

EXFO Electro-Optical Engineering Inc.

Interim Consolidated Balance Sheet

(in thousands of US dollars)

	<u>As at November 30, 2006</u>	<u>As at August 31, 2006</u>
	(unaudited)	
Assets		
Current assets		
Cash	\$ 7,741	\$ 6,853
Short-term investments	103,573	104,437
Accounts receivable		
Trade, less allowance for doubtful accounts of \$451 ((\$451 as at August 31, 2006))	22,910	20,891
Other	1,815	2,792
Income taxes and tax credits recoverable	2,149	2,201
Inventories (note 3)	23,496	24,623
Prepaid expenses	1,358	1,404
	163,042	163,201
Income taxes and tax credits recoverable	859	476
Property, plant and equipment	16,789	17,392
Intangible assets	9,793	10,948
Goodwill	26,317	27,142
	\$ 216,800	\$ 219,159
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (note 4)	\$ 16,798	\$ 17,337
Deferred revenue	1,877	1,772
Current portion of long-term debt	105	107
	18,780	19,216
Deferred revenue	2,881	2,632
Government grants	678	723
Long-term debt	317	354
	22,656	22,925
Contingency (note 5)		
Shareholders' Equity		
Share capital	149,089	148,921
Contributed surplus	4,011	3,776
Retained earnings (note 6)	3,533	—
Cumulative translation adjustment	37,511	43,537
	194,144	196,234
	\$ 216,800	\$ 219,159

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

EXFO Electro-Optical Engineering Inc.

Interim Unaudited Consolidated Statements of Earnings

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

	Three months ended November 30,	
	2006	2005
Sales	\$ 35,547	\$ 27,044
Cost of sales ^(1,2)	15,229	12,064
Gross margin	20,318	14,980
Operating expenses		
Selling and administrative ⁽¹⁾	11,542	9,058
Net research and development ⁽¹⁾ (note 7)	4,354	3,122
Amortization of property, plant and equipment	781	896
Amortization of intangible assets	882	1,221
Total operating expenses	17,559	14,297
Earnings from operations	2,759	683
Interest income	1,172	555
Foreign exchange gain (loss)	383	(318)
Earnings before income taxes	4,314	920
Income taxes (note 8)	781	565
Net earnings for the period	\$ 3,533	\$ 355
Basic and diluted net earnings per share	\$ 0.05	\$ 0.01
Basic weighted average number of shares outstanding (000's)	68,775	68,571
Diluted weighted average number of shares outstanding (000's) (note 9)	69,385	69,058
(1) Stock-based compensation costs included in:		
Cost of sales	\$ 34	\$ 42
Selling and administrative	197	181
Net research and development	54	51
	\$ 285	\$ 274

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

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

EXFO Electro-Optical Engineering Inc.
Interim Unaudited Consolidated Statements of Retained Earnings (Deficit)
and Contributed Surplus

(in thousands of US dollars)

Retained earnings (Deficit)

	Three months ended November 30,	
	2006	2005
Balance – Beginning of period (note 6)	\$ –	\$ (381,846)
Add		
Net earnings for the period	3,533	355
Balance – End of period	\$ 3,533	\$ (381,491)

Contributed surplus

	Three months ended November 30,	
	2006	2005
Balance – Beginning of period	\$ 3,776	\$ 2,949
Add (deduct)		
Stock-based compensation costs	282	274
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	(47)	–
Balance – End of period	\$ 4,011	\$ 3,223

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

EXFO Electro-Optical Engineering Inc.
Interim Unaudited Consolidated Statements of Cash Flows

(in thousands of US dollars)

	Three months ended November 30,	
	2006	2005
Cash flows from operating activities		
Net earnings for the period	\$ 3,533	\$ 355
Add (deduct) items not affecting cash		
Discount on short-term investments	414	171
Stock-based compensation costs	285	274
Amortization	1,663	2,117
Deferred revenue	494	293
Government grants	(22)	–
	6,367	3,210
Change in non-cash operating items		
Accounts receivable	(3,035)	(3,193)
Income taxes and tax credits	(418)	(288)
Inventories	381	(1,133)
Prepaid expenses	2	(116)
Accounts payable and accrued liabilities	36	2,418
	3,333	898
Cash flows from investing activities		
Additions to short-term investments	(194,266)	(131,375)
Proceeds from disposal and maturity of short-term investments	191,503	132,399
Additions to property, plant and equipment and intangible assets	(811)	(635)
Net proceeds from disposal of property, plant and equipment	1,228	–
	(2,346)	389
Cash flows from financing activities		
Repayment of long-term debt	(27)	(32)
Exercise of stock options	121	19
	94	(13)
Effect of foreign exchange rate changes on cash	(193)	94
Change in cash	888	1,368
Cash – Beginning of period	6,853	7,119
Cash – End of period	\$ 7,741	\$ 8,487

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

EXFO Electro-Optical Engineering Inc.

Notes to Unaudited Interim Consolidated Financial Statements

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

1. Interim financial information

The financial information as at November 30, 2006 and for the three-month periods ended November 30, 2005 and 2006 is unaudited. In the opinion of management, all adjustments necessary to present fairly the results of these periods in accordance with generally accepted accounting principles (GAAP) in Canada have been included. The adjustments made were of a normal and recurring nature. Interim results may not necessarily be indicative of results anticipated for the entire year.

These interim consolidated financial statements are prepared in accordance with generally accepted accounting principles in Canada and use the same accounting policies and methods used in the preparation of the company's most recent annual consolidated financial statements. However, all disclosures required for annual financial statements have not been included in these financial statements. Consequently, these interim consolidated financial statements should be read in conjunction with the company's most recent annual consolidated financial statements.

2. New accounting standards and pronouncements

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. The company will adopt these new standards on September 1, 2007. Although the final adjustments will be based on the financial instruments that the company will be a party to on the adoption date, the company is currently assessing the effects of these new standards and impacts consistent with the adjustments described under note 20 item b) of the company's most recent annual consolidated financial statements are expected.

3. Inventories

	As at November 30, 2006	As at August 31, 2006
	(unaudited)	
Raw materials	\$ 12,758	\$ 14,353
Work in progress	1,310	1,043
Finished goods	9,428	9,227
	\$ 23,496	\$ 24,623

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Notes to Unaudited Interim Consolidated Financial Statements

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

4. Accounts payable and accrued liabilities

	As at November 30, 2006	As at August 31, 2006
	(unaudited)	
Trade	\$ 9,027	\$ 7,487
Salaries and social benefits	4,847	5,991
Warranty	855	1,006
Commissions	751	835
Restructuring charges	314	691
Other	1,004	1,327
	\$ 16,798	\$ 17,337

Changes in the warranty provision are as follows:

	Three months ended November 30,	
	2006	2005
	(unaudited)	
Balance - Beginning of period	\$ 1,006	\$ 725
Provision	270	249
Settlements	(421)	(158)
Balance - End of period	\$ 855	\$ 816

Changes in the restructuring charges payable are as follows:

	Balance as at August 31, 2006	Payments	Balance as at November 30, 2006
		(unaudited)	(unaudited)
<i>Fiscal 2006 plan</i>			
Severance expenses	\$ 631	\$ (357)	\$ 274
<i>Fiscal 2003 plan</i>			
Exited leased facilities	60	(20)	40
Total for all plans	\$ 691	\$ (377)	\$ 314

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Notes to Unaudited Interim Consolidated Financial Statements

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

5. Contingency

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

On April 19, 2002, the plaintiffs filed an amended complaint containing master allegations against all of the underwriters in all of the 310 cases included in this class action and also filed an amended complaint containing allegations specific to four of the company's underwriters, the company and two of its executive officers. In addition to the allegations mentioned above, the amended complaint alleges that the underwriters (i) used their analysts to manipulate the stock market; and (ii) implemented schemes that allowed issuer insiders to sell their shares rapidly after an initial public offering and benefit from high market prices. As concerns the company and its two executive officers in particular, the amended complaint alleges that (i) the company's registration statement was materially false and misleading because it failed to disclose the additional commissions and compensation to be received by underwriters; (ii) the two named executive officers learned of or recklessly disregarded the alleged misconduct of the underwriters; (iii) the two named executive officers had motive and opportunity to engage in alleged wrongful conduct due to personal holdings of the company's stock and the fact that an alleged artificially inflated stock price could be used as currency for acquisitions; and (iv) the two named executive officers, by virtue of their positions with the company, controlled the company and the contents of the registration statement and had the ability to prevent its issuance or cause it to be corrected. The plaintiffs in this suit seek an unspecified amount for damages suffered.

In July 2002, the issuers filed a motion to dismiss the plaintiffs' amended complaint and 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.

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The plaintiffs have continued to litigate against the underwriter defendants. The district court has directed that the litigation proceed within a number of "focus cases" rather than in all of the 310 cases that have been consolidated. The company's case is not one of these focus cases. On October 13, 2004, the district court certified the focus cases as class actions. The underwriter defendants appealed that ruling, and on December 5, 2006, the Court of Appeals for the Second Circuit reversed the district court's class certification decision. Because the company's settlement with the plaintiffs involves the certification of the case as a class action as part of the approval process, the impact of the Court of Appeals' ruling on the company's settlement is unclear.

If the court determines that the settlement is fair to the class members, and that the settlement classes can be certified, 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 interim consolidated financial statements as at November 30, 2006.

6. Elimination of deficit

On August 31, 2006, upon the approval of the Board of Directors on that date, the company eliminated its deficit of \$373,711,000 against its share capital.

7. Net research and development expenses

	Three months ended November 30,	
	2006	2005
	(unaudited)	
Gross research and development expenses	\$ 5,509	\$ 4,006
Research and development tax credits and grants	(1,155)	(884)
	\$ 4,354	\$ 3,122

8. Income taxes

During the three months ended November 30, 2005 and 2006, the company recorded income taxes of \$565,000 and \$781,000, respectively. Most of these income taxes 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 company records a full valuation allowance against its future income tax assets because it is more likely than not that these assets will not be recovered. This caused its income tax rate to be distorted in relation to its pre-tax accounting income.

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Notes to Unaudited Interim Consolidated Financial Statements

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

9. 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:

	Three months ended November 30,	
	2006	2005
	(unaudited)	
Basic weighted average number of shares outstanding (000's)	68,775	68,571
Plus dilutive effect of:		
Stock options (000's)	435	426
Restricted share units (000's)	132	37
Deferred share units (000's)	43	24
Diluted weighted average number of shares outstanding (000's)	69,385	69,058
Stock awards excluded from the calculation of the diluted weighted average number of shares because their exercise price was greater than the average market price of the common shares (000's)	1,444	1,803

10. 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 following tables set out information by segment:

	Three months ended November 30, 2006		
	Telecom Division	Life Sciences and Industrial Division	Total
	(unaudited)		
Sales	\$ 29,522	\$ 6,025	\$ 35,547
Earnings from operations	\$ 1,803	\$ 956	\$ 2,759
Unallocated items			
Interest income			1,172
Foreign exchange gain			383
Earnings before income taxes			4,314
Income taxes			781
Net earnings for the period			\$ 3,533

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

	Three months ended November 30, 2005		
	Telecom Division	Life Sciences and Industrial Division	Total
	(unaudited)		
Sales	\$ 22,076	\$ 4,968	\$ 27,044
Earnings from operations	\$ 488	\$ 195	\$ 683
Unallocated items			
Interest income			555
Foreign exchange loss			(318)
Earnings before income taxes			920
Income taxes			565
Net earnings for the period			\$ 355

Total assets by reportable segment are detailed as follows:

	As at November 30, 2006	As at August 31, 2006
	(unaudited)	
Total assets		
Telecom Division	\$ 91,964	\$ 93,853
Life Sciences and Industrial Division	10,514	11,339
Unallocated assets	114,322	113,967
	\$ 216,800	\$ 219,159

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

11. Stock-based compensation

On September 1, 2003, the company adopted the amendment made to the CICA Handbook section 3870, "Stock-Based Compensation and Other Stock-Based Payments". Accordingly, employee stock awards granted on or after September 1, 2003, were accounted for using the fair value-based method. However, if the fair value-based method had been applied to employee stock awards granted prior to September 1, 2003, and outstanding as at November 30, 2005, the pro forma net earnings per share would have been lower than the net earnings per share for the three months ended November 30, 2005, by \$0.01.

12. Differences between Canadian and U.S. GAAP

These interim consolidated financial statements are prepared in accordance with Canadian GAAP and significant differences in measurement and disclosure from U.S. GAAP are set out in note 20 to the company's most recent annual consolidated financial statements. This note describes significant changes occurring since the most recent annual consolidated financial statements and provides a quantitative analysis of all significant differences. All disclosures required in annual financial statements under U.S. GAAP and Regulation S-X of the Securities and Exchange Commission in the United States have not been provided in these interim consolidated financial statements.

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Notes to Unaudited Interim Consolidated Financial Statements

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Comprehensive income (loss) under U.S. GAAP

Comprehensive income (loss) under U.S. GAAP is as follows:

	Three months ended November 30,	
	2006	2005
	(unaudited)	
Net earnings for the period in accordance with Canadian GAAP and U.S. GAAP	\$ 3,533	\$ 355
Other comprehensive income (loss)		
Foreign currency translation adjustment	(5,832)	3,048
Unrealized gains (losses) on forward exchange contracts	(2,075)	1,097
Reclassification of realized gains on forward exchange contracts in net earnings	(736)	(435)
Comprehensive income (loss) under U.S. GAAP	\$ (5,110)	\$ 4,065

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:

	As at November 30, 2006	As at August 31, 2006
	(unaudited)	
Shareholders' equity in accordance with Canadian GAAP	\$ 194,144	\$ 196,234
Forward exchange contracts	2,640	5,451
Goodwill	(11,750)	(11,908)
Shareholders' equity in accordance with U.S. GAAP	\$ 185,034	\$ 189,777

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Notes to Unaudited Interim Consolidated Financial Statements

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

The following table summarizes the shareholders' equity activity under U.S. GAAP since August 31, 2006:

	<u>Share capital</u>	<u>Contributed surplus</u>	<u>Deficit</u>	<u>Deferred stock-based compensation costs</u>	<u>Other capital</u>	<u>Accumulated other comprehensive income</u>	<u>Shareholders' equity</u>
	(unaudited)	(unaudited)	(unaudited)	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Balance as at August 31, 2006	\$ 598,421	\$ 1,537	\$ (458,944)	\$ (1,371)	\$ 5,504	\$ 44,630	\$ 189,777
Net earnings for the period	-	-	3,533	-	-	-	3,533
Stock-based compensation costs	-	-	-	(347)	593	-	246
Foreign currency translation adjustment	-	-	-	-	-	(5,832)	(5,832)
Unrealized losses on forward exchange contracts	-	-	-	-	-	(2,811)	(2,811)
Exercise of stock options	121	-	-	-	-	-	121
Reclassification of stock-based compensation costs upon exercise of stock awards	47	-	-	-	(47)	-	-
Balance as at November 30, 2006	<u>\$ 598,589</u>	<u>\$ 1,537</u>	<u>\$ (455,411)</u>	<u>\$ (1,718)</u>	<u>\$ 6,050</u>	<u>\$ 35,987</u>	<u>\$ 185,034</u>

Accumulated other comprehensive income is comprised of the following:

	<u>As at November 30, 2006</u>	<u>As at August 31, 2006</u>
	(unaudited)	
Foreign currency translation adjustment		
Current period	\$ (5,832)	\$ 12,322
Cumulative effect of prior periods	<u>39,179</u>	<u>26,857</u>
	33,347	39,179
Unrealized gains on forward exchange contracts		
Current period	(2,811)	2,514
Cumulative effect of prior periods	<u>5,451</u>	<u>2,937</u>
	<u>2,640</u>	<u>5,451</u>
	<u>\$ 35,987</u>	<u>\$ 44,630</u>

Research and development tax credits

Under Canadian GAAP, all research and development tax credits are recorded as a reduction of gross research and development expenses. Under U.S. GAAP, tax credits that are refundable against taxable income are recorded in the income taxes. These tax credits amounted to \$536,000 and \$771,000 for the three months ended November 30, 2005 and 2006, respectively. This difference has no impact on the net earnings and the net earnings per share for the reporting periods.

EXFO Electro-Optical Engineering Inc.

Notes to Unaudited Interim Consolidated Financial Statements

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

Statements of cash flows

For the three months ended November 30, 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.

New accounting standards and pronouncements

In May 2005, the Financial Accounting Standard Board (FASB) issued Statement of Financial Accounting Standard (SFAS) 154, "Accounting Changes and Error Corrections – a replacement of APB Opinion No. 20 and FASB Statement No. 3". This statement replaces APB Opinion No. 20, "Accounting Changes", and FASB Statement No. 3, "Reporting Accounting Changes in Interim Financial Statements", and changes the requirements for the accounting 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 error corrections in fiscal years beginning after December 15, 2005.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), "Accounting for 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 is currently assessing the impact its adoption will have on its financial statements.

On September 15, 2006, the FASB issued SFAS 157, "Fair Value Measurements", which establishes a framework for measuring fair value in GAAP, and is applicable to other accounting pronouncements in which fair value is considered to be the relevant measurement attribute. SFAS 157 also expands disclosures about fair value measurement. This statement is effective for fiscal years beginning after November 15, 2007. The company will adopt this statement on September 1, 2008 and has not yet assessed the impact its adoption will have on its financial statements.