities assumed	(134)
Net identifiable assets acquired	1,705
Goodwill	2,958
Purchase price	4,663
Less: Subordinate voting shares issued	2,796
Cash paid on the date of acquisition	\$ 1,867

Acquired goodwill is deductible for income tax purposes.

### 4 | Special Charges

#### **Impairment of long-lived assets and goodwill**

##### *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 at the time, 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 estimates of the fair values and the undiscounted future cash flows, including industry conditions, reflected management's best estimations.

##### *2004*

In fiscal 2004, the company put one of its buildings (located in Quebec City) up for sale and received, at the beginning of fiscal 2005, a formal purchase offer for this building. Based on that offer, the company concluded that the building was impaired and it recorded an impairment loss of \$620,000 in fiscal 2004, representing the excess of the carrying value of the building over its expected selling price. However, during the first quarter of fiscal 2005, some conditions of the formal offer were not met and the offer was declined. During fiscal 2005, the company withdrew the building from the market. As at August 31, 2004, the building was not shown as a long-lived asset held for sale in the balance sheet because it was still used by the company and, consequently, it was not available for immediate sale. This building reports to the Telecom Division.

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

#### *2003*

During fiscal 2003, the company implemented a restructuring plan to align its cost structure to market conditions. Under that plan, the company recorded 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 were 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 were included in the cost of sales in the statement of earnings for that same year.

#### *2004 and 2005*

During fiscal 2004, the company approved a restructuring plan to consolidate the operations of its Life Sciences and Industrial Division, transferring EXFO Burleigh's operations mainly to EXFO Photonic Solutions facilities in Toronto. This consolidation process, which started in August 2004, was completed during fiscal 2005.

Overall, for that process, the company incurred \$2,515,000 in restructuring and other charges from which \$2,033,000 were recorded in fiscal 2004 and the remaining of \$482,000 were recorded in fiscal 2005. The overall costs, which were recorded in the restructuring and other charges in the statements of earnings of the corresponding years, are detailed as follows: \$855,000 for severance expenses for the layoff of all employees of EXFO Burleigh, \$1,261,000 mainly for the impairment of the EXFO Burleigh building and the remaining \$399,000 for other expenses such as training and recruiting expenses and transfer of assets.

The EXFO Burleigh building was put up for sale in fiscal 2004, but it is not yet sold because of the difficult real estate market in Rochester, NY. The building is available for sale in its present condition and management expects to sell the property within the next twelve months. Consequently, in accordance with CICA handbook, section 3475, "Disposal of Long-Lived Assets and Discontinued Operations", it was shown in the balance sheet as a long-lived asset held for sale. The fair value used to determine the impairment loss of the building represents the company's best estimate of its selling price based upon the municipal valuation. Since September 1, 2004, the building is no longer amortized.

Finally, in fiscal 2005, the company recorded adjustments of \$190,000 to the fiscal 2003 plan because actual charges, mainly for leased equipment, were lower than expected.

The following table summarizes changes in restructuring charges payable since August 31, 2002:

<b>Year ended August 31, 2005</b>						
	Balance as at August 31, 2004	Additions	Payments	Adjustments	Balance as at August 31, 2005	
<i>Fiscal 2004 plan</i>						
Severance expenses	\$ 467	\$ 83	\$ (550)	\$ —	\$ —	
Other	—	399	(399)	—	—	
	467	482	(949)	—	—	
<i>Fiscal 2003 plan</i>						
Severance expenses	109	—	(77)	(32)	—	
Exited leased facilities	386	—	(229)	(7)	150	
Other	197	—	(46)	(151)	—	
	692	—	(352)	(190)	150	
<i>Fiscal 2001 plan</i>						
Exited leased facilities	10	—	(10)	—	—	
	10	—	(10)	—	—	
Total for all plans (note 9)	\$ 1,169	\$ 482	\$ (1,311)	\$ (190)	\$ 150	
<b>Year ended August 31, 2004</b>						
	Balance as at August 31, 2003	Additions	Payments	Adjustments	Balance as at August 31, 2004	
<i>Fiscal 2004 plan</i>						
Severance expenses	\$ —	\$ 772	\$ (305)	\$ —	\$ 467	
	—	772	(305)	—	467	
<i>Fiscal 2003 plan</i>						
Severance expenses	1,233	—	(870)	(254)	109	
Exited leased facilities	748	—	(362)	—	386	
Other	295	—	(90)	(8)	197	
	2,276	—	(1,322)	(262)	692	
<i>Fiscal 2002 plans</i>						
Other	68	—	(68)	—	—	
	68	—	(68)	—	—	
<i>Fiscal 2001 plan</i>						
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	
<b>Year ended August 31, 2003</b>						
	Balance as at August 31, 2002	Additions	Payments	Adjustments	Balance as at August 31, 2003	
<i>Fiscal 2003 plan</i>						
Severance expenses	\$ —	\$ 2,767	\$ (1,534)	\$ —	\$ 1,233	
Exited leased facilities	—	855	(107)	—	748	
Other	—	512	(217)	—	295	
	—	4,134	(1,858)	—	2,276	
<i>Fiscal 2002 plans</i>						
Severance expenses	231	—	(231)	—	—	
Other	68	—	—	—	68	
	299	—	(231)	—	68	
<i>Fiscal 2001 plan</i>						
Exited leased facilities	483	—	(359)	—	124	
	483	—	(359)	—	124	
Total for all plans	\$ 782	\$ 4,134	\$ (2,448)	\$ —	\$ 2,468	

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

During fiscal 2003, the company reviewed the carrying value of its future income tax assets and its research and development tax credits recoverable. 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 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 16). 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 15).

## 5 | Inventories

As at August 31,	2005		2004	
Raw materials	\$	9,373	\$	7,244
Work in progress		934		1,370
Finished goods		7,442		6,757
	\$	17,749	\$	15,371

## 6 | Property, Plant and Equipment

As at August 31,	2005		2004	
	Cost	Accumulated amortization	Cost	Accumulated amortization
Land and land improvements	\$ 3,179	\$ 815	\$ 2,868	\$ 558
Buildings	9,206	2,250	8,311	1,699
Equipment	33,216	29,553	29,110	23,422
Leasehold improvements	2,395	1,659	2,110	1,278
	47,996	\$ 34,277	42,399	\$ 26,957
Less: Accumulated amortization	34,277		26,957	
	\$ 13,719		\$ 15,442	

As at August 31, 2004 and 2005, unpaid purchases of property, plant and equipment amounted to \$358,000 and \$111,000, respectively.

## 7 | Intangible Assets and Goodwill

As at August 31,	2005		2004	
	Cost	Accumulated amortization	Cost	Accumulated amortization
Core technology	\$ 35,554	\$ 32,214	\$ 32,815	\$ 25,733
Software	6,607	4,345	5,847	3,482
	42,161	\$ 36,559	38,662	\$ 29,215
Less: Accumulated amortization	36,559		29,215	
	\$ 5,602		\$ 9,447	

Amortization expenses for intangible assets in each of the next five fiscal years will amount to \$3,190,000 in 2006, \$893,000 in 2007, \$429,000 in 2008, \$352,000 in 2009 and \$325,000 in 2010.

Changes in the carrying value of goodwill are as follows:

As at August 31,	2005	2004
Balance – Beginning of year	\$ 18,393	\$ 17,673
Foreign currency translation adjustment	1,977	720
Balance – End of year (note 19)	\$ 20,370	\$ 18,393

## 8 | Credit Facilities

The company has a line of credit which provides for advances of up to Cdn\$10,000,000 (US\$8,411,000). This line of credit, which is renewable annually, bears interest at prime rate (prime rate in 2004). 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, 2005, an amount of Cdn\$3,163,000 (US\$2,661,000) was reserved from this line of credit for letters of guarantee and forward exchange contracts.

## 9 | Accounts Payable and Accrued Liabilities

As at August 31,	2005	2004
Trade	\$ 5,781	\$ 4,484
Salaries and social benefits	4,526	3,932
Warranty	725	390
Tax on capital	538	526
Restructuring charges (notes 4 and 20)	150	1,169
Other	481	892
	\$ 12,201	\$ 11,393

Changes in the warranty provision are as follows:

As at August 31,	2005	2004
Balance - Beginning of year	\$ 390	\$ 687
Provision	869	564
Settlements	(583)	(889)
Foreign currency translation adjustment	49	28
Balance - End of year	\$ 725	\$ 390

## 10 | Long-Term Debt

As at August 31,	2005	2004
Loans collateralized by equipment, bearing interest at 9.6%, repayable in monthly instalments of \$13,000 including principal and interest, maturing in 2008	\$ 332	\$ 453
Less: Current portion	134	121
	\$ 198	\$ 332

As at August 31, 2005, minimum principal repayments required in each of the next three years will amount to \$134,000 in 2006, \$147,000 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, 2005, minimum rentals payable under these operating leases in each of the next five years will amount to \$1,050,000 in 2006, \$952,000 in 2007, \$632,000 in 2008, \$584,000 in 2009 and \$594,000 in 2010. As at August 31, 2005, the total commitment under these operating leases amounts to \$4,247,000.

For the years ended August 31, 2003, 2004 and 2005, rental expenses amounted to \$1,718,000, \$1,219,000 and \$1,370,000, respectively (note 20).

## 12 | Contingencies

### ***Class action***

On November 27, 2001, a class action suit was filed in the United States District Court for the Southern District of New York against the company, four of the underwriters of its Initial Public Offering and some of its executive officers pursuant to the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder and Sections 11, 12 and 16 of the Securities Act of 1933. This class action alleges that the company's registration statement and prospectus filed with the Securities and Exchange Commission on June 29, 2000, contained material misrepresentations and/or omissions resulting from (i) the underwriters allegedly soliciting and receiving additional, excessive and undisclosed commissions from certain investors in exchange for which they allocated material portions of the shares issued in connection with the company's Initial Public Offering; and (ii) the underwriters allegedly entering into agreements with customers whereby shares issued in connection with the company's Initial Public Offering would be allocated to those customers in exchange for which customers agreed to purchase additional amounts of shares in the after-market at pre-determined prices.

On April 19, 2002, the plaintiffs filed an amended complaint containing master allegations against all of the underwriters in all of the 310 cases included in this class action and also filed an amended complaint containing allegations specific to four of the company's underwriters, the company and two of its executive officers. In addition to the allegations mentioned above, the amended complaint alleges that the underwriters (i) used their analysts to manipulate the stock market; and (ii) implemented schemes that allowed issuer insiders to sell their shares rapidly after an initial public offering and benefit from high market prices. As concerns the company and its two executive officers in particular, the amended complaint alleges that (i) the company's registration statement was materially false and misleading because it failed to disclose the additional commissions and compensation to be received by underwriters; (ii) the two named executive officers learned of or recklessly disregarded the alleged misconduct of the underwriters;

(iii) the two named executive officers had motive and opportunity to engage in alleged wrongful conduct due to personal holdings of the company's stock and the fact that an alleged artificially inflated stock price could be used as currency for acquisitions; and (iv) the two named executive officers, by virtue of their positions with the company, controlled the company and the contents of the registration statement and had the ability to prevent its issuance or cause it to be corrected. The plaintiffs in this suit seek an unspecified amount for damages suffered.

In July 2002, the issuers filed a motion to dismiss the plaintiffs' amended complaint and judgment was rendered on February 19, 2003. Only one of the claims against the company was dismissed. On October 8, 2002, the claims against its officers were dismissed pursuant to the terms of Reservation of Rights and Tolling Agreements entered into with the plaintiffs.

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. 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.

On June 25, 2004, the Plaintiffs moved for Preliminary Approval of the settlement. The court granted the preliminary approval motion on February 15, 2005, subject to certain modifications. On August 31, 2005, the court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. The court also appointed the Notice Administrator for the settlement and ordered that notice of the settlement be distributed to all settlement class members beginning on November 15, 2005, and completed by January 15, 2006. The settlement fairness hearing has been set for April 26, 2006. Following the hearing, if the court determines that the settlement is fair to the class members, the settlement will be approved. There can be no assurance that this proposed settlement would be approved and implemented in its current form, or at all. 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, 2005.

### ***Letters of guarantee***

As at August 31, 2005, in the normal course of its operations, the company had outstanding letters of guarantee of Cdn\$1,418,000 (US\$1,193,000), 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, 2002:

	Multiple voting shares		Subordinate voting shares		Total amount
	Number	Amount	Number	Amount	
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 (note 14)	–	–	25,498	45	45
Exercise of stock awards (note 14)	–	–	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 <sup>(1)</sup>	–	–	5,200,000	29,164	29,164
Exercise of stock options (note 14)	–	–	111,071	254	254
Exercise of stock awards (note 14)	–	–	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
Exercise of stock options (note 14)	–	–	71,699	148	148
Exercise of stock awards (note 14)	–	–	53,592	–	–
Share issue expenses	–	–	–	(6)	(6)
Balance as at August 31, 2005	37,900,000	\$ 1	30,665,774	\$ 521,874	\$ 521,875

(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 18).

## 14 | Stock-Based Compensation Plans

The maximum number of subordinate voting shares issuable under the Long-Term Incentive Plan and the Deferred Share Unit Plan cannot exceed 6,306,153 shares. The maximum number of subordinate voting shares that may be granted to any individual on an annual basis cannot exceed 5% of the number of outstanding subordinate voting shares.

### Long-Term Incentive 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. In January 2005, the company made certain amendments to the existing Stock Option Plan, including the renaming of the plan to Long-Term Incentive Plan, which includes stock options and restricted share units.

#### Stock Options

The exercise price of stock options granted under the Long-Term Incentive Plan is the market price of the common shares on the date of grant. Stock options granted under the plan generally expire ten years from the date of grant. Stock 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 stock options upon the occurrence of a change of control.

The following table summarizes stock option activity since August 31, 2002:

Years ended August 31,	2005		2004		2003	
	Number	Weighted average exercise price (Cdn\$)	Number	Weighted average exercise price (Cdn\$)	Number	Weighted average exercise price (Cdn\$)
Outstanding – Beginning of year	2,934,518	\$ 21	3,176,613	\$ 23	2,597,574	\$ 34
Granted	246,233	6	536,500	5	1,268,450	3
Exercised	(71,699)	(3)	(111,071)	(3)	(25,498)	(3)
Forfeited	(345,293)	(27)	(667,524)	(23)	(663,913)	(25)
Outstanding – End of year	2,763,759	\$ 19	2,934,518	\$ 21	3,176,613	\$ 23
Exercisable – End of year	1,650,404	\$ 28	1,331,707	\$ 32	1,068,595	\$ 33

The weighted average grant-date fair value of stock options granted during fiscal 2004 and 2005 amounted to \$2.73 and \$3.51, respectively.

The fair value of stock options granted in fiscal 2003 (for pro forma only), 2004 and 2005 was estimated using the Black-Scholes options valuation model with the following weighted average assumptions:

Years ended August 31,	2005	2004	2003
Risk-free interest rate	3.6%	2.7%	4.8%
Expected volatility	95%	100%	80%
Dividend yield	Nil	Nil	Nil
Expected life	66 months	49 months	36 months

If the fair value-based method had been applied to stock options granted prior to September 1, 2003 and outstanding as at August 31, 2003, 2004 and 2005, the net loss and the net loss per share would have been as follows on a pro forma basis:

Years ended August 31,	2005	2004	2003
Net loss for the year	\$ (1,634)	\$ (8,424)	\$ (54,950)
Pro forma adjustment for stock-based compensation costs	131	(174)	(683)
Pro forma net loss for the year	\$ (1,503)	\$ (8,598)	\$ (55,633)
Basic and diluted net loss per share	\$ (0.02)	\$ (0.13)	\$ (0.87)
Basic and diluted pro forma net loss per share	\$ (0.02)	\$ (0.13)	\$ (0.88)

The following table summarizes information about stock options as at August 31, 2005:

Exercise price (Cdn\$)	Number	Stock options outstanding		Stocks options exercisable	
		Weighted average exercise price (Cdn\$)	Weighted average remaining contractual life	Number	Weighted average exercise price (Cdn\$)
\$2.50 to \$3.36	542,054	\$ 2.50	7.1 years	226,993	\$ 2.50
\$3.96 to \$5.60	620,342	5.04	5.2 years	122,275	4.78
\$6.22 to \$9.02	243,770	6.53	8.4 years	70,397	7.01
\$14.27 to \$20.00	507,446	15.87	6.2 years	380,592	15.87
\$29.70 to \$43.00	600,846	36.29	5.2 years	600,846	36.29
\$51.25 to \$68.17	205,771	65.83	5.0 years	205,771	65.83
\$83.66	43,530	83.66	5.0 years	43,530	83.66
	2,763,759	\$ 19.22	6.0 years	1,650,404	\$ 28.28

#### *Restricted Share Units (RSUs)*

RSUs are "phantom" shares that rise and fall in value based on the value of the company's subordinate voting shares and are redeemable for actual subordinate voting shares or cash at the discretion of the Board of Directors on the vesting dates established by the Board of Directors at the time of grant. The vesting dates are subject to a minimum term of three years and a maximum term of ten years from the award date. RSUs granted under the plan expire at the latest ten years from the date of grant.

During fiscal 2005, the company granted 176,185 RSUs that were outstanding as at August 31, 2005. However, none of them were exercisable at that date. As at August 31, 2005, the weighted average remaining contractual life of the outstanding RSUs was 9.4 years. The weighted average grant-date fair value of these RSUs was \$4.68.

#### *Deferred Share Unit Plan*

In January 2005, the company established a Deferred Share Unit (DSU) Plan for the members of the Board of Directors as part of their annual retainer fees. Each DSU entitles the Board members to receive one subordinate voting share. DSUs are acquired on the date of grant and will be redeemed in subordinate voting shares when the Board member will cease to be Director of the company.

During fiscal 2005, the company granted 23,734 DSUs that were outstanding as at August 31, 2005 to the members of the Board of Directors.

The weighted average grant-date fair value of these DSUs was \$4.47.

#### *Stock Appreciation Rights Plan*

In August 2001, the company established the 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 \$4.67 as at August 31, 2005, compensation cost for those stock appreciation rights was nominal as at August 31, 2005.

The following table summarizes stock appreciation rights activity since August 31, 2002:

Years ended August 31,	2005		2004		2003	
	Number	Weighted average exercise price	Number	Weighted average exercise price	Number	Weighted average exercise price
Outstanding – Beginning of year	13,000	\$ 16	9,000	\$ 24	10,000	\$ 26
Granted	6,000	4	6,000	5	5,000	2
Forfeited	–	–	(2,000)	(19)	(6,000)	(9)
Outstanding – End of year	19,000	\$ 12	13,000	\$ 16	9,000	\$ 24
Exercisable – End of year	7,500	\$ 24	4,250	\$ 30	3,500	\$ 30

The following table summarizes information about stock appreciation rights as at August 31, 2005:

Exercise price	Stock appreciation rights outstanding		Stock appreciation rights exercisable
	Number	Weighted average remaining contractual life	Number
\$2.10	2,000	7.6 years	1,000
\$4.51 to \$4.65	12,000	9.0 years	1,500
\$22.25	2,500	5.4 years	2,500
\$45.94	2,500	5.0 years	2,500
	19,000	7.9 years	7,500

### **Restricted Stock Award Plan**

In December 2000, the company established a Restricted Stock Award Plan for employees of EXFO Burleigh. This plan expired in December 2004. Each stock award entitled employees to receive one subordinate voting share at a purchase price of nil. Stock awards granted under the plan vested 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 vested.

The following table summarizes restricted stock awards activity since August 31, 2002:

Years ended August 31,	2005	2004	2003
Outstanding – Beginning of year	53,592	143,096	215,249
Exercised	(53,592)	(89,504)	(69,935)
Forfeited	-	-	(2,218)
Outstanding – End of year	-	53,592	143,096

## **15 | Other Disclosures**

### **Net research and development expenses**

Net research and development expenses comprise the following:

Years ended August 31,	2005	2004	2003
Gross research and development expenses	\$ 15,878	\$ 15,668	\$ 17,133
Research and development tax credits and grants	(3,688)	(3,278)	(3,551)
Research and development tax credit write-offs (note 4)	-	-	2,297
	\$ 12,190	\$ 12,390	\$ 15,879

Tax credits written off in fiscal 2003 can be carried forward against future years' income taxes payable over the next eight years.

### **Government grants**

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\$2,220,000 (US\$1,867,000) 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 claimed the maximum amount of Cdn\$2,220,000 (US\$1,867,000), of which Cdn\$770,000 (US\$647,000) was credited to earnings. The balance of Cdn\$1,450,000 (US\$1,220,000) was included in government grants in the balance sheet. This latter amount will be recognized upon the final approval by the sponsor of the program.

Furthermore, since 2000, companies operating in the Quebec City area are eligible for a refundable 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 claimed a total of Cdn\$5,815,000 (US\$4,891,000) under this program, of which Cdn\$5,041,000 (US\$4,239,000) was credited to earnings, the balance of Cdn\$774,000 (US\$652,000) was included in government grants in the balance sheet. This latter amount 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, 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 credits (government grants) in the statements of earnings of the reporting years.

Cost of sales for the years ended August 31, 2003, 2004 and 2005, is net of government grants of \$518,000, \$3,000 and \$89,000, respectively.

Selling and administrative expenses for the years ended August 31, 2003, 2004 and 2005, are net of government grants of \$286,000, \$5,000 and \$32,000, respectively.

Research and development expenses for the years ended August 31, 2003, 2004 and 2005, are net of government grants of \$45,000, \$80,000 and \$22,000, 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% (until May 2005 and 2% thereafter) 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. Cash contributions to this plan and expenses for the years ended August 31, 2003, 2004 and 2005, amounted to Cdn\$93,000 (US\$63,000), Cdn\$141,000 (US\$106,000) and Cdn\$221,000 (US\$179,000), 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, 2003, 2004 and 2005, the company recorded cash contributions and expenses totaling \$253,000, \$187,000 and \$134,000, respectively.

## 16 | 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 in the financial statements is as follows:

Years ended August 31,	2005	2004	2003
Income tax provision at combined Canadian federal and provincial statutory tax rate (31% in 2005, 32% in 2004 and 34% in 2003)	\$ 307	\$ (3,011)	\$ (13,563)
Increase (decrease) due to:			
Foreign income taxed at different rates	(580)	(767)	(999)
Non-taxable income	(827)	(128)	(298)
Non-deductible expenses	784	1,205	1609
Tax deductions	(81)	(169)	(80)
Reduction of Canadian federal statutory tax rate	-	274	92
Effect of consolidation of subsidiaries	(209)	(1,384)	184
Previous year tax recovery upon a tax assessment	-	(1,406)	(645)
Other	(146)	446	374
Change in valuation allowance	3,375	3,954	28,385
	\$ 2,623	\$ (986)	\$ 15,059
The income tax provision consists of the following:			
Current			
Canadian	\$ 2,513	\$ (577)	\$ 4,829
United States	6	-	(247)
Other	104	(409)	339
	2,623	(986)	4,921
Future			
Canadian	(569)	(1,104)	(13,553)
United States	(1,988)	(2,448)	(4,307)
Other	(206)	(402)	(387)
	(2,763)	(3,954)	(18,247)
Valuation allowance			
Canadian	569	1,104	20,359
United States	1,988	2,448	7,374
Other	206	402	652
	2,763	3,954	28,385
	\$ 2,623	\$ (986)	\$ 15,059
Details of the company's income taxes:			
Earnings (loss) before income taxes			
Canadian	\$ 3,092	\$ (7,740)	\$ (20,449)
United States	(953)	(5,879)	(13,116)
Other	(1,150)	4,209	(6,326)
	\$ 989	\$ (9,410)	\$ (39,891)

Most of the company's income tax provision for fiscal 2005 represents income taxes payable at the Canadian federal level, which are reduced by research and development tax credits that are recorded against gross research and development expenses.

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

As at August 31,	2005	2004
Future income tax assets		
Long-lived assets	\$ 4,902	\$ 3,291
Provisions and accruals	7,406	8,755
Government grants	209	188
Deferred revenue	318	336
Share issue expenses	590	657
Research and development expenses	7,292	5,064
Losses carried forward	18,424	15,110
	<b>39,141</b>	33,401
Valuation allowance	<b>(38,406)</b>	(32,613)
	<b>735</b>	788
Future income tax liabilities		
Research and development tax credits	<b>(735)</b>	(788)
Future income tax assets, net	\$ -	\$ -

As at August 31, 2005, the company had available operating losses in several tax jurisdictions, against which a full valuation allowance of \$18,424,000 was established. The following table summarizes the year of expiry of these operating losses by tax jurisdiction:

Year of expiry	Canada		United States and Other
	Federal	Provincial	
2006	\$ 63,000	\$ -	\$ -
2007	1,710,000	73,000	206,000
2008	5,614,000	61,000	1,916,000
2009	5,921,000	3,563,000	571,000
2010	4,211,000	2,211,000	257,000
2014	81,000	-	-
2015	1,775,000	1,778,000	-
2022	-	-	9,025,000
2023	-	-	10,517,000
2024	-	-	6,818,000
2025	-	-	8,207,000
Indefinite	2,041,000	2,349,000	1,750,000
	\$ 21,416,000	\$ 10,035,000	\$ 39,267,000

In addition to operating losses, as at August 31, 2005, the company had available research and development expenses in Canada amounting to \$24,420,000 at the federal level and \$20,668,000 at the provincial level, against which a full valuation allowance of \$7,292,000 was established. These expenses can be carried forward indefinitely against future years' taxable income in their respective tax jurisdiction.

## 17 | Loss per Share

The following table summarizes the reconciliation of the basic weighted average number of shares outstanding and the diluted weighted average number of shares outstanding:

Years ended August 31,	2005	2004	2003
Basic weighted average number of shares outstanding (000's)	68,526	66,020	62,852
Dilutive effect of stock options (000's)	422	502	301
Dilutive effect of restricted stock awards (000's)	17	93	164
Dilutive effect of deferred share units (000's)	8	—	—
Dilutive effect of restricted share units (000's)	8	—	—
Diluted weighted average number of shares outstanding (000's)	68,981	66,615	63,317
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)	1,962	2,128	2,533

The diluted net loss per share for the years ended August 31, 2003, 2004 and 2005, was the same as the basic net loss per share since the dilutive effect of stock options, restricted stock awards, deferred share units and restricted share units should not be included in the calculation; otherwise, the effect would be anti-dilutive. Accordingly, diluted net loss per share for those years was calculated using the basic weighted average number of shares outstanding.

## 18 | Financial Instruments

### Short-term investments

Short-term investments consist of the following:

As at August 31,	2005	2004
Commercial paper denominated in Canadian dollars, bearing interest at annual rates of 2.44% to 2.75% in 2005 and 2.00% to 2.14% in 2004, maturing on different dates between September 2005 and January 2006 in fiscal 2005, and October 2004 and January 2005 in fiscal 2004	\$ 104,883	\$ 65,359
Mutual funds denominated in Canadian dollars	—	18,610
	\$ 104,883	\$ 83,969

### Fair value

Cash, accounts receivable, as well as accounts payable and accrued liabilities, are financial instruments whose carrying values approximate their fair values.

The fair value of the long-term debt amounted to \$481,000 and \$344,000 as at August 31, 2004 and 2005.

The fair value of short-term investments, based on market value, amounted to \$83,969,000 and \$104,883,000 as at August 31, 2004 and 2005, respectively.

The fair value of forward exchange contracts, which represents the difference between their contractual amounts and their current trading value, amounted to an unrecognized gain of \$1,975,000 and \$2,937,000 as at August 31, 2004 and 2005, 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 six (seven in 2004) 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.

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 \$510,000 and \$352,000 as at August 31, 2004 and 2005, respectively.

### Interest rate risk

As at August 31, 2005, 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, 2004 and 2005, 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, 2004		
September 2004 to August 2005	\$ 7,480	1.5427
September 2005 to March 2007	8,400	1.3622
As at August 31, 2005		
September 2005 to August 2006	\$ 26,000	1.2630
September 2006 to November 2007	7,600	1.2500

## 19 | Segment Information

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

The reporting structure reflects how the company manages its business and how it classifies its operations for planning and measuring performance.

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, 2005	Telecom Division	Life Sciences and Industrial Division	Total
Sales	\$ 80,120	\$ 17,096	\$ 97,216
Earnings (loss) from operations	\$ 763	\$ (962)	\$ (199)
Unallocated items:			
Interest and other income			2,524
Foreign exchange loss			(1,336)
Earnings before income taxes			989
Income taxes			2,623
Net loss for the year			\$ (1,634)
Amortization of capital assets	\$ 6,504	\$ 2,588	\$ 9,092
Stock-based compensation costs	\$ 897	\$ 66	\$ 963
Capital expenditures	\$ 1,408	\$ 93	\$ 1,501

Year ended August 31, 2004	Telecom Division	Life Sciences and Industrial 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
Impairment of long-lived assets (note 4)	\$ 620	\$ —	\$ 620
Restructuring and other charges (note 4)	\$ —	\$ 1,261	\$ 1,261
Capital expenditures	\$ 607	\$ 244	\$ 851

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

Comparative information for fiscal 2003 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.

Total assets by reportable segment are detailed as follows:

As at August 31,	2005	2004
Telecom Division	\$ 64,655	\$ 60,284
Life Sciences and Industrial Division	11,449	15,094
Unallocated assets	114,853	97,413
	\$ 190,957	\$ 172,791

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

Carrying value of goodwill by reportable segment is detailed as follows:

As at August 31,	2005	2004
Telecom Division	\$ 16,092	\$ 14,530
Life Sciences and Industrial Division	4,278	3,863
	\$ 20,370	\$ 18,393

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

Years ended August 31,	2005	2004	2003
United States	\$ 56,282	\$ 40,019	\$ 31,561
Canada	6,830	5,818	4,806
Latin America	3,127	3,547	4,467
	66,239	49,384	40,834
Europe, Middle East and Africa	19,396	13,706	11,092
Asia-Pacific	11,581	11,540	10,004
	\$ 97,216	\$ 74,630	\$ 61,930

Sales were allocated to geographic regions based on the country of residence of the related customers. In fiscal 2004 and 2005, one customer represented more than 10% of sales with 13.8% of sales (\$10,325,000) in fiscal 2004 and 23.3% (\$22,629,000) in fiscal 2005. In fiscal 2003, no single customer accounted for 10% of sales or more. For fiscal 2004 and 2005, the most important customer purchased from the Telecom Division.

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

As at August 31,	2005		2004	
Canada	\$	35,690	\$	37,948
United States		5,601		6,934
	\$	41,291	\$	44,882

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

## 20 | 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, 2003 and 2004, the company leased facilities from the company owned by the President of EXFO. The annual rental expense amounted to \$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 the EXFO in connection with this exited leased facility. However, 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.

## 21 | 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 of the SEC 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,	2005	2004	2003
Net loss for the year in accordance with Canadian GAAP	\$ (1,634)	\$ (8,424)	\$ (54,950)
Stock-based compensation costs a)	-	(867)	(832)
Unrealized gains (losses) on forward exchange contracts b)	(1,286)	(280)	1,645
Amortization of intangible assets c)	-	-	832
Write-down of goodwill and intangible assets c)	-	-	6,178
Income tax effect on reconciliation items	-	-	(1,074)
Net loss for the year in accordance with U.S. GAAP	(2,920)	(9,571)	(48,201)
Other comprehensive income (loss)			
Foreign currency translation adjustment	15,669	5,969	15,089
Unrealized gains on forward exchange contracts b)	2,313	689	-
Reclassification of losses on forward exchange contracts in net loss b)	(65)	-	-
Comprehensive income (loss)	\$ 14,997	\$ (2,913)	\$ (33,112)
Basic and diluted net loss per share in accordance with U.S. GAAP	\$ (0.04)	\$ (0.14)	\$ (0.77)
Basic weighted average number of shares outstanding (000's)	68,526	66,020	62,852

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

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

As at August 31,	2005	2004	2003
Shareholders' equity in accordance with Canadian GAAP	\$ 173,400	\$ 157,327	\$ 129,826
Forward exchange contracts b)	2,937	1,975	1,566
Goodwill c)	(11,042)	(10,008)	(9,771)
Other	-	-	(29)
Shareholders' equity in accordance with U.S. GAAP	\$ 165,295	\$ 149,294	\$ 121,592

The following table summarizes the shareholders' activity under U.S. GAAP since August 31, 2002:

	Share capital	Contributed surplus	Deficit	Deferred stock-based compensation costs	Other capital	Accumulated other comprehensive income (loss)	Shareholders' equity
Balance as at August 31, 2002	\$ 560,943	\$ 1,487	\$ (406,387)	\$ (2,867)	\$ 7,693	\$ (9,870)	\$ 150,999
Net loss for the year	—	—	(48,201)	—	—	—	(48,201)
Stock-based compensation costs a)	1,507	—	—	1,589	(2,264)	—	832
Foreign currency transaction adjustment	—	—	—	—	—	15,089	15,089
Business combination (note 13)	2,796	—	—	—	—	—	2,796
Exercise of stock options (note 13)	45	—	—	—	—	—	45
Premium on resale of share capital	—	32	—	—	—	—	32
Balance as at August 31, 2003	565,291	1,519	(454,588)	(1,278)	5,429	5,219	121,592
Net loss for the year	—	—	(9,571)	—	—	—	(9,571)
Stock-based compensation costs a), e)	1,737	—	—	339	(760)	—	1,316
Foreign currency transaction adjustment	—	—	—	—	—	5,969	5,969
Unrealized gains on forward exchange contracts b)	—	—	—	—	—	689	689
Public offering (note 13)	29,164	—	—	—	—	—	29,164
Exercise of stock options (note 13)	254	—	—	—	—	—	254
Share issue expenses (note 13)	(137)	—	—	—	—	—	(137)
Premium on resale of share capital	—	18	—	—	—	—	18
Balance as at August 31, 2004	596,309	1,537	(464,159)	(939)	4,669	11,877	149,294
Net loss for the year	—	—	(2,920)	—	—	—	(2,920)
Stock-based compensation costs a), e)	1,213	—	—	(776)	425	—	862
Foreign currency transaction adjustment	—	—	—	—	—	15,669	15,669
Unrealized gains on forward exchange contracts b)	—	—	—	—	—	2,248	2,248
Exercise of stock options (note 13)	148	—	—	—	—	—	148
Share issue expenses (note 13)	(6)	—	—	—	—	—	(6)
Balance as at August 31, 2005	\$ 597,664	\$ 1,537	\$ (467,079)	\$ (1,715)	\$ 5,094	\$ 29,794	\$ 165,295

Accumulated other comprehensive income (loss) is comprised of the following:

As at August 31,	2005	2004	2003
Foreign currency translation adjustment			
Current year	\$ 15,669	\$ 5,969	\$ 15,089
Cumulative effect of prior years	11,188	5,219	(9,870)
	<b>26,857</b>	11,188	5,219
Unrealized gains on forward exchange contracts			
Current year	2,248	689	–
Cumulative effect of prior years	689	–	–
	<b>2,937</b>	689	–
	<b>\$ 29,794</b>	\$ 11,877	\$ 5,219

### Statements of cash flows

For the years ended August 31, 2003, 2004 and 2005, there were no significant differences between the statements of cash flows under Canadian GAAP as compared to U.S. GAAP, except for the subtotal before change in non-cash operating items, whose presentation is not permitted under U.S. GAAP.

### Reconciliation items

#### a) Accounting for stock-based compensation

Until August 31, 2003, and 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 e) 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".

##### *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. Compensation costs related to this plan became fully amortized during fiscal 2004.

##### *Long-Term Incentive Plan (formerly Stock Option Plan)*

Until August 31, 2003, and under APB 25, compensation costs related to the long-term incentive plan were measured as the difference between the market price 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. Compensation costs related to stock options granted prior to September 1, 2003, and accounted for under APB 25 became fully amortized during fiscal 2004.

#### *Restricted Stock Award Plan*

Under APB 25, compensation costs related to the restricted stock award plan were measured as the difference between the market price 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. Compensation costs related to this plan became fully amortized during fiscal 2004.

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

#### b) Forward exchange contracts

The forward exchange contracts entered into by the company prior to September 1, 2003, do not qualify for hedge accounting treatment under SFAS 133, "Accounting for Derivative Instruments and Hedging Activities"; accordingly, changes in the fair value of these derivatives are charged to earnings. However, on September 1, 2003, the company implemented the documentation for the designation, documentation and assessment of the effectiveness of its forward exchange contracts, for the purposes of applying hedge accounting. 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 income. Upon the recognition of the hedged sales, accumulated changes in fair value are reclassified in the statements of earnings.

Under Canadian GAAP, foreign exchange translation gains and losses on forward exchange 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.

The company estimates to \$950,000 the amount of unrealized gain on forward exchange contracts as of August 31, 2005 that will be reclassified to net earnings over the next twelve months.

### c) Write-down of goodwill and intangible assets

#### 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 and a permanent difference in the carrying value of goodwill exists between Canadian and U.S. GAAP.

Upon the impairment test, 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 2003.

### d) Research and development tax credits

Under Canadian GAAP, all research and development tax credits are recorded as a reduction of gross research and development expenses. 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 \$2,169,000 for fiscal 2004 and 2005, 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.

### e) New accounting standards and pronouncements

#### *Adopted in fiscal 2004 and still applicable in 2005*

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 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 on or after September 1, 2003.

#### *To be adopted after fiscal 2005*

In November 2004, the Financial Accounting Standard Board (FASB) issued SFAS 151, "Inventory Costs", an amendment to ARB No. 43, Chapter 4. The amendments made by SFAS 151 will improve financial reporting by clarifying that any abnormal amount of idle facility expenses, freight, handling costs, and wasted materials (spoilage) should be recognized as current-period charges and by requiring the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. This SFAS is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The company will adopt this new statement on September 1, 2005, and its adoption will have no significant impact on its financial statements.

In December 2004, the FASB issued SFAS 123(R), "Share-Based Payments". This Statement supersedes ABP 25, "Accounting for Stock Issued to Employees" and related implementation guidance, and revises SFAS 123 in a number of areas. Under SFAS 123(R), all forms of share-based payment to employees result in compensation cost recognized in financial statements. This statement is effective for fiscal years beginning after June 15, 2005. The company will adopt this Statement on September 1, 2005, and its adoption will have no significant impact on its financial statements.

In May 2005, the FASB issued SFAS 154, "Accounting Changes and Errors Corrections – a replacement of APB Opinion No. 20 and FASB Statement No. 3". This Statement replaces APB Opinion No. 20, "Accounting Changes", and FASB Statement No. 3, "Reporting Accounting Changes in Interim Financial Statements", and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. In general, this Statement requires a company to account for the adoption of a new accounting policy by applying the new principle to prior accounting periods as if that principle had always been adopted. This statement is effective for accounting changes or corrections of errors in fiscal years beginning after December 15, 2005.

#### **Accounting for stock-based compensation**

Under U.S. GAAP, 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 to awards granted prior to September 1, 2003. Consequently, if the fair value-based method had been applied to these awards, the pro forma net loss per share would have been the same as the net loss per share in fiscal 2005, lower than the net loss per share in 2004 (by \$0.01) and higher than the net loss per share in 2003 (by \$0.01).

The fair value of options or awards granted was estimated using the Black-Scholes options pricing model.