

Consolidated Balance Sheets

(in thousands of US dollars)

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

As at August 31,	2006	2005
Assets		
Current assets		
Cash	\$ 6,853	\$ 7,119
Short-term investments (notes 8 and 18)	104,437	104,883
Accounts receivable (notes 8 and 18)		
Trade	20,891	13,945
Other (note 4)	2,792	2,007
Income taxes and tax credits recoverable (note 8)	2,201	2,392
Inventories (notes 5 and 8)	24,623	17,749
Prepaid expenses	1,404	1,112
	163,201	149,207
Income taxes recoverable	476	459
Property, plant and equipment (notes 4, 6 and 8)	17,392	13,719
Long-lived asset held for sale (note 4)	—	1,600
Intangible assets (notes 7 and 8)	10,948	5,602
Goodwill (note 7)	27,142	20,370
	\$ 219,159	\$ 190,957
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (note 9)	\$ 17,337	\$ 12,201
Deferred revenue	1,772	1,584
Current portion of long-term debt	107	134
	19,216	13,919
Deferred revenue	2,632	1,568
Government grants (note 15)	723	1,872
Long-term debt (note 10)	354	198
	22,925	17,557
Commitments (note 11)		
Contingencies (note 12)		
Shareholders' Equity		
Share capital (note 13)	148,921	521,875
Contributed surplus	3,776	2,949
Deficit (note 13)	—	(381,846)
Cumulative translation adjustment	43,537	30,422
	196,234	173,400
	\$ 219,159	\$ 190,957

On behalf of the Board



Germain Lamonde
Chairman, President and CEO



André Tremblay
Chairman, Audit Committee

Consolidated Statements of Earnings

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

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

Years ended August 31,	2006	2005	2004
Sales (note 19)	\$ 128,253	\$ 97,216	\$ 74,630
Cost of sales ^(1,2)	57,275	44,059	34,556
Gross margin	70,978	53,157	40,074
Operating expenses			
Selling and administrative ⁽¹⁾	40,298	31,782	25,890
Net research and development ⁽¹⁾ (note 15)	15,404	12,190	12,390
Amortization of property, plant and equipment	3,523	4,256	4,935
Amortization of intangible assets	4,394	4,836	5,080
Impairment of long-lived assets (note 4)	604	—	620
Government grants (note 15)	(1,307)	—	—
Restructuring and other charges (note 4)	—	292	1,729
Total operating expenses	62,916	53,356	50,644
Earnings (loss) from operations	8,062	(199)	(10,570)
Interest and other income	3,253	2,524	1,438
Foreign exchange loss	(595)	(1,336)	(278)
Earnings (loss) before income taxes (note 16)	10,720	989	(9,410)
Income taxes (note 16)	2,585	2,623	(986)
Net earnings (loss) for the year	\$ 8,135	\$ (1,634)	\$ (8,424)
Basic and diluted net earnings (loss) per share	\$ 0.12	\$ (0.02)	\$ (0.13)
Basic weighted average number of shares outstanding (000's)	68,643	68,526	66,020
Diluted weighted average number of shares outstanding (000's) (note 17)	69,275	68,981	66,615
(1) Stock-based compensation costs included in:			
Cost of sales	\$ 127	\$ 143	\$ 62
Selling and administrative	701	626	265
Net research and development	204	194	122
	\$ 1,032	\$ 963	\$ 449

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

Consolidated Statements of Deficit and Contributed Surplus

(in thousands of US dollars)

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

Deficit			
Years ended August 31,	2006	2005	2004
Balance – Beginning of year	\$ (381,846)	\$ (380,212)	\$ (371,788)
Deduct (add)			
Net earnings (loss) for the year	8,135	(1,634)	(8,424)
Elimination of deficit by reduction of share capital (note 13)	373,711	–	–
Balance – End of year	\$ –	\$ (381,846)	\$ (380,212)

Contributed surplus			
Years ended August 31,	2006	2005	2004
Balance – Beginning of year	\$ 2,949	\$ 1,986	\$ 1,519
Add (deduct)			
Stock-based compensation costs	1,027	963	449
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards (note 13)	(200)	–	–
Premium on resale of share capital	–	–	18
Balance – End of year	\$ 3,776	\$ 2,949	\$ 1,986

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,	2006	2005	2004
Cash flows from operating activities			
Net earnings (loss) for the year	\$ 8,135	\$ (1,634)	\$ (8,424)
Add (deduct) items not affecting cash			
Discount on short-term investments	(229)	(302)	197
Stock-based compensation costs	1,032	963	449
Amortization	7,917	9,092	10,015
Impairment of long-lived assets	604	–	620
Restructuring and other charges	–	–	1,261
Government grants	(1,307)	–	154
Deferred revenue	786	977	1,404
	16,938	9,096	5,676
Change in non-cash operating items			
Accounts receivable	(2,637)	(838)	(2,677)
Income taxes and tax credits	329	6,096	(2,464)
Inventories	(2,287)	(699)	1,016
Prepaid expenses	79	544	(449)
Accounts payable and accrued liabilities	(144)	(164)	(351)
	12,278	14,035	751
Cash flows from investing activities			
Additions to short-term investments	(673,289)	(585,665)	(653,348)
Proceeds from disposal and maturity of short-term investments	681,500	574,207	624,722
Additions to property, plant and equipment and intangible assets	(3,378)	(1,501)	(851)
Business combinations, net of cash acquired	(18,054)	–	(241)
	(13,221)	(12,959)	(29,718)
Cash flows from financing activities			
Repayment of long-term debt	(415)	(121)	(109)
Net proceeds of offering (note 13)	–	–	29,164
Exercise of stock options	557	148	254
Share issue expenses	–	(6)	(137)
Redemption of share capital	–	–	(5)
Resale of share capital	–	–	23
	142	21	29,190
Effect of foreign exchange rate changes on cash	535	863	(430)
Change in cash	(266)	1,960	(207)
Cash – Beginning of year	7,119	5,159	5,366
Cash – End of year	\$ 6,853	\$ 7,119	\$ 5,159
Supplementary information			
Interest paid	\$ 65	\$ 30	\$ 408
Income taxes paid (recovered)	\$ 2,541	\$ (669)	\$ 120

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 TV operators, system vendors and optical component manufacturers. The Life Sciences and Industrial 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, 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 20. These consolidated financial statements include the accounts of the company and its domestic and international subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Accounting estimates

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting years. Significant estimates include the allowance for doubtful accounts receivable, the amount of tax credits recoverable, the provision for excess and obsolete inventories, the useful lives of capital assets, the valuation of long-lived assets, the future income taxes valuation allowance, the amount of certain accrued liabilities and deferred revenue as well as stock-based compensation costs. Actual results could differ from those estimates.

Reporting currency

The measurement 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. Foreign exchange gains and losses arising from such translation 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 measurement currency are translated into the measurement 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. Foreign exchange 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 measurement 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 remeasured at the exchange rate in effect on the date of the balance sheet. Revenues and expenses are remeasured at the monthly average exchange rate. Foreign exchange gains and losses arising from such remeasurement are reflected in the statements of earnings. The company has no self-sustaining foreign subsidiary for which the functional currency is not the US dollar.

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 foreign exchange 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:

	Term
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.

Impairment of long-lived assets

Long-lived assets are reviewed for impairment when events or 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.

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 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, 2006, 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 (note 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 earnings (loss) and net earnings (loss) per share as if stock-based compensation costs were recognized in the financial statements for all reporting years using the fair value-based method for outstanding stock options granted prior to September 1, 2003 (note 14).

New accounting standards and pronouncements

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 20 item b) of these consolidated financial statements are expected.

3. Business Combination

On January 26, 2006, the company acquired substantially all the assets of Consultronics Limited. Based in Toronto, Canada, and with operations in the United Kingdom and Hungary, Consultronics was a privately held company specializing in x-Digital Subscriber Line (xDSL), Internet Protocol TV and Voice-over-Internet Protocol (VoIP) test solutions for broadband access networks.

This acquisition was settled for a total cash consideration valued at \$19,093,000 or \$18,838,000 net of \$255,000 of cash acquired. The total consideration includes severance expenses of \$660,000 for the termination of employees of the acquired business as well as other acquisition-related costs of \$822,000. As at August 31, 2006, a portion of the total consideration, in the amount of \$816,000, was not yet paid. From this amount, \$631,000 is related to severance expenses and has been recorded as restructuring charges payable (note 4), while the remainder of \$185,000, relating to acquisition-related costs, has been recorded as an account payable related to a business combination (note 9). Severance expenses will be fully paid in fiscal 2007.

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 January 26, 2006; that is being the date of acquisition.

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

Assets acquired		
Current assets	\$	5,135
Property, plant and equipment		3,115
Core technology		8,709
Current liabilities assumed		(2,826)
Loans assumed		(402)
Net identifiable assets acquired		13,731
Goodwill		5,107
Purchase price, net of cash acquired	\$	18,838

Acquired core technology is amortized on a straight-line basis over its estimated useful life of five years.

This business, including acquired goodwill, reports to the Telecom Division. Acquired goodwill is deductible for tax purposes.

4. Special Charges

Impairment of long-lived assets

Fiscal 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 purchase offer were not met and the offer was declined. During fiscal 2005, the company withdrew the building from the market and continued to use it. This building reported to the Telecom Division.

Fiscal 2006

In June 2006, the company entered into an agreement to sell its building (located in Rochester, NY) along with some equipment and it recorded an impairment charge of \$604,000 in the third quarter of fiscal 2006, representing the excess of the carrying value of these assets over the net expected selling price of \$1,200,000. The sale of these assets was finalized in the fourth quarter of 2006 for the net expected selling price. This amount is included in the other receivables in the balance sheet as at August 31, 2006, and it will be recovered in the first quarter of fiscal 2007. These assets report to the Life Science and Industrial Division.

Restructuring and other charges

Fiscal 2004 and 2005

During fiscal 2004, the company approved a restructuring plan to consolidate the operations of its Life Sciences and Industrial Division, transferring its Rochester, NY, operations mainly to its 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 was recorded in fiscal 2004 and the remaining \$482,000 was recorded in 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 at the Rochester facilities, \$1,261,000 mainly for the impairment of the building in Rochester and the remaining \$399,000 for other expenses such as training and recruiting expenses and transfer of assets.

Finally, in fiscal 2005 and 2004, the company recorded adjustments of \$190,000 and \$304,000, respectively, to the fiscal 2003 and 2001 plans because actual charges, mainly for leased equipment, were lower than expected.

The following tables summarize changes in the restructuring charges payable since August 31, 2003:

Year ended August 31, 2006					
	Balance as at August 31, 2005	Additions	Payments	Adjustments	Balance as at August 31, 2006
<i>Fiscal 2006 plan (note 3)</i>					
Severance expenses	\$ —	\$ 660	\$ (29)	\$ —	\$ 631
<i>Fiscal 2003 plan</i>					
Exited leased facilities	150	—	(90)	—	60
Total for all plans (note 9)	\$ 150	\$ 660	\$ (119)	\$ —	\$ 691

Year ended August 31, 2005					
	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)	—	—
Total for all plans (note 9)	\$ 1,169	\$ 482	\$ (1,311)	\$ (190)	\$ 150

Year ended August 31, 2004					
	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
<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)	—	—
<i>Fiscal 2001 plan</i>					
Exited leased facilities	124	—	(72)	(42)	10
Total for all plans	\$ 2,468	\$ 772	\$ (1,767)	\$ (304)	\$ 1,169

5. Inventories

As at August 31,	2006	2005
Raw materials	\$ 14,353	\$ 9,373
Work in progress	1,043	934
Finished goods	9,227	7,442
	\$ 24,623	\$ 17,749

6. Property, Plant and Equipment

As at August 31,	2006		2005	
	Cost	Accumulated amortization	Cost	Accumulated amortization
Land and land improvements	\$ 4,249	\$ 1,082	\$ 3,179	\$ 815
Buildings	14,417	6,262	9,206	2,250
Equipment	33,562	28,263	33,216	29,553
Leasehold improvements	2,788	2,017	2,395	1,659
	55,016	\$ 37,624	47,996	\$ 34,277
Less:				
Accumulated amortization	37,624		34,277	
	\$ 17,392		\$ 13,719	

As at August 31, 2005 and 2006, unpaid purchases of property, plant and equipment amounted to \$111,000 and \$176,000, respectively.

7. Intangible Assets and Goodwill

As at August 31,	2006		2005	
	Cost	Accumulated amortization	Cost	Accumulated amortization
Core technology	\$ 47,629	\$ 38,972	\$ 35,554	\$ 32,214
Software	6,781	4,490	6,607	4,345
	54,410	\$ 43,462	42,161	\$ 36,559
Less:				
Accumulated amortization	43,462		36,559	
	\$ 10,948		\$ 5,602	

Amortization expenses for intangible assets in each of the next five fiscal years will amount to \$2,877,000 in 2007, \$2,337,000 in 2008, \$2,252,000 in 2009, \$2,200,000 in 2010 and \$1,099,000 in 2011.

Changes in the carrying value of goodwill are as follows:

As at August 31,	2006	2005
Balance – Beginning of year	\$ 20,370	\$ 18,393
Addition from business combination (note 3)	5,107	–
Foreign currency translation adjustment	1,665	1,977
Balance – End of year (note 19)	\$ 27,142	\$ 20,370

8. Credit Facilities

The company has a line of credit that provides for advances of up to CA\$10,000,000 (US\$9,037,000). This line of credit bears interest at prime rate (prime rate in 2005). As at August 31, 2006, this line of credit was unused.

The company also has another line of credit, which provides for advances of up to CA\$4,500,000 (US\$4,067,000) for letters of guarantee. As at August 31, 2006, an amount of CA\$2,073,000 (US\$1,873,000) was reserved from this line of credit (note 12).

Finally, the company has a third line of credit of \$12,000,000 for the foreign currency exposure related to its forward exchange contracts. As at August 31, 2006, an amount of \$751,000 was reserved from this line of credit.

These lines of credit are renewable annually. Short-term investments, accounts receivable, inventories and all tangible and intangible assets of the company are pledged as collateral against these lines of credit.

9. Accounts Payable and Accrued Liabilities

As at August 31,	2006	2005
Trade	\$ 7,487	\$ 5,781
Salaries and social benefits	5,991	4,526
Warranty	1,006	725
Commissions	835	211
Restructuring charges (note 4)	691	150
Business combination (note 3)	185	–
Other	1,142	808
	\$ 17,337	\$12,201

Changes in the warranty provision are as follows:

As at August 31,	2006	2005
Balance - Beginning of year	\$ 725	\$ 390
Provision	895	869
Settlements	(708)	(583)
Addition from business combination	31	–
Foreign currency translation adjustment	63	49
Balance - End of year	\$ 1,006	\$ 725

10. Long-Term Debt

As at August 31,	2006	2005
Loans collateralized by equipment, bearing interest at 4.9%, repayable in monthly installments of \$10,600 including principal and interest, maturing in 2010	\$ 461	\$ –
Loans collateralized by equipment, bearing interest at 9.6%, fully repaid in fiscal 2006	–	332
	461	332
Less: Current portion	107	134
	\$ 354	\$ 198

As at August 31, 2006, minimum principal repayments required in each of the next four years will amount to \$107,000 in 2007, \$113,000 in 2008, \$118,000 in 2009 and \$123,000 in 2010.

11. Commitments

The company entered into operating leases for certain of its premises and equipment, which expire at various dates through September 2013. As at August 31, 2006, minimum rentals payable under these operating leases in each of the next five years will amount to \$1,748,000 in 2007, \$1,223,000 in 2008, \$1,177,000 in 2009, \$1,200,000 in 2010 and \$990,000 in 2011 for total commitments of \$6,888,000.

For the years ended August 31, 2004, 2005 and 2006, rental expenses amounted to \$1,219,000, \$1,370,000 and \$1,523,000, respectively.

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 predetermined 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 a decision was rendered on February 19, 2003. Only one of the claims against the company was dismissed. On October 8, 2002, the claims against its officers were dismissed pursuant to the terms of Reservation of Rights and Tolling Agreements entered into with the plaintiffs.

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.

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. A settlement fairness hearing was held on April 24, 2006; however, no ruling has been issued yet by the court. If the court determines that the settlement is fair to the class members, the settlement will be approved. The settlement provides that, if the plaintiffs do not obtain any recovery from the underwriter defendants, the members of the class action would receive an amount not expected to exceed \$2,507,678. Any direct financial impact plus any legal fees are expected to be borne by the company's insurance carriers. However, 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 to 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, 2006.

Letters of guarantee

As at August 31, 2006, in the normal course of its operations, the company had outstanding letters of guarantee of CA\$2,073,000 (US\$1,873,000), which expire at various dates through fiscal 2010 and that were reserved from one of the lines of credit (note 8).

13. Share Capital

Authorized – unlimited as to number, without par value

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

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

The following table summarizes the share capital activity since August 31, 2003:

	Multiple voting shares		Subordinate voting shares		
	Number	Amount	Number	Amount	Total amount
Balance as at August 31, 2003	37,900,000	\$ 1	25,139,908	\$ 492,451	\$ 492,452
Public offering ⁽¹⁾	–	–	5,200,000	29,164	29,164
Exercise of stock options (note 14)	–	–	111,071	254	254
Exercise of restricted 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 restricted 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
Exercise of stock options (note 14)	–	–	182,425	557	557
Exercise of restricted share units (note 14)	–	–	4,770	–	–
Conversion of multiple voting shares into subordinate voting shares	(757,000)	–	757,000	–	–
Reclassification of stock-based compensation cost to share capital upon exercise of stock awards	–	–	–	200	200
Elimination of deficit by reduction of share capital ⁽²⁾	–	–	–	(373,711)	(373,711)
Balance as at August 31, 2006	37,143,000	\$ 1	31,609,969	\$ 148,920	\$ 148,921

(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 (CA\$38,438,400), after deduction of underwriting commission of \$1,215,000 (CA\$1,601,000).

(2) Upon the approval of the Board of Directors dated August 31, 2006, the company eliminated its deficit against its share capital.

14. Stock-Based Compensation Plans

The maximum number of additional 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 and employees 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 and 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, 2003:

Years ended August 31,	2006		2005		2004	
	Number	Weighted average exercise price (CA\$)	Number	Weighted average exercise price (CA\$)	Number	Weighted average exercise price (CA\$)
Outstanding – Beginning of year	2,763,759	\$ 19	2,934,518	\$ 21	3,176,613	\$ 23
Granted	31,992	6	246,233	6	536,500	5
Exercised	(182,425)	(4)	(71,699)	(3)	(111,071)	(3)
Forfeited	(173,951)	(18)	(345,293)	(27)	(667,524)	(23)
Outstanding – End of year	2,439,375	\$ 20	2,763,759	\$ 19	2,934,518	\$ 21
Exercisable – End of year	1,852,870	\$ 25	1,650,404	\$ 28	1,331,707	\$ 32

The intrinsic value of stock options exercised during the year ended August 31, 2006, was CA\$552,000.

The weighted average grant-date fair value of stock options granted during fiscal 2004, 2005 and 2006 amounted to \$2.73, \$3.51 and \$4.76, respectively.

The fair value of stock awards granted in fiscal 2004, 2005 and 2006 was estimated using the Black-Scholes options valuation model with the following weighted average assumptions:

Years ended August 31,	2006	2005	2004
Risk-free interest rate	3.9%	3.6%	2.7%
Expected volatility (based on historical volatility)	87%	95%	100%
Dividend yield	Nil	Nil	Nil
Expected life	66 months	66 months	49 months

The company is required to make pro forma disclosures of net earnings (loss) and net earnings (loss) per share for any periods included in the financial statements, as if the fair value-based method of accounting had been applied to outstanding unvested awards granted prior to September 1, 2003. Consequently, if the fair value-based method had been applied to unvested stock options granted prior to September 1, 2003, and outstanding as at August 31, 2004, 2005 and 2006, the net earning (loss) per share and the pro forma net earning (loss) per share would have been the same for all reporting years.

The following table summarizes information about stock options as at August 31, 2006:

Exercise price (CA\$)	Stock options outstanding				Stock options exercisable		
	Number	Weighted average exercise price (CA\$)	Aggregate intrinsic value (CA\$)	Weighted average remaining contractual life	Number	Weighted average exercise price (CA\$)	Aggregate intrinsic value (CA\$)
\$2.50 to \$3.36	419,655	\$ 2.50	\$ 1,402	6.1 years	273,313	\$ 2.50	\$ 913
\$3.96 to \$5.84	547,687	5.07	422	7.6 years	206,464	4.92	190
\$6.22 to \$9.02	193,200	6.52	–	7.4 years	94,260	6.82	–
\$14.27 to \$20.00	476,396	15.78	–	5.2 years	476,396	15.78	–
\$29.70 to \$43.00	564,436	36.27	–	4.2 years	564,436	36.27	–
\$51.25 to \$68.17	199,771	65.76	–	4.0 years	199,771	65.76	–
\$83.66	38,230	83.66	–	4.0 years	38,230	83.66	–
	2,439,375	\$ 20.26	\$ 1,824	5.7 years	1,852,870	\$ 25.19	\$ 1,103

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.

The following table summarizes RSUs activity since January 2005:

Years ended August 31,	2006	2005
Outstanding – Beginning of year	176,185	–
Granted	173,803	176,185
Exercised	(4,770)	–
Forfeited	(17,341)	–
Outstanding – End of year	327,877	176,185

None of the RSUs outstanding as at August 31, 2005 and 2006 were redeemable. As at August 31, 2006, the weighted average remaining contractual life of the outstanding RSUs was 8.9 years. The weighted average grant-date fair value of RSUs granted during fiscal 2005 and 2006 amounted to \$4.68 and \$5.39, respectively.

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.

The following table summarizes DSU activity since January 2005:

Years ended August 31,	2006	2005
Outstanding – Beginning of year	23,734	–
Granted	19,556	23,734
Outstanding – End of year	43,290	23,734

None of the DSUs outstanding as at August 31, 2005 and 2006 were redeemable. The weighted average grant-date fair value of DSUs granted during fiscal 2005 and 2006 amounted to \$4.47 and \$5.81.

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 and vest over a four-year period, with 25% vesting on an annual basis commencing on the first anniversary of the date of grant.

The following table summarizes stock appreciation rights activity since August 31, 2003:

Years ended August 31,	2006		2005		2004	
	Number	Weighted average exercise price	Number	Weighted average exercise price	Number	Weighted average exercise price
Outstanding – Beginning of year	19,000	\$ 12	13,000	\$ 16	9,000	\$ 24
Granted	5,500	6	6,000	4	6,000	5
Forfeited	–	–	–	–	(2,000)	(19)
Outstanding – End of year	24,500	\$ 11	19,000	\$ 12	13,000	\$ 16
Exercisable – End of year	11,000	\$ 18	7,500	\$ 24	4,250	\$ 30

The following table summarizes information about stock appreciation rights as at August 31, 2006:

Exercise price	Stock appreciation rights outstanding		Stock appreciation rights exercisable
	Number	Weighted average remaining contractual life	Number
\$2.21	2,000	6.6 years	1,500
\$4.51 to \$6.50	17,500	8.4 years	4,500
\$22.25	2,500	4.4 years	2,500
\$45.94	2,500	4.0 years	2,500
	24,500	7.4 years	11,000

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, 2003:

Years ended August 31,	2005	2004
Outstanding – Beginning of year	53,592	143,096
Exercised	(53,592)	(89,504)
Outstanding – End of year	–	53,592

15. Other Disclosures

Net research and development expenses

Net research and development expenses comprise the following:

Years ended August 31,	2006	2005	2004
Gross research and development expenses	\$ 19,488	\$ 15,878	\$ 15,668
Research and development tax credits and grants	(4,084)	(3,688)	(3,278)
	\$ 15,404	\$ 12,190	\$ 12,390

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 CA\$2,220,000 (US\$1,995,000) over the period from January 1, 1998, through December 31, 2002, payable based on the number of full-time jobs created during that period.

Since the beginning of the program, the company has claimed and received the maximum amount of CA\$2,220,000. However, these grants were 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. Since the beginning of the program, the company deferred in the balance sheet CA\$1,450,000 (US\$1,307,000) from the amounts received until it received the final approval by the sponsor of the program related to jobs created. In fiscal 2006, the sponsor of the program granted the company with its final approval and the company recorded a non-recurring revenue of CA\$1,450,000 (US\$1,307,000) in the earnings from operations in the statement of earnings of fiscal 2006.

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%. From the total amount received by the company so far under this program, CA\$774,000 (US\$700,000) was deferred and was included in government grants in the balance sheet. This 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 this program 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, 2004, 2005 and 2006, is net of government grants of \$3,000, \$89,000 and \$262,000, respectively.

Selling and administrative expenses for the years ended August 31, 2004, 2005 and 2006, are net of government grants of \$5,000, \$32,000 and \$76,000, respectively.

Research and development expenses for the years ended August 31, 2004, 2005 and 2006, are net of government grants of \$80,000, \$22,000 and \$4,000, 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 2% (1% prior to June 2005) 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, 2004, 2005 and 2006, amounted to CA\$141,000 (US\$106,000), CA\$221,000 (US\$179,000) and CA\$363,000 (US\$316,000), 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, 2004, 2005 and 2006, the company recorded cash contributions and expenses totaling \$187,000, \$134,000 and \$126,000, 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,	2006	2005	2004
Income tax provision at combined Canadian federal and provincial statutory tax rate (32% in 2006, 31% in 2005 and 32% in 2004)	\$ 3,430	\$ 307	\$ (3,011)
Increase (decrease) due to:			
Foreign income taxed at different rates	(85)	(580)	(767)
Non-taxable income	(207)	(827)	(128)
Non-deductible expenses	527	784	1,205
Tax deductions	–	(81)	(169)
Change in enacted rates	497	–	274
Effect of consolidation of subsidiaries	61	(209)	(1,384)
Previous year tax recovery	–	–	(1,406)
Other	239	(146)	446
Change in valuation allowance	(1,877)	3,375	3,954
	\$ 2,585	\$ 2,623	\$ (986)
The income tax provision consists of the following:			
Current			
Canadian	\$ 2,573	\$ 2,513	\$ (577)
Other	12	110	(409)
	2,585	2,623	(986)
Future			
Canadian	2,687	(1,445)	(1,104)
United States	(601)	(1,723)	(2,448)
Other	(209)	(207)	(402)
	1,877	(3,375)	(3,954)
Valuation allowance			
Canadian	(2,687)	1,445	1,104
United States	601	1,723	2,448
Other	209	207	402
	(1,877)	3,375	3,954
	\$ 2,585	\$ 2,623	\$ (986)
Details of the company's income taxes:			
Earnings (loss) before income taxes			
Canadian	\$ 13,202	\$ 3,092	\$ (7,740)
United States	(2,103)	(953)	(5,879)
Other	(379)	(1,150)	4,209
	\$ 10,720	\$ 989	\$ (9,410)

Most of the company's income tax provision for fiscal 2005 and 2006 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 in the statements of earnings.

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

As at August 31,	2006	2005
Future income tax assets		
Long-lived assets	\$ 4,453	\$ 4,902
Provisions and accruals	7,315	7,406
Government grants	–	209
Deferred revenue	486	318
Share issue expenses	531	590
Research and development expenses	8,527	7,292
Losses carried forward	18,118	18,424
	39,430	39,141
Valuation allowance	(38,543)	(38,406)
	887	735
Future income tax liabilities		
Research and development tax credits	(887)	(735)
Future income tax assets, net	\$ –	\$ –

As at August 31, 2006, the company had available operating losses in several tax jurisdictions, against which a full valuation allowance of \$18,118,000 was recorded. The following table summarizes the year of expiry of these operating losses by tax jurisdiction:

Year of expiry	Canada		United States and Other
	Federal	Provinces	
2008	\$ 1,252	\$ 92	\$ 1,857
2009	5,186	394	599
2010	4,677	327	266
2011	168	86	–
2013	–	–	876
2015	1,666	1,670	–
2022	–	–	9,406
2023	–	–	11,621
2024	–	–	6,700
2025	–	–	6,690
2026	1,694	1,696	2,737
Indefinite	1,702	1,775	1,996
	\$ 16,345	\$ 6,040	\$ 42,748

As at August 31, 2006, in addition to operating losses, the company had available research and development expenses in Canada amounting to \$33,745,000 at the federal level and \$15,276,000 at the provincial level, against which a full valuation allowance of \$8,527,000 was recorded. These expenses can be carried forward indefinitely against future years' taxable income in their respective tax jurisdiction.

Finally, as at August 31, 2006, the company had available research and development tax credits at the Canadian federal level in the amount of \$3,697,000 that can be carried forward against future years' income taxes payable over the next ten years. These tax credits were not recorded in the balance sheet as at August 31, 2006.

17. Earnings per Share

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

Years ended August 31,	2006	2005	2004
Basic weighted average number of shares outstanding (000's)	68,643	68,526	66,020
Plus dilutive effect of:			
Stock options (000's)	502	422	502
Deferred share units (000's)	31	8	—
Restricted share units (000's)	99	8	—
Restricted stock awards (000's)	—	17	93
Diluted weighted average number of shares outstanding (000's)	69,275	68,981	66,615
Stock awards excluded from the calculation of the diluted weighted average number of shares outstanding because their exercise price was greater than the average market price of the common shares (000's)	1,628	1,962	2,128

The diluted net loss per share for the years ended August 31, 2004 and 2005, was the same as the basic net loss per share since the dilutive effect of stock options, deferred share units, restricted share units and restricted stock awards 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,	2006	2005
Commercial paper denominated in Canadian dollars, bearing interest at annual rates of 3.92% to 4.31% in 2006 and 2.44% to 2.75% in 2005, maturing on different dates between September 2006 and January 2007 in fiscal 2006, and September 2005 and January 2006 in fiscal 2005	\$ 104,437	\$ 104,883

Fair value

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

The fair value of short-term investments, based on market value, amounted to \$104,883,000 and \$104,437,000 as at August 31, 2005 and 2006, respectively.

The fair value of forward exchange contracts, which represents the difference between their contractual amounts and their current trading value, amounted to unrecognized gains of \$2,937,000 and \$5,451,000 as at August 31, 2005 and 2006, 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 nine (six in 2005) quality high-credit corporations and trusts. The company's cash and forward exchange contracts are held with or issued by quality high-credit 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 \$352,000 and \$451,000 as at August 31, 2005 and 2006, respectively.

Interest rate risk

As at August 31, 2006, 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, 2005 and 2006, 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, 2005		
September 2005 to August 2006	\$ 26,000	1.2630
September 2006 to November 2007	7,600	1.2500
As at August 31, 2006		
September 2006 to August 2007	\$ 37,000	1.1676
September 2007 to June 2009	26,800	1.1261

19. Segment Information

The company is organized 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 TV 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.

The following tables present information by segment:

Year ended August 31, 2006	Telecom Division	Life Sciences and Industrial Division	Total
Sales	\$ 107,376	\$ 20,877	\$ 128,253
Earnings from operations	\$ 6,679	\$ 1,383	\$ 8,062
Unallocated items:			
Interest and other income			3,253
Foreign exchange loss			(595)
Earnings before income taxes			10,720
Income taxes			2,585
Net earnings for the year			\$ 8,135
Government grants (note 15)	\$ (1,307)	\$ –	\$ (1,307)
Amortization of capital assets	\$ 6,689	\$ 1,228	\$ 7,917
Stock-based compensation costs	\$ 962	\$ 70	\$ 1,032
Impairment of long-lived assets (note 4)	\$ –	\$ 604	\$ 604
Capital expenditures	\$ 3,049	\$ 329	\$ 3,378

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

Total assets by reportable segment are detailed as follows:

As at August 31,	2006	2005
Telecom Division	\$ 93,853	\$ 64,655
Life Sciences and Industrial Division	11,339	11,449
Unallocated assets	113,967	114,853
	\$ 219,159	\$ 190,957

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,	2006	2005
Telecom Division	\$ 22,545	\$ 16,092
Life Sciences and Industrial Division	4,597	4,278
	\$ 27,142	\$ 20,370

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

Years ended August 31,	2006	2005	2004
United States	\$ 59,457	\$ 56,282	\$ 40,019
Canada	8,767	6,830	5,818
Latin America	8,380	3,127	3,547
	76,604	66,239	49,384
Europe, Middle East and Africa	32,379	19,396	13,706
Asia-Pacific	19,270	11,581	11,540
	\$ 128,253	\$ 97,216	\$ 74,630

Sales were allocated to geographic regions based on the country of residence of the related customers. In fiscal 2004, 2005 and 2006, one customer represented more than 10% of sales with 13.8% of sales (\$10,325,000) in fiscal 2004, 23.3% of sales (\$22,629,000) in 2005 and 13.8% of sales (\$17,706,000) in 2006. For fiscal 2004, 2005 and 2006, the most important customer purchased from the Telecom Division.

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

As at August 31,	2006	2005
Canada	\$ 51,724	\$ 35,690
United States	3,758	5,601
	\$ 55,482	\$ 41,291

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

20. United States Generally Accepted Accounting Principles

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

Reconciliation of net earnings (loss) to conform to U.S. GAAP

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

Years ended August 31,	2006	2005	2004
Net earnings (loss) for the year in accordance with Canadian GAAP	\$ 8,135	\$ (1,634)	\$ (8,424)
Stock-based compensation costs a)	-	-	(867)
Unrealized losses on forward exchange contracts b)	-	(1,286)	(280)
Net earnings (loss) for the year in accordance with U.S. GAAP	8,135	(2,920)	(9,571)
Other comprehensive income (loss)			
Foreign currency translation adjustment	12,322	15,669	5,969
Unrealized gains on forward exchange contracts b)	5,394	2,313	689
Reclassification of realized gains on forward exchange contracts in net earnings (loss) b)	(2,880)	(65)	-
Comprehensive income (loss)	\$ 22,971	\$ 14,997	\$ (2,913)
Basic and diluted net earnings (loss) per share in accordance with U.S. GAAP	\$ 0.12	\$ (0.04)	\$ (0.14)
Basic weighted average number of shares outstanding (000's)	68,643	68,526	66,020
Diluted weighted average number of shares outstanding (000's)	69,275	68,981	66,615

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 refer to the corresponding explanatory note in the Reconciliation Items section.

As at August 31,	2006	2005	2004
Shareholders' equity in accordance with Canadian GAAP	\$ 196,234	\$ 173,400	\$ 157,327
Forward exchange contracts b)	5,451	2,937	1,975
Goodwill	(11,908)	(11,042)	(10,008)
Shareholders' equity in accordance with U.S. GAAP	\$ 189,777	\$ 165,295	\$ 149,294

The following table summarizes the shareholders' equity activity under U.S. GAAP since August 31, 2003:

	Share capital	Contributed surplus	Deficit	Deferred stock-based compensation costs	Other capital	Accumulated other comprehensive income	Shareholders' equity
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	1,737	—	—	339	(760)	—	1,316
Foreign currency translation adjustment	—	—	—	—	—	5,969	5,969
Unrealized gains on forward exchange contracts	—	—	—	—	—	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	1,213	—	—	(776)	425	—	862
Foreign currency translation adjustment	—	—	—	—	—	15,669	15,669
Unrealized gains on forward exchange contracts	—	—	—	—	—	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
Net earnings for the year	—	—	8,135	—	—	—	8,135
Stock-based compensation costs	—	—	—	344	610	—	954
Foreign currency translation adjustment	—	—	—	—	—	12,322	12,322
Unrealized gains on forward exchange contracts	—	—	—	—	—	2,514	2,514
Exercise of stock options (note 13)	557	—	—	—	—	—	557
Reclassification of stock-based compensation costs upon exercise of stock awards (note 13)	200	—	—	—	(200)	—	—
Balance as at August 31, 2006	\$ 598,421	\$ 1,537	\$ (458,944)	\$ (1,371)	\$ 5,504	\$ 44,630	\$ 189,777

Accumulated other comprehensive income is comprised of the following:

As at August 31,	2006	2005	2004
Foreign currency translation adjustment			
Current year	\$ 12,322	\$ 15,669	\$ 5,969
Cumulative effect of prior years	26,857	11,188	5,219
	39,179	26,857	11,188
Unrealized gains on forward exchange contracts	b)		
Current year	2,514	2,248	689
Cumulative effect of prior years	2,937	689	–
	5,451	2,937	689
	\$ 44,630	\$ 29,794	\$ 11,877

Statements of cash flows

For the years ended August 31, 2004, 2005 and 2006, 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" and subsequently, SFAS123(R), "Share-Based Payments".

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

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 stock 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 of the stock award, which was 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, which were accounted for under APB 25, 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, did 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 were 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 since 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.

Based on the portfolio of forward exchange contracts as at August 31, 2006, the company estimates that the portion of the unrealized gain on forward exchange contracts as of August 31, 2006, and that will be realized and reclassified to net earnings over the next fiscal year amounts to \$2,872,000.

c) Research and development tax credits

Under Canadian GAAP, all research and development tax credits are recorded as a reduction of gross research and development expenses in the statements or earnings. 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, \$2,169,000 and \$2,546,000 for fiscal 2004, 2005 and 2006, respectively. This difference has no impact on the net earnings (loss) and the net earnings (loss) per share figures for the reporting years.

d) Elimination of deficit by reduction of share capital

As at August 31, 2006, under Canadian GAAP, the company proceeded to eliminate its deficit against its share capital (note 13). However, under U.S. GAAP, such elimination is not permitted, which creates a permanent difference of \$373,711,000 in the deficit and the share capital between the Canadian GAAP and U.S. GAAP figures. This difference has no impact on the total amount of the shareholders' equity.

e) New accounting standards and pronouncements

Adopted in fiscal 2006

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 improves 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 adopted this new statement on September 1, 2005, and its adoption had 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 adopted this statement on September 1, 2005, using the modified prospective application method of transition and its adoption had no significant impact on its financial statements.

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(R), the company is required to make pro forma disclosures of net earnings (loss) and net earnings (loss) per share for any periods included in the financial statements that ended prior to the adoption of SFAS 123(R) (i.e., fiscal 2004 and 2005) as if the fair value-based method of accounting had been applied to outstanding unvested awards granted prior to September 1, 2003. Consequently, if the fair value-based method had been applied to these awards, the pro forma net earnings (loss) per share would have been the same as the net earnings (loss) per share for all reporting periods.

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

To be adopted after fiscal 2006

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 20, "Accounting Changes", and SFAS 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.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), "Accounting to Uncertainty in Income Taxes", which clarifies the accounting for uncertainties in income taxes recognized in accordance with SFAS 109, "Accounting for Income Taxes". The interpretation is effective for fiscal years beginning after December 15, 2006. The company will adopt this interpretation on September 1, 2007, and has not yet assessed the impact its adoption will have on its financial statements.