

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

The following discussion and analysis of the consolidated financial condition and results of operations of EXFO Electro-Optical Engineering Inc. for the fiscal years ended August 31, 2004, 2005 and 2006, should be read in conjunction with our consolidated financial statements and the related notes included elsewhere in this Annual Report. Our consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Canada, or Canadian GAAP. Significant differences in measurement and disclosure from generally accepted accounting principles in the United States, or U.S. GAAP, are set out in note 20 to our consolidated financial statements. Our measurement currency is the Canadian dollar although we report our financial statements in US dollars.

The following discussion and analysis of financial condition and results of operations is dated November 1, 2006.

All dollar amounts are expressed in US dollars, except as otherwise noted.

Industry Overview

Global market demand for telecom test and measurement equipment should remain strong in the years to come as most network service providers (NSPs) are increasing capital expenditures to upgrade their networks for converged Internet protocol (IP) services and triple-play (voice, data and video) offerings. These market forces create needs for differentiated test solutions to help NSPs accelerate deployment and ensure service quality in their network build-outs.

With the ongoing globalization of the world's economy and the emergence of new consumer markets, NSPs are poised to capitalize on growing demand for communications and entertainment services. Early in 2006, some smaller telecom operators launched broadcast-quality video services based on IP communications. This technology, better known as IPTV, allows telephone companies (telcos) to efficiently offer TV, HDTV and interactive TV services to their broadband subscribers. Tier-1 and Tier-2 telcos are expected to launch similar IPTV services on a large-scale basis starting in 2007. While Web-based streaming video is offered for free on a best-effort basis, IPTV, whom many regard as the broadband "killer application," will require a high level of performance to ensure a quality user experience. NSPs, after all, don't want customer churn to prevent a meaningful return on their massive investments.

To deliver a wide range of differentiated IP services, NSPs will continue transforming their legacy, circuit-switched networks into highly efficient, flexible and scalable packet-based IP architectures. Telcos and cablecos have already proven that they can generate significant revenues from higher-margin services on hybrid networks, while reducing operating costs. IPTV should only accelerate the migration towards fully converged, IP-based networks, since it typically allows NSPs to nearly double average revenue per user (ARPU).

The increasing reliance on telecom and IP-related services will continue driving bandwidth consumption, thus pushing the deployment of fiber deeper into access networks. Competition between telcos and cablecos has intensified as triple-play offerings are announced almost daily. Hybrid architectures combining copper and fiber (fiber-to-the-curb, or FTTC and fiber-to-the-node, or FTTN), will keep expanding worldwide, since this is the quickest and least expensive method to increase bandwidth. To remain competitive with cablecos, telcos are migrating from former asymmetric digital subscriber line (ADSL), to current ADSL2+, and onto future very-high-data-rate digital subscriber line 2+ (VDSL2+) technologies as interoperability becomes a reality. Telcos, however, will

increasingly opt for all-fiber, passive optical network (PON)-based architectures (fiber-to-the-premises, or FTTP) to meet heightened bandwidth requirements and to future-proof their networks. These decisions will apply not only to green-field deployments and high-rise buildings, but also to larger-scale rollouts as operating costs are less than FTTC and FTTN and cost of deployments are falling. We are still in the early stages of building access networks around the world.

Metro network deployments, taking advantage of carrier-grade Ethernet and metro-Ethernet technologies, are moving ahead to handle large increases in bandwidth consumption in access networks. These network upgrades, in turn, will eventually place a strain on long-haul networks, where excess capacity created by massive overspending in the late-90s is gradually being consumed. NSPs are more than ever committed to deploying next-generation SONET/SDH transport technologies, while 40 Gb/s deployments are not far behind.

These key market trends affected multiple segments of the global telecommunications supply chain in fiscal 2006. System vendors benefited from orders by both telcos and cablecos for next-generation, converged IP networks as well as from major investments by telcos in access networks. Component vendors saw increased demand for optical components that support FTTx and IP-based systems. Some test and measurement equipment vendors attracted the attention of telcos, cablecos, system manufacturers and component vendors, especially ones offering test solutions for IP networking and/or FTTx applications.

Company Overview

EXFO is a recognized test and measurement expert in the global telecommunications industry. The Telecom Division, which represents our main business activity, offers fully integrated and complete test solutions to network service providers (NSPs), cable TV operators, telecom system vendors and component manufacturers in approximately 70 countries. We are the global market leader for portable optical test solutions and a leading supplier of protocol and copper access test solutions to enable triple-play services over converged, IP networks. Our PC/Windows-based modular FTB-200, FTB-400 and IQS-500 test platforms host a wide range of test solutions across optical, physical, data and network layers, while maximizing technology reuse across several market segments. Our Life Sciences and Industrial Division, which leverages several core telecom technologies, offers value-added solutions in the life sciences and high-precision assembly sectors, such as those required for microelectronics and optoelectronics. These solutions are based on advanced spot-curing, fluorescence microscopy and nanopositioning technologies.

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

Over the past several years, we have enhanced our competitive position through the acquisition of two protocol test businesses in order to expand our product offering and address our customers' requirements more completely. In November 2001, we acquired Avantas Networks Corporation (renamed EXFO Protocol Inc.), a supplier of protocol-testing and optical-network performance management equipment for NSPs.

This transaction was highly strategic because it enabled us to combine optical and protocol test modules inside a single field-portable test platform to help our customers increase revenues and reduce operating costs. In October 2002, our wholly-owned subsidiary, EXFO Gnubi, purchased substantially all the assets of *gnubi communications, L.P.*, a supplier of multi-channel telecom and datacom testing solutions for the system manufacturer market. These strategic acquisitions, which were consolidated in Montreal, Canada, in fiscal 2004, enabled us to more than double our addressable market, as we expanded from optical testing to protocol testing applications, and to offer a more complete line of test solutions to our customers.

During the second quarter of 2006, we announced and subsequently completed the acquisition of substantially all the assets of Consultronics Limited. Based in Toronto, Canada, and with operations in Southampton, United Kingdom, and Budapest, Hungary, Consultronics is a leading supplier of test equipment for copper-based broadband access networks. It ranked among the top three vendors in handheld x-digital subscriber line (xDSL) testing with a global market share of 13.4%, according to an industry report from Frost & Sullivan, a leading authority in the fiber-optic test and measurement industry. Consultronics also boasts a rich product portfolio for testing next-generation technologies, such as IPTV (Internet Protocol TV) and VoIP (Voice-over-Internet Protocol), which are critical for network service providers in their deployment of triple-play services (voice, data, video) over optical and copper links in access networks. Other test solutions offered by Consultronics include network monitoring probes for VoIP and legacy telephone networks, Gigabit Ethernet analyzers for remote testing applications, as well as protocol and physical characterization instruments for local copper loops (copper access networks). This acquisition is a strategic initiative to position EXFO as a genuine one-stop shop for broadband access and triple-play testing, since it greatly complements our market leadership in the FTTx market.

This acquisition was settled for a total cash consideration valued at \$19.1 million, or \$18.8 million net of cash acquired. Total consideration included acquisition-related costs of \$1.5 million. The estimated fair value of acquired intangible assets amounts to \$8.7 million. These intangible assets, namely core technology, are amortized on a straight-line basis over their estimated useful life of five years. Consultronics, which is now part of our Telecom Division, contributed about seven months to our consolidated financial results in fiscal 2006.

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

During the first quarter of 2006, we were selected as sole-source supplier by Deutsche Telekom for all its fiber deployment test applications – including FTTx.

Early in the fourth quarter of 2006, Frost & Sullivan released new market-share numbers for calendar 2005. According to the industry report, EXFO was the only company to report significant organic growth in the global fiber-optic test equipment (FOTE) market, moving from 10.3% in 2004 to 11.0% in 2005 for third place overall in the FOTE market.

Based on this report, we estimate that we improved our leadership position in our core installation and maintenance test market segment from 22.2% in 2004 to 23.0% in 2005.

We launched 18 new products in fiscal 2006, including among others the two-slot FTB-200 Compact Platform for multi-layer and multi-medium testing; the handheld AXS-100 OTDR for fiber-to-the-x (FTTx) test applications; SONET/SDH test modules measuring transmission rates up to 10 Gb/s for the FTB-200 Compact Platform; next-generation SONET/SDH test modules for the FTB-400 field-test and IQS-500 R&D/manufacturing platforms; 10 Gigabit Ethernet and Fibre Channel test solutions for our IQS-500 R&D/manufacturing platform; the next-generation CoLT-450P, a handheld IPTV and xDSL test solution for high-speed, copper-based networks; and the PPM-352B-EG Passive Optical Network (PON) Power Meter, optimized for Ethernet PON and Gigabit PON architectures.

In fiscal 2006, in addition to reporting significant growth in sales with \$128.3 million, compared to \$97.2 million in 2005, we renewed with GAAP profitability and reported GAAP net earnings of \$8.1 million, or \$0.12 per diluted share, compared to a net loss of \$1.6 million, or \$0.02 per diluted share in 2005. Also, the fourth quarter of fiscal 2006 marked the seventh consecutive quarter of GAAP profitability. GAAP net earnings in fiscal 2006 included \$4.4 million in amortization of intangible assets, \$1.0 million in stock-based compensation costs, \$604,000 in impairment of long-lived assets and a non-recurring revenue grant of \$1.3 million.

Sales

We sell our products to a diversified customer base in approximately 70 countries through our direct sales force and channel partners like sales representatives and distributors. Most of our sales are denominated in US dollars and Euros.

Over the last three fiscal years, we had one customer that accounted for more than 10% of our global sales with 13.8%, 23.3% and 13.8% in fiscal 2006, 2005 and 2004, respectively. We believe the significant sales concentration in fiscal 2005 was largely due to our leadership position in the FTTx test market, as a large portion of our sales to our top customer was for a series of products related to FTTx deployments. Although this sales concentration significantly decreased in fiscal 2006, as this customer migrated to lower-priced test solutions, we still maintained our leadership position with this customer, while strongly developing other accounts, especially on the international scene. This allowed us to reach a level of concentration closer to our historical pattern, which reflects the improved diversification of our customer base. All in all, our year-over-year sales growth in fiscal 2006 stands at 48.2% excluding major account mentioned above. We expect this sales concentration to further decrease in fiscal 2007, as we continue efforts to diversify our customer base and expand on international markets.

We believe that we have a vast array of products and a diversified customer base, both in terms of industry sector and geographical area, which provides us with reasonable protection against concentration of sales and credit risk.

Cost of Sales

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

Operating Expenses

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

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

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

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

Our Strategy

Strategic Objectives for Fiscal 2006

In our fiscal 2005 Annual Report, we had established three strategic objectives for fiscal 2006. We planned to increase sales through market-share gains, maximize profitability and focus on innovation. The following section reviews our strategic objectives for fiscal 2006 and the results achieved for each of these objectives.

Increase sales through market-share gains

In fiscal 2006, we focused on continued market-share gains to achieve medium- and long-term growth. We posted our second-best sales performance in history, growing sales 31.9% to \$128.3 million in 2006, thus outperforming our revised growth metric of 25%. Given strong sales growth in our two Divisions and the Consultronics acquisition, we raised our growth metric from 15% to 25% midway through the fiscal year. Considering that the telecommunications market increased in the mid single digits in fiscal 2006, this is a clear indication that we gained market share overall. For fiscal 2006, our Telecom Division and our Life Sciences and Industrial Division reported strong sales increases of 34.0% and 22.1%, respectively.

Maximize profitability

Returning to profitability was a top priority for EXFO in fiscal 2006. During the year, we posted earnings from operations of \$8.1 million, or 6.3% of sales, compared to a loss from operations of \$199,000 in 2005. This also compares to our stated goal of earnings from operations of 5% for fiscal 2006. This marks the first year that EXFO generated earnings from operations since fiscal 2001, when the telecommunications industry went through a major downturn. To that point, EXFO had historically been profitable. This significant improvement in earnings from operations is even more impressive considering the strengthening of the Canadian dollar compared to the US dollar (7.3% increase in fiscal 2006 in terms of average rate), and the significant pricing pressure we faced during the year. Also, earnings from operations for fiscal 2006 included additional amortization expenses for intangible assets of \$1.0 million following the

acquisition of Consultronics in January 2006. However, earnings from operations of 2006 included a non-recurring gain of \$703,000, comprised of a revenue grant of \$1.3 million, and an impairment loss for long-lived assets of \$604,000.

Focus on innovation

In fiscal 2006, innovation was a key driver at EXFO. We maintained a significant level of research and development investments and introduced 18 new products to the marketplace. We invested \$19.5 million, or 15.2% of sales, in gross research and development expenses, compared to \$15.9 million, or 16.3% of sales in 2005. Net of research and development tax credits, those expenses stand at 12.0% and 12.5% in fiscal 2006 and 2005, respectively. In fiscal 2006, 37.1% of our sales originated from products that have been on the market for two years or less, which is below our aggressive goal of 40% for fiscal 2006 and the 42.4% level reached in 2005. Our successful FTTx products, moving down to the denominator part of the ratio as they have been on the market for more than two years, still strongly contributed to our sales performance. However, we believe this innovation mark reached in fiscal 2006 is well above the market average.

Strategic Objectives for Fiscal 2007

Global market demand for telecom test and measurement equipment should remain strong in the years to come as most network service providers (NSPs) are increasing capital expenditures to upgrade their networks for converged IP services and triple-play offerings. These market forces create needs for differentiated test solutions to help NSPs accelerate deployment and ensure service quality in their network build-outs. In fiscal 2007, we will strengthen our competitive position by leveraging revenue and earnings from operations, both organically and through strategic and selected acquisitions if stringent criteria are met.

As we remain committed to best practices in financial reporting, once again this year, we are providing our investors with our strategic objectives for fiscal 2007 along with key performance metrics. The strategic objectives for fiscal 2007 are the continuity of those of 2006. As always, we are highly focused on creating value for our shareholders, providing the highest degree of profitable growth. In fiscal 2007, we intend to maintain our long-term focus on profitable growth by increasing sales in both divisions through market-share gains; maximize profitability through proper execution and efficiency of our cost-reduction programs; and focus on innovation to positively position the organization for the long-term growth opportunities that exist in our space.

Increase sales through market-share gains

In fiscal 2007, we intend to continue increasing sales through market-share gains. We were among the last companies to be impacted by the telecommunications downturn in 2001 and the first to recover with significant sales growth of 20.5% in fiscal 2004, 30.3% in 2005 and 31.9% in 2006, including 12 consecutive quarters of growth. This remarkable recovery was accomplished mainly through market-share gains, since our end-markets reportedly experienced negative growth in fiscal 2004 and increased in the mid single digits in 2005 and 2006. On the strength of our past and current research and development investments, as well as our market position in key areas, we intend to maintain a high growth rate in 2007; more specifically, we aim to achieve this by further increasing our market share in telecom testing – especially in the rapidly growing protocol test segment – and by leveraging core technologies in targeted life sciences and industrial markets.

Maximize profitability

In fiscal 2007, we will focus on accelerating our profitability by increasing our earnings from operations, according to our expected sales growth and our strong focus on operations. In the last few years, our bottom-line improved even faster than our top-line with earnings from operations of 6.3% of sales in fiscal 2006, which included a non-recurring gain of 0.5%. We remain confident that our earnings from operations will continue to improve as various factors are expected to come into play namely, higher-margin protocol and copper access revenues; better absorption of fixed costs on higher sales volumes; specific internal initiatives; and currency stability. This assumes no acquisitions.

Focus on innovation

For fiscal 2007, we will keep our focus on innovation by devoting significant efforts to the development of new and differentiated solutions that support long-term growth and profitability as well as deliver added value to our customers. Over the past few years, our new products, with their built-in superior performance and lower cost of goods, contributed significantly to raising our gross margin and earnings from operations, while being able to overcome considerable pricing pressure in our industry. In fiscal 2007, we intend to significantly increase our investment in research and development activities in dollars and slightly as a percentage of sales. We also intend to increasingly take advantage of talent pools around the world to cost-effectively design innovative test solutions. Our numerous but focused research and development initiatives should enable our new products to continue gaining traction with customers and lead to further growth, market-share gains and increased profitability in the coming years.

Key Performance Indicators

As measures to assess the realization of our strategic plan and its objectives, we have set out three consolidated key performance indicators for fiscal 2007. They are summarized as follows:

Strategic objectives for fiscal 2007	Key performance indicators for fiscal 2007
Increase sales through market-share gains	20% sales growth year-over-year
Maximize profitability	7% in earnings from operations
Focus on innovation	35% of sales from new products (on the market two years or less)

Capability to Deliver Results

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

Critical Accounting Policies and Estimates

Management's discussion and analysis of financial conditions and results of operations is based on our consolidated financial statements included elsewhere in this Annual Report. As previously mentioned, they have been prepared in accordance with Canadian GAAP. The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported

amounts of revenues and expenses during the reporting years. On an ongoing basis, we evaluate these estimates and assumptions, including those related to revenue recognition, the allowance for doubtful accounts, the amount of tax credits recoverable, the allowance for excess and obsolete inventories, the useful lives of capital assets, the valuation of long-lived assets, the valuation allowance of future income tax assets, the amount of certain accrued liabilities and deferred revenue as well as stock-based compensation costs. We base our estimates and assumptions on historical experience and on other factors that we believe to be reasonable under the circumstances, the result of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates.

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

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

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

For all sales, we use a binding purchase order as evidence that a sales arrangement exists.

Delivery generally occurs when the product is handed over to a transporter for shipment.

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

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

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

Allowance for doubtful accounts. We estimate collectibility of accounts receivable on an ongoing basis by reviewing balances outstanding over a certain period of time. We determine our allowance for doubtful accounts receivable based on our historical accounts receivable collection experience and on the information that we have about the status of our accounts receivable balances. If the financial conditions of our customers

deteriorate, resulting in an impairment of their ability to make required payments, additional allowance may be required, which could adversely affect our future results.

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

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

Impairment of long-lived assets and goodwill. We assess impairment of goodwill on an annual basis, or more frequently, if events or circumstances 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.

We assess impairment of long-lived assets when events or circumstances indicate that costs may not be recoverable. Impairment exists when the carrying value of an asset, or a group of assets, is greater than the pre-tax undiscounted future cash flows expected to be provided by the asset or the group of assets. The amount of impairment loss, if any, is the excess of the carrying value over the fair value. We assess fair value of long-lived assets based on discounted future cash flows.

Future income taxes. We account for income taxes using the liability method of tax allocation. Under this method, future income tax assets and liabilities are determined based on deductible or taxable temporary differences between financial statement values and tax values of assets and

liabilities, using enacted income tax rates for the years in which the differences are expected to reverse. In assessing the recoverability of our future income tax assets, we consider whether it is more likely than not that some or all of the future income tax assets will not be realized. The ultimate realization of our future income tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences will become deductible. As at August 31, 2006, we had established a full valuation allowance against our future income tax assets. The valuation allowance will be reversed once management will have concluded that realization of future income tax assets is more likely than not.

Stock-based compensation costs. We account for all forms of employee stock-based compensation using the fair value-based method. This method requires that we make estimates about the risk-free interest rate, the expected volatility of our shares and the expected life of the awards.

In January 2005, the Canadian Institute of Chartered Accountants (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. We will adopt these new standards on September 1, 2007. While we are 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.

Results of Operations

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

Consolidated statements of earnings data:	2006	2005	2004	2006	2005	2004
Sales	\$ 128,253	\$ 97,216	\$ 74,630	100.0%	100.0%	100.0%
Cost of sales ⁽¹⁾	57,275	44,059	34,556	44.7	45.3	46.3
Gross margin	70,978	53,157	40,074	55.3	54.7	53.7
Operating expenses						
Selling and administrative	40,298	31,782	25,890	31.4	32.7	34.7
Net research and development	15,404	12,190	12,390	12.0	12.5	16.6
Amortization of property, plant and equipment	3,523	4,256	4,935	2.7	4.4	6.6
Amortization of intangible assets	4,394	4,836	5,080	3.4	5.0	6.8
Impairment of long-lived assets	604	-	620	0.5	-	0.8
Government grants	(1,307)	-	-	(1.0)	-	-
Restructuring and other charges	-	292	1,729	-	0.3	2.3
Total operating expenses	62,916	53,356	50,644	49.0	54.9	67.8
Earnings (loss) from operations	8,062	(199)	(10,570)	6.3	(0.2)	(14.1)
Interest and other income	3,253	2,524	1,438	2.5	2.6	1.9
Foreign exchange loss	(595)	(1,336)	(278)	(0.5)	(1.4)	(0.4)
Earnings (loss) before income taxes	10,720	989	(9,410)	8.3	1.0	(12.6)
Income taxes	2,585	2,623	(986)	2.0	2.7	(1.3)
Net earnings (loss) for the year	\$ 8,135	\$ (1,634)	\$ (8,424)	6.3%	(1.7)%	(11.3)%
Basic and diluted net earnings (loss) per share	\$ 0.12	\$ (0.02)	\$ (0.13)			
Segment information						
Sales:						
Telecom Division	\$ 107,376	\$ 80,120	\$ 58,882	83.7%	82.4%	78.9%
Life Sciences and Industrial Division	20,877	17,096	15,748	16.3	17.6	21.1
	\$ 128,253	\$ 97,216	\$ 74,630	100.0%	100.0%	100.0%
Operating earnings (loss):						
Telecom Division	\$ 6,679	\$ 763	\$ (5,557)	5.2%	0.8%	(7.4)%
Life Sciences and Industrial Division	1,383	(962)	(5,013)	1.1	(1.0)	(6.7)
	\$ 8,062	\$ (199)	\$ (10,570)	6.3%	(0.2)%	(14.1)%
Research and development data:						
Gross research and development	\$ 19,488	\$ 15,878	\$ 15,668	15.2%	16.3%	21.0%
Net research and development	\$ 15,404	\$ 12,190	\$ 12,390	12.0%	12.5%	16.6%
Consolidated balance sheets data:						
Total assets	\$ 219,159	\$ 190,957	\$ 172,791			

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

Sales

Fiscal 2006 vs. 2005

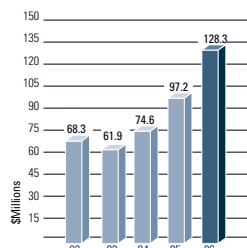
In fiscal 2006, our global sales increased 31.9% to \$128.3 million from \$97.2 million in 2005, with an 84%-16% split in favor of our Telecom Division.

Telecom Division

In fiscal 2006, sales of our Telecom Division increased 34.0% to \$107.4 million from \$80.1 million in 2005.

In fiscal 2006, we leveraged our portfolio of new products and an increased demand for our test solutions, especially in Europe, Middle East and Africa (EMEA) and Asia-Pacific (APAC), to increase our year-over-year sales in our Telecom Division. We also consolidated our dominant FTTx market position in the Americas by enabling a Tier-1 carrier to migrate to less expensive test solutions. Although revenues were down at this customer year-over-year, we maintained our market share through the sales of cost-effective test solutions, such as our handheld AXS-100 OTDR, to help it reduce cost of deployments. In addition, the positive spending environment, as well as the market share we believe that we gained in fiscal 2006 for our optical and protocol products, helped us increase our sales of that division year-over-year. Also, Consultronics contributed about seven months to our Telecom Division, which had a positive impact on our consolidated sales during fiscal 2006. Consultronics' results have been included in our consolidated statements of earnings since the closing of the acquisition on January 26, 2006. Finally, in fiscal 2006, our top customer accounted for 16.5% of our Telecom sales, compared to 28.2% of sales in 2005, reflecting the diversification of our customer base. In fact, excluding sales to our top customer, our sales to this Division would have increased 56.0% in fiscal 2006, compared to 2005.

Although, in the past few years, our market share in the protocol test market has been modest, our protocol-product results in the second half of fiscal 2006 increased substantially year-over-year, making this sector our fastest-growing line of business. We expect continued strong growth in fiscal 2007 based on our solid product offering in next-generation solutions, which are at the basis of the whole trend toward IP convergence. During the second half of fiscal 2006, we reached a key milestone in our protocol-product development program. More specifically, this consisted in the launch of legacy and next-generation SONET/SDH network test modules for our FTB-200, FTB-400 and IQS-500 platforms. These latest product launches, combined with our existing offering for Ethernet (from 10 Mb/s up to 10 Gb/s), Gigabit Ethernet and Fibre Channel test solutions, provide us with an extensive product portfolio to compete against the incumbent players in protocol testing, especially in the network service provider (NSP) market segment, but also to a lesser degree, with system vendors. Among many key differentiators, we believe EXFO now offers the most complete and advanced compact test solutions combining legacy and next-generation SONET/SDH as well as Ethernet test modules for rates up to 10 Gb/s within the same portable platform (i.e., our FTB-400 mainframe and GP-404 module receptacle). In fiscal 2006, sales of our protocol products, which almost doubled compared to 2005, increased to their highest historical levels, representing well above 10% of our optical sales.



Based on these data points and given the much larger addressable market for protocol test solutions, we believe that protocol revenues will increase and grow faster than our optical revenues. On a medium- and long-term basis, we anticipate that revenues from these segments will eventually be equal.

As our newly acquired copper access product line is now better leveraged by EXFO's global sales channels and improved innovation processes, we intend to strengthen our offering in this market segment.

Life Sciences and Industrial Division

In fiscal 2006, sales of our Life Sciences and Industrial Division increased 22.1% to \$20.9 million from \$17.1 million in 2005. The increase in sales in fiscal 2006, compared to 2005, is mainly due to increased sales activities in the curing market as well as market-share gains in the fluorescence illumination market, following our efforts to expand international markets, mainly in Europe and Asia.

Overall, for the two divisions, net accepted orders increased 27.2% to \$129.4 million in fiscal 2006 from \$101.7 million in 2005, for a book-to-bill ratio of 1.01 in fiscal 2006. Our increase of 27.2% in net accepted orders in fiscal 2006, compared to 2005 reflects the impact of the Consultronics acquisition, an increased demand for our test solutions (especially in EMEA and APAC regions), market-share gains in the telecommunications and life sciences markets as well as the improvement in the telecommunications market environment.

Fiscal 2005 vs. 2004

In fiscal 2005, our global sales increased 30.3% to \$97.2 million from \$74.6 million in 2004, with an 82%-18% split in favor of our Telecom Division.

Telecom Division

In fiscal 2005, sales of our Telecom Division increased 36.1% to \$80.1 million from \$58.9 million in 2004. Since the second half of fiscal 2004, we have benefited from an increased demand for our test solutions following the deployment of fiber deeper into access networks (FTTx). In fiscal 2005, we consolidated our leadership position in the FTTx test market by recognizing significant revenue from two leading U.S. carriers deploying fiber in their access networks. Our top customer, who purchased several orders of FTTx test equipment, accounted for 28.2% of telecom sales in fiscal 2005 (17.5% in 2004). In addition, the positive spending environment helped us increase our sales in 2005.

Although sales of our protocol test products increased sequentially each quarter in fiscal 2005 and reached more than 10% of Telecom Division revenues in the fourth quarter of 2005, they still fell below 10% for the whole fiscal year.

Life Sciences and Industrial Division

In fiscal 2005, sales of our Life Sciences and Industrial Division increased 8.6% to \$17.1 million from \$15.7 million in 2004. The increase in sales in fiscal 2005, compared to 2004, is mainly due to market-share gains in the fluorescence illumination market as well as increased sales activities in the curing market.

Geographic distribution

Fiscal 2006 vs. 2005

During fiscal 2006, sales to the Americas, Europe-Middle East-Africa (EMEA) and Asia-Pacific (APAC) accounted for 60%, 25% and 15% of global sales, respectively, compared to 68%, 20% and 12%, respectively in 2005. Although our sales increased in dollars in every geographic area, we made greater progress in EMEA and APAC in fiscal 2006, compared to 2005, where we gained market share in both divisions. Global sales to these two markets increased 66.9% and 66.4%, respectively in fiscal 2006, compared to 2005. In comparison, our sales to the Americas increased 15.6% year-over-year.

The significant increase in sales in the EMEA market is mainly due to improved market penetration by both divisions, following our efforts to develop this market in the last several quarters. Namely, since the second quarter of fiscal 2006, we were selected as sole-source supplier by a Tier-1 network service provider for all its fiber deployment test applications – including FTTx – further increasing our sales to this market year-over-year.

Over the last several quarters, we strengthened our product offering in APAC, specifically by implementing a multi-tiered platform strategy to meet different customer demands and different price points and by expanding our sales and marketing activities in this region. Our increased focus on and interaction with this market, combined with our enhanced capability to win tenders (which may vary in number and importance), contributed to our growth in the APAC region.

In the Americas, sales to our top customer, who is located in the United States, decreased in fiscal 2006, compared to 2005, as it migrated to lower-priced test solutions, thus affecting our sales to the Americas year-over-year. However, we were able to leverage our customer base and increase our sales to this region in fiscal 2006, compared to 2005. Also, Consultronics, whose customers are mainly in the Americas, helped increase our sales to the Americas in fiscal 2006. In fact, excluding sales to our top customer, our sales to the Americas would have increased 35.1% year-over-year, which is quite remarkable considering that our end-markets increased in mid-single digits in 2006.

Fiscal 2005 vs. 2004

During fiscal 2005, sales to the Americas, EMEA and APAC accounted for 68%, 20% and 12% of global sales, respectively, compared to 66%, 18% and 16%, respectively in 2004. Our sales to the Americas, which increased 34% year-over-year, benefited from the recent deployments of fiber deeper in access networks (mainly in the United States). Our sales to EMEA increased more significantly (42%) year-over-year, mainly due to market-share gains in both divisions, following our efforts to develop this important end-market. Finally, our sales to APAC remained flat in dollars year-over-year. A significant portion of our sales to this region of the world are made through price-driven tenders that may vary in number and importance from quarter to quarter. Also, the competitive landscape in this market led to pricing pressure, which prevented us from increasing our sales year-over-year.

Through our two divisions, we sell our products to a broad range of customers, including NSPs, cable TV operators, optical system and component manufacturers, as well as customers in the life sciences and high-precision assembly sectors. In fiscal 2006, our top customer accounted for 13.8% of our total sales, compared to 23.3% in 2005 and 13.8% in 2004. In fiscal 2006, our top three customers accounted for 19.4% of our global sales, compared to 28.4% in fiscal 2005 and 20.8% in 2004. Our significant sales increase, despite the fact that our revenue

from our top customer was significantly reduced, is a good sign that we continued to strengthen our market acceptance, diversify our customer base and reduce our sales concentration with a single customer. This also indicates that our second and third most important customers, who may vary from quarter to quarter, have gained importance as we continue our diversification efforts.

Gross Margin

Gross margin amounted to 55.3%, 54.7% and 53.7% of sales for fiscal 2006, 2005 and 2004, respectively.

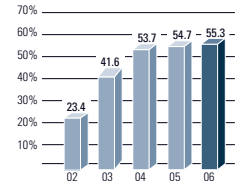
Fiscal 2006 vs. 2005

The increase in our gross margin in fiscal 2006, compared to 2005, can be explained by the following factors. First, we succeeded in increasing the market acceptance of our new products (designed in the last few years) on which we had focused our research and development efforts to simultaneously create lower cost of goods and the most advanced solutions. Second, the significant rise in sales year-over-year resulted in an increase in manufacturing activities, allowing us to better absorb our fixed manufacturing costs. Also, we were able to reduce our cost of goods sold by better leveraging our supplier base. Furthermore, streamlined operations following our consolidation action in fiscal 2005 and continued cost-reduction programs allowed us to further improve our gross margin. However, the shift in the geographic distribution of our sales resulted in more sales, in percentage of total sales, made to the EMEA and APAC markets, where gross margins tend to be lower as most of our sales to these markets are made through distribution channels. In addition, we are facing aggressive pricing pressure worldwide. Furthermore, in fiscal 2006, we incurred one-time charges related to the integration of Consultronics manufacturing activities, which reduced our gross margin year-over-year. Finally, a stronger Canadian dollar, compared to the US dollar, prevented us from further improving our gross margin as some cost of sales items are denominated in Canadian dollars.

On an ongoing basis, we adjust the design of our products and, over the past few years, we experienced higher sales than expected. Consequently, we were able to reuse excess inventories that were written off during the telecom downturn in 2001 and 2002. Excess inventory reuse accounted for approximately \$1.2 million, or 0.9% of sales in fiscal 2006, compared to approximately \$1.6 million, or 1.7% of sales in 2005 and approximately \$600,000, or 0.8% of sales in 2004. Inventory write-offs recorded during the telecom downturn were based on our best estimate at that time.

Fiscal 2005 vs. 2004

The increase in our gross margin in fiscal 2005, compared to 2004, can be explained by the following factors. First, we were able to reduce our cost of goods sold by better leveraging our supplier base and by developing innovative new products with a cost-effective design. Also, the significant rise in sales resulted in an increase in manufacturing activities, allowing us to better absorb our fixed manufacturing costs. Furthermore, streamlined operations following our consolidation actions in fiscal 2004 and 2005 and cost-reduction programs allowed us to further improve our gross margin. In addition, the shift in the geographic distribution of our sales resulted in more sales made to the Americas market, where gross margins tend to be higher because we sell direct to the customers. However, a stronger Canadian dollar, compared to the US



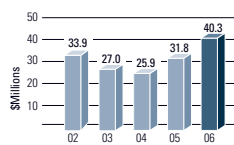
dollar, prevented us, to some extent, from further improving our gross margin as some cost of sales elements are denominated in Canadian dollars. As well, the different customer mix and aggressive pricing pressure observed in fiscal 2005 also prevented us from further improving our gross margin.

Outlook for Fiscal 2007

Considering the expected sales growth in fiscal 2007, the expected increase in sales of protocol products (which tend to generate higher margins), the cost-effective design of our products, our tight control on operating costs as well as the full contribution of Consultronics, whose products have slightly higher margins than our existing ones, we expect our gross margin to improve in 2007 and beyond. However, our gross margin may fluctuate quarter-over-quarter as our sales may fluctuate. Furthermore, our gross margin can be negatively affected by increased competitive pricing pressure, customer concentration and/or consolidation, increased obsolescence costs, shifts in customer and product mix, under-absorption of fixed manufacturing costs and increases in product offerings by other suppliers in our industry. Finally, any further increase in the strength of the Canadian dollar would have a negative impact on our gross margin in fiscal 2007.

Selling and Administrative

Selling and administrative expenses were \$40.3 million, \$31.8 million and \$25.9 million for fiscal 2006, 2005 and 2004, respectively. As a percentage of sales, selling and administrative expenses amounted to 31.4%, 32.7% and 34.7% for fiscal 2006, 2005 and 2004, respectively.



Fiscal 2006 vs. 2005

The increase in our selling and administrative expenses in dollars in fiscal 2006, compared to 2005, is mainly due to our decision to increase our sales activities to better leverage the significant research and development investments of the prior years, which resulted in higher sales and marketing expenditures (including number of employees). In addition, our commission expenses increased year-over-year due to the increase in sales. Furthermore, a stronger Canadian dollar, compared to the US dollar year-over-year, caused our selling and administrative expenses to increase, as more than half of these are incurred in Canadian dollars. Finally, in fiscal 2006, Consultronics contributed about seven months to our selling and administrative expenses, increasing these expenses year-over-year.

Fiscal 2005 vs. 2004

During fiscal 2005, we also significantly increased our sales activities around the world, which resulted in higher sales and marketing expenditures. In addition, increased sales activities, especially in the Americas market, resulted in higher commission expenses year-over-year. Furthermore, as witnessed in fiscal 2006, the strengthening of the Canadian dollar, compared to the US dollar year-over-year, caused our selling and administrative expenses to increase. Also, stock-based compensation costs were higher in fiscal 2005 (\$626,000) than in 2004 (\$265,000), further increasing our selling and administrative expenses year-over-year. Finally, costs to comply with Section 404 of the Sarbanes-Oxley Act further increased our selling and administrative expenses year-over-year.

For both fiscal 2005 and 2006, we were able to mitigate the increase in our selling and administrative expenses as well as reduce these expenses in percentage of sales year-over-year due to tight cost-control measures. In addition, our significant increase in revenues allowed us to reduce our selling and administrative expenses on a percentage basis.

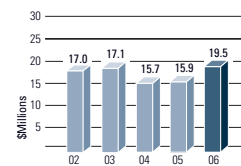
Outlook for Fiscal 2007

For fiscal 2007, we expect our selling and administrative expenses to increase in dollars, while remaining relatively stable as a percentage of sales. In particular, in fiscal 2007, we will have the full impact of the acquisition of Consultronics on our selling and administrative expenses. Also, we expect our commission expenses to increase as sales volume increases. Furthermore, considering our goal of becoming the leading player in the telecom test and measurement space, we will intensify our sales and marketing efforts, both domestic and international, which will also cause our expenses to rise. Finally, any further increase in the strength of the Canadian dollar would also cause our selling and administrative expenses to increase, as more than half of these expenses are incurred in Canadian dollars.

Research and Development

Gross research and development expenses

Gross research and development expenses totaled \$19.5 million, \$15.9 million and \$15.7 million for fiscal 2006, 2005 and 2004, respectively. As a percentage of sales, gross research and development expenses amounted to 15.2%, 16.3% and 21.0% for fiscal 2006, 2005 and 2004, respectively, while net research and development expenses accounted for 12.0%, 12.5% and 16.6% of sales for these respective periods.



Fiscal 2006 vs. 2005

The increase in our gross research and development expenses in dollars in fiscal 2006, compared to 2005, is due to the following reasons. First, in fiscal 2006, Consultronics contributed about seven months to our gross research and development expenses, which caused these expenses to increase year-over-year. In addition, in fiscal 2006, our gross research and development expenses were negatively affected by the increased strength of the Canadian dollar, compared to the US dollar year-over-year. This can be explained by the fact that, following the consolidation of most of our research and development activities in Canada, the majority of our expenses are incurred in Canadian dollars. Finally, mix and timing of research and development projects in fiscal 2006 resulted in more gross research and development expenses during that year compared to 2005 for both divisions.

The decrease in gross research and development expenses as a percentage of sales in fiscal 2006, compared to 2005, is directly related to the significant increase in sales year-over-year.

Fiscal 2005 vs. 2004

As mentioned above, we incur most of our gross research and development expenses in Canadian dollars. Consequently, the significant increase in the strength of the Canadian dollar, compared to the US dollar year-over-year, caused our gross research and development expenses to

increase in fiscal 2005, compared to 2004. However, this increase was mostly offset by the decrease in our gross research and development expenses in our Life Sciences and Industrial Division following the consolidation of this division in Toronto. The decrease in our gross research and development expenses as a percentage of sales in fiscal 2005, compared to 2004, is directly attributable to the significant increase in sales year-over-year while these expenses remained relatively flat.

Tax credits and grants

Tax credits and grants from the Canadian federal and provincial governments for research and development activities were \$4.1 million, \$3.7 million and \$3.3 million for fiscal 2006, 2005 and 2004, respectively. As percentage of gross research and development expenses, tax credits and grants amounted to 21.0%, 23.2% and 20.9% for fiscal 2006, 2005 and 2004, respectively.

Fiscal 2006 vs. 2005

The increase in our tax credits in dollars in fiscal 2006, compared to 2005, is mainly related to the increase in our eligible gross research and development expenses in Canada, since we were also entitled to similar grant programs and tax credits year-over-year. In addition, the increased strength of the Canadian dollar, compared to the US dollar, year-over-year, resulted in higher tax credits since these credits are earned in Canada. However, our tax credits decreased as a percentage of gross research and development expenses. Indeed, following the acquisition of Consultronics, we incurred less gross expenses entitling to tax credits since a part of Consultronics research and development activities were held outside Canada and Quebec. In addition, a mix of research and development projects resulted in a lower proportion of expenses being eligible for tax credits in fiscal 2006, compared to 2005.

Fiscal 2005 vs. 2004

The increase in our tax credits in fiscal 2005, compared to 2004, is mainly related to the increase in our eligible gross research and development expenses in Canada, since we were entitled to similar grant programs and tax credits year-over-year. Following the consolidation of our research and development activities in Canada, we incurred most of our research and development expenses in Canada, where we are entitled to research and development tax credits. In addition, the increased strength of the Canadian dollar, compared to the US dollar, year-over-year, resulted in higher tax credits since these credits are earned in Canada.

We still invested significantly in research and development activities in fiscal 2006 as we firmly believe that innovation and new product introductions are key in gaining market share in the current economic environment and ensuring the long-term growth and profitability of EXFO.

Outlook for Fiscal 2007

For fiscal 2007, we intend to significantly increase our research and development expenses in dollars and slightly in percentage of sales, given our focus on innovation, our desire to gain market share, our goal to exceed customer needs and expectations and the full impact of the acquisition of Consultronics. We also intend to increasingly take advantage of talent pools around the world to cost-effectively design innovative test solutions. Finally, any further increase in the strength of the Canadian dollar would cause our net research and development expenses to increase, as most of these are incurred in Canadian dollars.

Amortization of Property, Plant and Equipment

For fiscal 2006, amortization of property, plant and equipment was \$3.5 million, compared to \$4.3 million in 2005 and \$4.9 million in 2004. The decrease in amortization expenses over the last two fiscal years, despite the increase in the strength of the Canadian dollar compared to the US dollar as well as the acquisition of Consultronics in 2006 is mainly due to the fact that some of our property, plant and equipment became fully amortized over the last three years.

Outlook for Fiscal 2007

For fiscal 2007, despite a potential increase in the strength of the Canadian dollar and the full impact of the acquisition of Consultronics, we expect the amortization of property, plant and equipment to decrease compared to 2006 considering that some of these assets became fully amortized in 2006 or will become fully amortized in 2007.

Amortization of Intangible Assets

In conjunction with the business combinations we completed over the past several years, we recorded intangible assets, primarily consisting of core technology. These intangible assets resulted in amortization expenses of \$4.4 million, \$4.8 million and \$5.1 million for fiscal 2006, 2005 and 2004, respectively. The decrease in amortization expenses in the last two fiscal years, despite the increased strength of the Canadian dollar, compared to the US dollar, and the acquisition of Consultronics in 2006 is mainly due to the fact that some of our core technologies became fully amortized during fiscal 2005 and 2006; namely, those related to the acquisition of EXFO Burleigh and EXFO Photonics Solutions.

Outlook for Fiscal 2007

For fiscal 2007, despite a potential increase in the strength of the Canadian dollar and the full impact of the acquisition of Consultronics, we expect the amortization of intangible assets to approximate \$3.0 million, considering that some core technologies will become fully amortized in 2007; namely, those related to our protocol business. This assumes no acquisitions will be made during this period.

Impairment of Long-Lived Assets

Fiscal 2006

In June 2006, we entered into an agreement to sell our building located in Rochester, NY, along with some equipment, and we 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 \$1.2 million. The sale of these assets was finalized in the fourth quarter of 2006 for the net expected selling price. This amount is included in other receivables in the balance sheet as at August 31, 2006, and will be recovered in the first quarter of fiscal 2007. These assets report to the Life Sciences and Industrial Division. As at August 31, 2005, this building was shown as a long-lived asset held for sale in the balance sheet.

Fiscal 2004

In fiscal 2004, we put one of our buildings located in Quebec City, Canada, up for sale and received, at the beginning of 2005, a formal purchase offer for this building. Based on that offer, we concluded that the building was impaired and we recorded an impairment charge 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, we withdrew the building from the market. This building reports to the Telecom Division.

In May of each of the reporting years, we performed our annual impairment test for goodwill and concluded that it was not impaired. Goodwill will be reviewed for impairment in May 2007, or prior if events or circumstances indicate it might be impaired.

Government Grants

During 1998, we 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\$2.2 million (US\$2.0 million) 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, we have claimed and received the maximum amount of CA\$2.2 million. 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, we deferred in the balance sheet CA\$1.5 million (US\$1.3 million) until we received the final approval by the sponsor of the program related to jobs created. In fiscal 2006, the sponsor of the program granted us with its final approval and we recorded non-recurring revenue of CA\$1.5 million (US\$1.3 million) in the earnings from operations in the statement of earnings for that period.

Restructuring and Other Charges

Fiscal 2004 and 2005

In fiscal 2004, the Board of Directors approved a restructuring plan to consolidate the operations of our Life Sciences and Industrial Division, transferring our Rochester, NY, operations mainly to EXFO Photonic Solutions facilities in Toronto. The consolidation process, which started in August 2004, was completed during fiscal 2005.

Overall, for that process, we incurred \$2.5 million in restructuring and other charges, from which \$2.0 million was recorded in fiscal 2004 and the remaining of \$482,000 was 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 at the Rochester facilities; \$1.3 million 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.

Finally, in fiscal 2005 and 2004, we 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.

Our restructuring plans and cost-reduction measures represented our best efforts to respond to the difficult market conditions of recent years. Although we believe that such restructuring actions were appropriate and delivered the expected results, changes in market or industry conditions may lead us to incur additional restructuring actions and cost-reduction measures in the coming years.

Interest and Other Income

Our interest income mainly resulted from our short-term investments, less interests and bank charges. Interest and other income amounted to \$3.3 million, \$2.5 million and \$1.4 million for fiscal 2006, 2005 and 2004, respectively. The increase in our interest income in fiscal 2006, compared to 2005, is mainly due to the increase in interest rates year-over-year. Also, despite the cash payment of \$18.1 million for the acquisition of Consultronics in January 2006, our average cash position increased in fiscal 2006 due to cash flows from operating activities, which contributed to the further increase in interest revenue year-over-year.

The increase in interest income in fiscal 2005, compared to 2004, is due in part to the increase in our average cash position following our public offering in February 2004, the cash flows from operating activities and the increase in interest rates year-over-year.

Outlook for fiscal 2007

Assuming no acquisitions are made in fiscal 2007, we expect our interest income to remain relatively flat, compared to 2006, assuming stability in interest rates.

Foreign Exchange Loss

Foreign exchange gains and losses are the result of the translation of operating activities denominated in currencies other than the Canadian dollar.

Foreign exchange loss amounted to \$595,000, \$1.3 million and \$278,000 for fiscal 2006, 2005 and 2004, respectively.

The significant exchange losses recorded in fiscal 2005 and 2006 are the result of the significant increase in the value of the Canadian dollar, compared to the US dollar, during these periods. However, the increase in the value of the Canadian dollar was more significant in fiscal 2005, compared to 2006, which resulted in a higher exchange loss in 2005. For instance, the year-end exchange rate was CA\$1.3167 = US\$1.00 in fiscal 2004, compared to CA\$1.1889 = US\$1.00 in 2005, representing an increase of 10.7% year-over-year. This compares to a year-end exchange rate of CA\$1.1066 = US\$1.00 in fiscal 2006, which resulted in an increase of 7.4%, compared to 2005. Also, the average exchange rate was CA\$1.2315 = US\$1.00 in fiscal 2005, compared to CA\$1.1481 = US\$1.00 in 2006. On the other hand, higher levels of activity in fiscal 2006, compared to 2005, contributed to the increase in exchange loss in 2006.

During fiscal 2004, the Canadian dollar value remained relatively stable compared to the US dollar, throughout the year, resulting in a slight exchange loss during that year.

It should be noted that additional foreign exchange rate fluctuations flow through the P&L line items as a significant portion of our operating items are denominated in Canadian dollars, and we report our results in US dollars.

We manage our exposure to currency risks with forward exchange contracts. In addition, some of our Canadian entities' operating activities are denominated in US dollars or other currencies, which further hedges these risks. However, any further increase in the value of the Canadian dollar, compared to the US dollar, would have a negative impact on our operating results.

Income Taxes

Our income tax expenses totaled \$2.6 million in fiscal 2006 and 2005, compared to an income tax recovery of \$986,000 in 2004.

Most of the income tax expenses recorded in fiscal 2005 and 2006 represent 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.

The income tax recovery recorded in fiscal 2004 is mainly due to the \$1.4 million of unusual income tax recovery recorded during that year, offset in part by income taxes payable in some specific tax jurisdictions, mainly at the Canadian federal level. These taxes were also reduced by research and development tax credits recorded against gross research and development expenses. The unusual tax recovery was due to the receipt, during that period, of income taxes paid in previous periods following the reception of a tax assessment.

We record a full valuation allowance against our future income tax assets because it is more likely than not that these assets will not be recovered. The valuation allowance will be reversed once we will have concluded that realization of future income tax assets is more likely than not. Consequently, our income tax rates are distorted compared to statutory rates. Please refer to note 16 of our consolidated financial statements included elsewhere in this Annual Report for a full reconciliation of the income tax provision.

Liquidity and Capital Resources

Cash Requirements and Capital Resources

As at August 31, 2006, cash and short-term investments consisted of \$111.3 million, almost flat compared to 2005, while our working capital was at \$144.0 million. During fiscal 2006, operating activities generated \$12.3 million in cash. In addition, we recorded an unrealized foreign exchange gain of \$7.9 million on our cash and short-term investments. This unrealized foreign exchange gain resulted from the translation, in US dollars, of our Canadian-dollar-denominated cash and short-term investments and was recorded in the cumulative translation adjustment in the balance sheet. On the other hand, we made cash payments of \$18.1 million and \$3.4 million for the acquisition of Consultronics and for the purchase of property, plant and equipment, respectively.

Our short-term investments consist of commercial paper issued by nine (six as of August 31, 2005) quality, high-credit corporations and trusts; therefore, we consider the risk of non-performance of these financial instruments to be remote. For the purposes of managing our cash position, we have established a cash management policy, which we follow and monitor on a regular basis. These short-term investments will be used for working capital and other general corporate purposes, including other potential acquisitions.

We believe that our cash balances and short-term investments will be sufficient to meet our liquidity and capital requirements for the foreseeable future. In addition to these assets, we have unused available lines of credit of \$11.2 million for working capital and other general corporate purposes and an unused line of credit of \$11.2 million for foreign currency exposure related to forward exchange contracts. However, possible operating losses and/or possible investments in or acquisitions of complementary businesses, products or technologies may require additional financing. There can be no assurance that additional debt or equity financing will be available when required or, if available, that it can be secured on satisfactory terms. Our lines of credit bear interest at prime rate.

The following table summarizes our commitments as at August 31, 2006:

Years ending August 31,	2007	2008	2009	2010	2011 and later	Total
Long-term debt	\$ 107,000	\$ 113,000	\$ 118,000	\$ 123,000	\$ -	\$ 461,000
Operating leases	1,748,000	1,223,000	1,177,000	1,200,000	1,540,000	6,888,000
Total commitments	\$ 1,855,000	\$ 1,336,000	\$ 1,295,000	\$ 1,323,000	\$ 1,540,000	\$ 7,349,000



Sources and Uses of Cash

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

Operating Activities

Cash flows provided by operating activities were \$12.3 million in fiscal 2006, compared to \$14.0 million in 2005 and \$751,000 in 2004. Cash flows provided by operating activities in fiscal 2006 were mainly attributable to the net earnings before items not affecting cash of \$16.9 million, less the negative net change in non-cash operating items of \$4.7 million. Our accounts receivable and our inventories increased in fiscal 2006, resulting in negative effects on cash flows of \$2.6 million and \$2.3 million, respectively. The increase in sales year-over-year explains the increase in accounts receivable. Also, larger sales activities in fiscal 2006 resulted in higher inventory levels in 2006 in order to sustain these increased sales activities.

Cash flows provided by operating activities in fiscal 2005 were mainly attributable to the net earnings before items not affecting cash of \$9.1 million and the positive net change in non-cash operating items of \$4.9 million. This net change in non-cash operating items is mainly due to the decrease of \$6.1 million in our income taxes and tax credits recoverable following the recovery, during that year, of income taxes and tax credits from previous periods. On the other hand, our accounts receivable and our inventories increased by \$838,000 and \$699,000, respectively. The increase in our accounts receivable is related to the increase in sales year-over-year. Our inventories slightly increased despite the significant rise in sales due to tight inventory management.

Investing Activities

Cash flows used by investing activities were \$13.2 million in fiscal 2006, compared to \$13.0 million in 2005 and \$29.7 million in 2004.

In fiscal 2006, we made cash payments of \$18.1 million and \$3.4 million for the acquisition of Consultronics and the purchase of property, plant and equipment, respectively. In order to finance a part of these payments, we disposed of \$8.2 million worth of short-term investments. We paid the remaining with cash flows from operating activities and cash on-hand.

In fiscal 2005, we acquired \$11.5 million worth of short-term investments with cash flows from operating activities and cash on-hand and paid \$1.5 million for the purchase of property, plant and equipment as well as intangible assets.

Forward Exchange Contracts

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

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

As at August 31, 2006, we held forward exchange contracts to sell US dollars at various forward rates, which are summarized as follows:

Expiry dates	Contractual amounts	Weighted average contractual forward rates
September 2006 to August 2007	\$ 37,000,000	1.1676
September 2007 to June 2009	26,800,000	1.1261

As at August 31, 2006, the fair value of our forward exchange contracts, which represents the difference between their contractual amounts and their current trading value, amounted to an unrecognized gain of \$5.5 million (\$2.9 million as at August 31, 2005).

Contingency

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

In June 2003, a committee of the EXFO'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 EXFO and of the individual defendants for the conduct alleged in the action to be wrongful in the amended complaint. EXFO would agree to undertake other responsibilities under the settlement, including agreeing to assign away, not assert, or release certain potential claims EXFO may have against its underwriters. Any direct financial impact of the proposed settlement is expected to be borne by EXFO'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. 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 EXFO'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, EXFO 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.

Share Capital and Stock-Based Compensation Plans

Share Capital

As at November 1, 2006, EXFO had 37,143,000 multiple voting shares outstanding, entitling to 10 votes each and 31,632,857 subordinate voting shares outstanding. The multiple voting shares and the subordinate voting shares are unlimited as to number and without par value.

Long-Term Incentive Plan and Deferred Share Unit Plan

The aggregate number of subordinate voting shares covered by stock options, restricted share units (RSUs) and deferred share units (DSUs) granted under the Long-Term Incentive Plan and the Deferred Share Unit Plan was 2,882,369 as at November 1, 2006. The maximum number of subordinate voting shares issuable under these two plans cannot exceed 6,306,153 shares. The following tables summarize information about stock options, RSUs and DSUs granted to the members of the Board of Directors and to Management and Corporate Officers of the company and its subsidiaries as at November 1, 2006:

Stock Options	Number	% of issued and outstanding	Weighted average exercise price
Chairman of the Board, President and CEO (one individual)	179,642	7%	\$ 9.05
Board of Directors (five individuals)	194,375	8%	\$ 6.23
Management and Corporate Officers (eight individuals)	313,836	13%	\$ 15.42
	687,853	28%	\$ 11.16

Restricted Share Units (RSUs)	Number	% of issued and outstanding
Chairman of the Board, President and CEO (one individual)	59,913	14%
Management and Corporate Officers (ten individuals)	255,616	60%
	315,529	74%

Deferred Share Units (DSUs)	Number	% of issued and outstanding
Board of Directors (five individuals)	43,290	100%

Off-Balance Sheet Arrangements

As at August 31, 2006, our off-balance sheet arrangements consisted of letters of guarantee and forward exchange contracts. These off-balance sheet arrangements are respectively described in detail in note 12 and 18 to our consolidated financial statements, included elsewhere in this Annual Report.

Variable Interest Entity

As of August 31, 2006, we did not have interests in any variable interest entities.

Risks and Uncertainties

Over the past few years, we have managed our business in a difficult environment; focused on research and development programs for new and innovative products aimed at expected growth pockets in our sector; continued the development of our domestic and international markets; and made strategic acquisitions. However, we operate in a highly

competitive sector that is in constant evolution and, as a result, we encounter various risks and uncertainties that must be given appropriate consideration in our strategic management policies.

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

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

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

Also, while strategic acquisitions, like those we have made in the past, the recent acquisition of Consultronics and possibly others in the future, are essential to our long-term growth, they also expose us to certain risks and uncertainties related to the rapid and effective integration of these businesses as well as their products, technologies and personnel. Finally, integration requires the dedication of management resources, which may detract their attention from our day-to-day business and operations.

The economic environment of our industry could also result in some of our customers experiencing difficulties and, consequently, this could have a negative effect on our results especially in terms of future sales and recoverability of accounts receivable. However, the sectorial and

geographic diversity of our customer base provides us with a reasonable level of protection in this area. Finally, other financial instruments, which potentially subject us to credit risks, consist mainly of cash, short-term investments and forward exchange contracts. Our short-term investments consist of debt instruments issued by nine quality high-credit corporations and trusts. Our cash and forward exchange contracts are held with or issued by quality high-credit financial institutions; therefore, we consider the risk of non-performance on these instruments to be remote.

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

Quarterly Summary Financial Information (unaudited)

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

	1st quarter	2nd quarter	3rd quarter	4th quarter	Years ended August 31,
2006					
Sales	\$ 27,044	\$ 30,066	\$ 35,410	\$ 35,733	\$ 128,253
Cost of sales	\$ 12,064	\$ 13,440	\$ 15,453	\$ 16,318	\$ 57,275
Gross margin	\$ 14,980	\$ 16,626	\$ 19,957	\$ 19,415	\$ 70,978
Earnings from operations	\$ 683	\$ 1,408	\$ 3,608	\$ 2,363	\$ 8,062
Net earnings	\$ 355	\$ 1,366	\$ 3,504	\$ 2,910	\$ 8,135
Basic and diluted net earnings per share	\$ 0.01	\$ 0.02	\$ 0.05	\$ 0.04	\$ 0.12
2005					
Sales	\$ 21,597	\$ 23,135	\$ 26,180	\$ 26,304	\$ 97,216
Cost of sales	\$ 10,225	\$ 10,431	\$ 11,478	\$ 11,925	\$ 44,059
Gross margin	\$ 11,372	\$ 12,704	\$ 14,702	\$ 14,379	\$ 53,157
Earnings (loss) from operations	\$ (1,337)	\$ (182)	\$ 509	\$ 811	\$ (199)
Net earnings (loss)	\$ (2,373)	\$ 9	\$ 276	\$ 454	\$ (1,634)
Basic and diluted net earnings (loss) per share	\$ (0.03)	\$ —	\$ —	\$ 0.01	\$ (0.02)
2004					
Sales	\$ 15,962	\$ 16,880	\$ 20,456	\$ 21,332	\$ 74,630
Cost of sales	\$ 7,815	\$ 7,528	\$ 9,637	\$ 9,576	\$ 34,556
Gross margin	\$ 8,147	\$ 9,352	\$ 10,819	\$ 11,756	\$ 40,074
Loss from operations	\$ (3,145)	\$ (3,485)	\$ (1,888)	\$ (2,052)	\$ (10,570)
Net loss	\$ (2,008)	\$ (2,885)	\$ (1,188)	\$ (2,343)	\$ (8,424)
Basic and diluted net loss per share ⁽¹⁾	\$ (0.03)	\$ (0.04)	\$ (0.02)	\$ (0.03)	\$ (0.13)

⁽¹⁾ Per share data is calculated independently for each of the quarters presented. Therefore, the sum of this quarterly information does not equal the corresponding annual information.

Fourth-Quarter Results

In the fourth quarter of fiscal 2006, sales were \$35.7 million, compared to \$26.3 million for the same period last year. In fiscal 2006, we leveraged our portfolio of new products and an increased demand for our test solutions especially in Europe, Middle East and Africa (EMEA) and Asia-Pacific (APAC) to increase our year-over-year sales. We also consolidated our dominant FTTx market position in the Americas by enabling a Tier-1 carrier to migrate to less expensive test solutions. In addition, the positive spending environment, as well as the market share we believe that we gained in fiscal 2006 for our optical and protocol products, helped us increase our sales year-over-year. In fact, during the second half of fiscal 2006, sales of our protocol products increased substantially year-over-year, making this sector our fastest-growing line of business in 2006. Furthermore, Consultronics, which we acquired in January 2006, contributed to our increase in sales during the second half of fiscal 2006, compared to the same period last year. Finally, we gained market share in the fluorescence illumination market in fiscal 2006 and we increased our sales activities in the curing market year-over-year.

In the fourth quarter of fiscal 2006, gross margin amounted to 54.3% of global sales, compared to 54.7% for the same period last year. Despite significant increase in sales year-over-year, gross margin decreased 40 basis points due to increased pricing pressure in fiscal 2006; one-time charges related to the integration of Consultronics manufacturing activities incurred in the fourth quarter of 2006; a different customer mix; and the increased strength of the Canadian dollar, compared to the US dollar, year-over-year.

In the fourth quarter of fiscal 2006, earnings from operations were \$2.4 million, compared to \$811,000 for the same period last year. Net earnings amounted to \$2.9 million, or \$0.04 per diluted share, in the fourth quarter of fiscal 2006, compared to \$454,000, or \$0.01 per diluted share, for the same period last year.