

# EXFO Electro-Optical Engineering Inc.

## Interim Consolidated Balance Sheet

(in thousands of US dollars)

	<b>As at November 30, 2008</b>	<b>As at August 31, 2008</b>
	<u>(unaudited)</u>	
<b>Assets</b>		
<b>Current assets</b>		
Cash	\$ 5,441	\$ 5,914
Short-term investments	65,915	81,626
Accounts receivable		
Trade (note 4)	33,018	31,473
Other	4,859	4,753
Income taxes and tax credits recoverable	3,541	4,836
Inventories (note 5)	30,125	34,880
Prepaid expenses	1,993	1,774
Future income taxes	8,895	9,140
	<u>153,787</u>	<u>174,396</u>
<b>Tax credits recoverable</b>	19,264	20,657
<b>Property, plant and equipment</b>	17,475	19,875
<b>Intangible assets</b>	16,121	19,945
<b>Goodwill</b>	36,634	42,653
<b>Future income taxes</b>	14,297	15,540
	<u>\$ 257,578</u>	<u>\$ 293,066</u>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities (note 6)	\$ 24,440	\$ 24,713
Deferred revenue	4,560	5,079
	<u>29,000</u>	<u>29,792</u>
<b>Deferred revenue</b>	3,388	3,759
<b>Forward exchange contracts (note 4)</b>	2,275	—
	<u>34,663</u>	<u>33,551</u>
<b>Contingency (note 7)</b>		
<b>Shareholders' equity</b>		
Share capital (note 8)	141,991	142,786
Contributed surplus	5,921	5,226
Retained earnings	65,781	60,494
Accumulated other comprehensive income	9,222	51,009
	<u>222,915</u>	<u>259,515</u>
	<u>\$ 257,578</u>	<u>\$ 293,066</u>

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,	
	2008	2007
<b>Sales</b>	\$ 46,363	\$ 40,985
<b>Cost of sales</b> (note 5) <sup>(1,2)</sup>	17,480	18,144
<b>Gross margin</b>	28,883	22,841
<b>Operating expenses</b>		
Selling and administrative <sup>(1)</sup>	17,091	14,817
Net research and development <sup>(1)</sup> (note 9)	7,221	6,012
Amortization of property, plant and equipment	1,159	976
Amortization of intangible assets	1,319	734
<b>Total operating expenses</b>	26,790	22,539
<b>Earnings from operations</b>	2,093	302
Interest income	466	1,483
Foreign exchange gain (loss)	4,568	(616)
<b>Earnings before income taxes</b>	7,127	1,169
<b>Income taxes</b> (note 10)		
Current	(61)	1,181
Future	1,901	81
	1,840	1,262
<b>Net earnings (loss) for the period</b>	\$ 5,287	\$ (93)
<b>Basic and diluted net earnings (loss) per share</b>	\$ 0.08	\$ (0.00)
<b>Basic weighted average number of shares outstanding (000's)</b>	67,340	69,000
<b>Diluted weighted average number of shares outstanding (000's)</b> (note 11)	67,717	69,672
<b>(1) Stock-based compensation costs included in:</b>		
Cost of sales	\$ 29	\$ 37
Selling and administrative	201	197
Net research and development	92	67
	\$ 322	\$ 301

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

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**EXFO Electro-Optical Engineering Inc.**  
**Interim Unaudited Consolidated Statements of Comprehensive Income (Loss)**  
**and Accumulated Other Comprehensive Income**

(in thousands of US dollars)

**Comprehensive income (loss)**

	<b>Three months ended November 30,</b>	
	<b>2008</b>	<b>2007</b>
Net earnings (loss) for the period	\$ 5,287	\$ (93)
Foreign currency translation adjustment	(36,933)	13,906
Changes in unrealized losses on short-term investments	22	39
Unrealized gains (losses) on forward exchange contracts	(6,929)	1,948
Reclassification of realized gains on forward exchange contracts in net earnings (loss)	(137)	(759)
Future income tax effect of the above items	2,190	(380)
Comprehensive income (loss)	\$ (36,500)	\$ 14,661

**Accumulated other comprehensive income**

	<b>Three months ended November 30,</b>	
	<b>2008</b>	<b>2007</b>
Foreign currency translation adjustment		
Cumulative effect of prior periods	\$ 51,129	\$ 53,418
Current period	(36,933)	13,906
	14,196	67,324
Unrealized gains (losses) on forward exchange contracts		
Cumulative effect of prior periods	(96)	1,948
Current period, net of realized gains and future income taxes	(4,876)	809
	(4,972)	2,757
Unrealized losses on short-term investments		
Cumulative effect of prior periods	(24)	(55)
Current period, net of future income taxes	22	39
	(2)	(16)
Accumulated other comprehensive income	\$ 9,222	\$ 70,065

Total retained earnings and accumulated other comprehensive income amounted to \$112,263 and \$75,003 as at November 30, 2007 and 2008, respectively.

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

# EXFO Electro-Optical Engineering Inc.

## Interim Unaudited Consolidated Statements of Retained Earnings and Contributed Surplus

(in thousands of US dollars)

### Retained earnings

	Three months ended November 30,	
	2008	2007
<b>Balance – Beginning of the period</b>	\$ 60,494	\$ 42,330
<b>Add (deduct)</b>		
Net earnings (loss) for the period	5,287	(93)
Premium on redemption of share capital (note 8)	–	(39)
<b>Balance – End of the period</b>	<u>\$ 65,781</u>	<u>\$ 42,198</u>

### Contributed surplus

	Three months ended November 30,	
	2008	2007
<b>Balance – Beginning of the period</b>	\$ 5,226	\$ 4,453
<b>Add (deduct)</b>		
Stock-based compensation costs	321	316
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	–	(2)
Discount on redemption of share capital (note 8)	374	–
<b>Balance – End of the period</b>	<u>\$ 5,921</u>	<u>\$ 4,767</u>

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)

	<b>Three months ended November 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Cash flows from operating activities</b>		
Net earnings (loss) for the period	\$ 5,287	\$ (93)
Add items not affecting cash		
Change in discount on short-term investments	456	902
Stock-based compensation costs	322	301
Amortization	2,478	1,710
Deferred revenue	353	351
Future income taxes	1,901	81
Change in unrealized foreign exchange gain	(3,456)	–
	7,341	3,252
Change in non-cash operating items		
Accounts receivable	(7,325)	1,166
Income taxes and tax credits	(696)	(458)
Inventories	(367)	(87)
Prepaid expenses	(542)	(612)
Accounts payable and accrued liabilities	(1,087)	(5,694)
	(2,676)	(2,433)
<b>Cash flows from investing activities</b>		
Additions to short-term investments	(122,100)	(211,453)
Proceeds from disposal and maturity of short-term investments	126,605	214,571
Additions to capital assets <sup>(1)</sup>	(1,514)	(1,573)
	2,991	1,545
<b>Cash flows from financing activities</b>		
Change in bank loan	–	699
Exercise of stock options	26	–
Redemption of share capital (note 8)	(447)	(174)
	(421)	525
<b>Effect of foreign exchange rate changes on cash</b>	(367)	343
<b>Change in cash</b>	(473)	(20)
<b>Cash – Beginning of the period</b>	5,914	5,541
<b>Cash – End of the period</b>	\$ 5,441	\$ 5,521

(1) As at November 30, 2007 and 2008, unpaid purchases of capital assets amounted to \$852 and \$312, respectively.

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

# EXFO Electro-Optical Engineering Inc.

## Notes to 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, 2008, and for the three-month periods ended November 30, 2007 and 2008, 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, except for changes as described in note 2. 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

#### *Adopted in fiscal 2009*

In December 2006, the Canadian Institute of Chartered Accountants (CICA) issued three new sections, which provide a complete set of disclosure and presentation requirements for financial instruments: Section 3862, "Financial Instruments – Disclosures"; Section 3863, "Financial Instruments – Presentation"; and Section 1535, "Capital Disclosures".

Section 3862 replaces the disclosure portion of Section 3861, "Financial Instruments – Disclosure and Presentation". The new standard places increased emphasis on disclosures regarding risks associated with both recognized and unrecognized financial instruments and how these risks are managed. It is also intended to remove any duplicate disclosures and simplify the disclosures about concentrations of risk, credit risk, liquidity risk and price risk previously found in Section 3861.

Section 3863 carries forward the presentation requirements from Section 3861, unchanged.

Section 1535 applies to all entities, regardless of whether they have financial instruments or are subject to external capital requirements. The new section requires disclosure of information about an entity's objectives, policies and processes for managing capital, as well as quantitative data about capital and whether the entity has complied with any capital requirements.

The company adopted these new standards on September 1, 2008 (notes 3 and 4).

In June 2007, the CICA issued Section 3031, "Inventories". This standard requires the measurement of inventories at the lower of cost and net realizable value and includes guidance on the determination of cost, including allocation of overheads and other costs to inventory. The standard also requires the consistent use of either first-in, first-out (FIFO) or weighted average cost formula to measure the cost of inventories and requires the reversal of previous write-downs to net realizable value when there is a subsequent increase in the value of inventories. The new standard applies to fiscal years beginning on or after January 1, 2008. The company adopted this new standard on September 1, 2008, and its adoption had no effect on its consolidated financial statements.

In June 2007, the CICA amended Section 1400, "General Standards of Financial Statement Presentation" to include new requirements regarding an entity's ability to continue as a going concern. These amendments apply to fiscal years beginning on or after January 1, 2008. The company adopted these amendments on September 1, 2008, and their adoption had no effect on its consolidated financial statements.

# **EXFO Electro-Optical Engineering Inc.**

## **Notes to Consolidated Financial Statements**

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

### ***To be adopted after fiscal 2009***

In February 2008, the CICA issued Section 3064, “Goodwill and intangible assets”, which supersedes Section 3062, “Goodwill and other intangible assets” and Section 3450, “Research and development costs”. Various changes have been made to other sections of the CICA Handbook for consistency purposes. Section 3064 establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill remain unchanged from the standards included in Section 3062. This new section applies to fiscal years beginning on or after October 1, 2008. The company will adopt this new standard on September 1, 2009, and has not yet determined the effects its adoption will have on its consolidated financial statements.

### **3 Capital Disclosures**

The company is not subject to any external restrictions on its capital.

The company’s objectives when managing capital are:

- To maintain a flexible capital structure, which optimizes the cost of capital at acceptable risk;
- To sustain future development of the company, including research and development activities and potential acquisitions of complementary businesses or products; and
- To provide the company’s shareholders with an appropriate return on their investment.

The company defines its capital as shareholders’ equity, excluding accumulated other comprehensive income. Accumulated other comprehensive income’s main component is the cumulative foreign currency translation adjustment, which is solely the result of the translation of the company’s consolidated financial statements into US dollars (the reporting currency).

The capital of the company amounted to \$208,506,000 and \$213,693,000 as at August 31, 2008 and November 2008, respectively.

Of this capital, as at November 30, 2008, an amount of \$71,356,000 represented cash and short-term investments (\$87,540,000 as at August 31, 2008), a portion of which can be considered in excess of the company’s current and expected needs. The company has consequently been actively repurchasing shares from the open market via a normal course issuer bid through the facilities of the Toronto Stock Exchange and the NASDAQ. Furthermore, as at November 30, 2008, the company had an outstanding substantial issuer bid to purchase for cancellation up to 8,823,529 subordinate voting shares for an aggregate purchase price not to exceed CA\$30,000,000 (note 14).

### **4 Financial Instruments**

#### **Market risk**

##### *Currency risk*

The principal measurement currency of the company is the Canadian dollar. The company is exposed to currency risks as a result of its export sales of products manufactured in Canada and China, the majority of which are denominated in US dollars and euros. These risks are partially hedged by forward exchange contracts (US dollars) and certain operating expenses (US dollars and euros).

# EXFO Electro-Optical Engineering Inc.

## Notes to Consolidated Financial Statements

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

As at November 30, 2008, the company held contracts to sell US dollars for Canadian dollars at various forward rates, which are summarized as follows:

<u>Expiry dates</u>	<u>Contractual amounts</u>	<u>Weighted average contractual forward rates</u>
	(unaudited)	
December 2008 to August 2009	\$ 28,300	1.0616
September 2009 to August 2010	24,200	1.0760
September 2010 to August 2011	14,600	1.1221
September 2011	1,000	1.1278
Total	<u>\$ 68,100</u>	<u>1.0807</u>

These contracts are designated and accounted for as cash flow hedges.

The fair value of forward exchange contracts, which represents the amount that the company would receive or pay to settle the contracts based on the forward exchange rate at period end, amounted to net gains of \$62,000 as at August 31, 2008 and net losses of \$7,973,000 as at November 30, 2008, following the significant decrease in the value of the Canadian dollar compared to the US dollar during the quarter. As at November 30, 2008, forward exchange contracts, in the amount of \$4,877,000, are presented in the accounts payable and accrued liabilities (note 6) in the balance sheet, and forward exchange contracts, in the amount of \$2,275,000, are presented in forward exchange contracts in the balance sheet.

The following table summarizes significant financial assets and liabilities that are subject to currency risk as at November 30, 2008:

	<u>Carrying amount (in thousands of US dollars)</u>	<u>Carrying amount (in thousands of euros)</u>
	(unaudited)	
<b>Financial Assets</b>		
Cash	\$ 2,773	€ 505
Accounts receivable	26,742	2,225
	<u>29,515</u>	<u>2,730</u>
<b>Financial Liabilities</b>		
Accounts payable and accrued liabilities	5,982	356
Forward exchange contracts	68,100	-
	<u>74,082</u>	<u>356</u>
Net exposure	<u>\$ (44,567)</u>	<u>€ 2,374</u>

The period-end value of the Canadian dollar compared to the US dollar was CA\$1.2372 = US\$1.00 as at November 30, 2008.

The period-end value of the Canadian dollar compared to the euro was CA\$1.5706 = €1.00 as at November 30, 2008.

The following sensitivity analyse summarizes the effect that a change in the value of the Canadian dollar (compared to US dollar and euro) would have on financial assets and liabilities denominated in US dollars and euros, as well as on net earnings, net earnings per diluted share and comprehensive income, based on the foreign exchange rates as at November 30, 2008:

- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the US dollar would decrease (increase) net earnings by \$1,832,000, or \$0.03 per diluted share.

# EXFO Electro-Optical Engineering Inc.

## Notes to Consolidated Financial Statements

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

- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the euro would decrease (increase) net earnings by \$333,000, or \$0.00 per diluted share.
- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the US dollar would increase (decrease) comprehensive income by \$4,500,000.

The impact of the change in the value of the Canadian dollar compared to the US dollar and the euro on these financial assets and liabilities is recorded in the foreign exchange gain or loss line item in the consolidated statements of earnings, except for outstanding forward contracts, which impact is recorded in comprehensive income. The change in the value of the Canadian dollar compared to the US dollar and the euro also impacts the company's balances of income tax and tax credits recoverable or payable and future income tax assets and liabilities related to integrated foreign subsidiaries; this may result in additional and significant foreign exchange gain or loss. However, these assets and liabilities are not considered financial instruments, and are excluded from the sensitivity analysis above. The foreign exchange rate fluctuations also flow through the statements of earnings line items, as a significant portion of the company's operating expenses are denominated in Canadian dollars, and the company reports its results in US dollars; that effect is not reflected in the sensitivity analysis above.

### *Interest rate risk*

The company is exposed to interest rate risks through its short-term investments. As at November 30, 2008, the company's short-term investments, in the amount of \$65,915,000, bear interest at rates ranging between 2.36% to 3.16% and mature between December 2008 and April 2009.

- An increase (decrease) of 0.5% in the interest rate of the company's short-term investments would increase (decrease) net earnings by \$57,000, or \$0.00 per diluted share on a quarterly basis.

Due to their short-term maturity of usually three months or less, the company's short-term investments are not subject to significant fair value interest rate risk. Accordingly, change in fair value has been nominal to the degree that amortized cost has historically approximated the fair value. Any change in fair value of the company's short-term investments, all of which are classified as available for sale, is recorded in comprehensive income.

Cash, accounts receivable and accounts payable and accrued liabilities are non-interest-bearing financial assets and liabilities.

### **Credit risk**

Financial instruments that potentially subject the company to credit risk consist primarily of cash, short-term investments, accounts receivable and forward exchange contracts (with a positive fair value). As at November 30, 2008, the company's short-term investments consist of debt instruments issued by 13 (10 as at August 31, 2008) high-credit quality corporations and trusts. None of these debt instruments are expected to be affected by a liquidity risk, and none of them represent asset-backed commercial paper. The company's cash and forward exchange contracts are held with or issued by high-credit quality financial institutions; therefore, the company considers the risk of non-performance on these instruments to be limited.

Generally, the company does not require collateral or other security from customers for trade accounts receivable; however, credit is extended to customers following an evaluation of creditworthiness. In addition, the company performs ongoing credit reviews of all its customers and establishes an allowance for doubtful accounts receivable when accounts are determined to be uncollectible. Allowance for doubtful accounts amounted to \$305,000 and \$331,000 as at August 31, 2008 and November 30, 2008, respectively and bad debt expense amounted to \$39,000 and \$40,000 for the three months ended November 30, 2007 and 2008, respectively.

# EXFO Electro-Optical Engineering Inc.

## Notes to Consolidated Financial Statements

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

For the three months ended November 30, 2008, no customer represented more than 10% of global sales.

The following table summarizes the age of trade accounts receivable as at November 30, 2008:

		<b>(unaudited)</b>
Current	\$	23,855
Past due since less than 30 days		6,720
Past due, 31 to 60 days		1,969
Past due, more than 61 days		805
Total accounts receivable		33,349
Allowance for doubtful accounts		(331)
	<b>\$</b>	<b>33,018</b>

### Liquidity risk

Liquidity risk is defined as the potential that the company cannot meet its obligations as they become due.

The following table summarizes the contractual maturity of the company's financial liabilities as at November 30, 2008:

	<u>0-12</u> <u>months</u>	<u>13-24</u> <u>months</u>	<u>25-36</u> <u>months</u>
			<b>(unaudited)</b>
Accounts payable and accrued liabilities	\$ 19,563	\$ –	\$ –
Forward exchange contracts			
Outflow	36,400	19,500	12,200
Inflow	(31,277)	(17,144)	(11,062)
Total	\$ 24,686	\$ 2,356	\$ 1,138

In addition to these contractual liabilities, the company has a cash contingent consideration payable for the acquisition of Brix Networks, up to a maximum of \$7,537,000, and any amount payable will be paid during fiscal 2009. Also, the company has share repurchase programs that may require additional cash outflows during fiscal 2009 and 2010 (notes 8 and 14).

As at November 30, 2008, the company had \$71,356,000 in cash and short-term investments. In addition to these financial assets, the company has unused available lines of credit totalling \$9,509,000 for working capital and other general corporate purposes, including potential acquisitions and share repurchase programs as well as unused lines of credit of \$10,227,000 for foreign currency exposure related to its forward exchange contracts.

### 5 Inventories

	<u>As at</u> <u>November 30,</u> <u>2008</u>	<u>As at</u> <u>August 31,</u> <u>2008</u>
		<b>(unaudited)</b>
Raw materials	\$ 14,355	\$ 17,651
Work in progress	1,601	1,961
Finished goods	14,169	15,268
	\$ 30,125	\$ 34,880

# EXFO Electro-Optical Engineering Inc.

## Notes to Consolidated Financial Statements

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

The cost of sales comprised almost exclusively the amount of inventory recognized as an expense during the reporting periods, except for the related amortization, that is shown separately in operating expenses.

Inventory write-down amounted to \$351,000 and \$794,000 for the three months ended November 30, 2007 and 2008, respectively.

### 6 Accounts Payable and Accrued Liabilities

	<b>As at November 30, 2008</b>	<b>As at August 31, 2008</b>
	(unaudited)	
Trade	\$ 8,273	\$ 10,303
Salaries and social benefits	7,027	8,888
Warranty	696	974
Commissions	782	761
Tax on capital	849	923
Restructuring charges	195	292
Forward exchange contracts (note 4)	4,877	714
Other	1,741	1,858
	\$ 24,440	\$ 24,713

Changes in the warranty provision are as follows:

	<b>Three months ended November 30,</b>	
	<b>2008</b>	<b>2007</b>
	(unaudited)	
Balance – Beginning of period	\$ 974	\$ 800
Provision	142	159
Settlements	(420)	(109)
Balance – End of period	\$ 696	\$ 850

### 7 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 predetermined prices.

# **EXFO Electro-Optical Engineering Inc.**

## **Notes to Consolidated Financial Statements**

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

On April 19, 2002, the plaintiffs filed an amended complaint containing master allegations against all of the defendants 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 2004, an agreement of partial settlement was submitted to the court for preliminary approval. The proposed partial settlement was between the plaintiffs, the issuer defendants in the consolidated actions, the issuer officers and directors named as defendants, and the issuers' insurance companies. 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 by January 15, 2006. The settlement fairness hearing occurred on April 24, 2006, and the court reserved decision at that time.

While the partial settlement was pending approval, the plaintiffs continued to litigate against the underwriter defendants. The district court 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.

On April 6, 2007, the Second Circuit denied the plaintiffs' petition for rehearing of that decision and, on May 18, 2007, the Second Circuit denied the plaintiffs' petition for rehearing *en banc*. In light of the Second Circuit's opinion, liaison counsel for all issuer defendants, including the company, informed the court that this settlement cannot be approved, because the defined settlement class, like the litigation class, cannot be certified. On June 25, 2007, the district court entered an order terminating the settlement agreement. On August 14, 2007, the plaintiffs filed their second consolidated amended class-action complaints against the focus cases and, on September 27, 2007, again moved for class certification. On November 12, 2007, certain of the defendants in the focus cases moved to dismiss the second consolidated amended class-action complaints. On March 26, 2008, the district court denied the motions to dismiss, except as to Section 11 claims raised by those plaintiffs who sold their securities for a price in excess of the initial offering price and those who purchased outside of the previously certified class period. Briefing on the class certification motion was completed in May 2008. That motion was withdrawn without prejudice on October 10, 2008.

Due to the inherent uncertainties of litigation, the final outcome of the case is uncertain and it is not possible to determine the amount of any possible losses. 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, 2008.

# EXFO Electro-Optical Engineering Inc.

## Notes to Consolidated Financial Statements

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

### 8 Share Capital

On November 6, 2008, the company announced that its Board of Directors had authorized a renewal of its share repurchase program, by way of a normal course issuer bid on the open market, of up to 10% of its public float (as defined by the Toronto Stock Exchange), or 2,738,518 subordinate voting shares, at the prevailing market price. The company expects to use cash, short-term investments or future cash flows from operations to fund the repurchase of shares. The period of the normal course issuer bid commenced on November 10, 2008, and will end on November 9, 2009, or on an earlier date if the company repurchases the maximum number of shares permitted under the bid. The program does not require the company to repurchase any specific number of shares, and it may be modified, suspended or terminated at any time and without prior notice. All shares repurchased under the bid will be cancelled.

On November 10, 2008, the company announced that its Board of Directors had authorized a substantial issuer bid (the "Offer") to purchase for cancellation up to 8,823,529 subordinate voting shares for an aggregate purchase price not to exceed CA\$30,000,000. The Offer is being made by way of a "modified Dutch Auction" pursuant to which shareholders might tender all or a portion of their shares (i) at a price not less than CA\$3.40 per share and not more than CA\$3.90 per share, in increments of CA\$0.05 per share, or (ii) without specifying a purchase price, in which case their shares would be purchased at the purchase price determined in accordance with the Offer. The Offer expired on December 16, 2008 (note 14).

Upon the announcement of the Offer, the company suspended the normal course issuer bid referred to above, until 20 business days following the expiration of the Offer.

The following tables summarize changes in share capital for the three months ended November 30, 2007 and 2008.

	Three months ended November 30, 2007				Total amount
	Multiple voting shares		Subordinate voting shares		
	Number	Amount	Number	Amount	
	(unaudited)				
Balance as at August 31, 2007	36,643,000	\$ 1	32,361,561	\$ 150,018	\$ 150,019
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	–	–	–	2	2
Redemption of share capital	–	–	(29,200)	(135)	(135)
Balance as at November 30, 2007	36,643,000	\$ 1	32,332,361	\$ 149,885	\$ 149,886

# EXFO Electro-Optical Engineering Inc.

## Notes to Consolidated Financial Statements

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

	Three months ended November 30, 2008				
	Multiple voting shares		Subordinate voting shares		Total amount
	Number	Amount	Number	Amount	
	(unaudited)				
Balance as at August 31, 2008	36,643,000	\$ 1	30,783,705	\$ 142,785	\$ 142,786
Exercise of stock options	–	–	12,500	26	26
Redemption of share capital	–	–	(176,914)	(821)	(821)
Balance as at November 30, 2008	36,643,000	\$ 1	30,619,291	\$ 141,990	\$ 141,991

### 9 Net Research and Development Expenses

Net research and development expenses comprise the following:

	Three months ended November 30,	
	2008	2007
		(unaudited)
Gross research and development expenses	\$ 8,612	\$ 7,486
Research and development tax credits	(1,391)	(1,474)
	\$ 7,221	\$ 6,012

# EXFO Electro-Optical Engineering Inc.

## Notes to Consolidated Financial Statements

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

### 10 Income Taxes

For the three months ended November 30, 2007 and 2008, the reconciliation of the income tax provision calculated using the combined Canadian federal and provincial statutory income tax rate with the income tax provision in the financial statements is as follows:

	<b>Three months ended November 30,</b>	
	<b>2008</b>	<b>2007</b>
	<b>(unaudited)</b>	
Income tax provision at combined Canadian federal and provincial statutory tax rate (31% in 2008 and 32% in 2007)	\$ 2,203	\$ 374
Increase (decrease) due to:		
Foreign income taxed at different rates	(19)	88
Non-taxable income	(48)	(81)
Non-deductible expenses	172	222
Foreign exchange effect of translation of foreign integrated subsidiaries	(836)	127
Other	177	157
Unrecognized future income tax assets on temporary deductible differences and unused tax losses and deductions	191	375
	\$ 1,840	\$ 1,262
The income tax provision consists of the following:		
Current	\$ (61)	\$ 1,181
Future	1,710	(294)
Valuation allowance	191	375
	1,901	81
	\$ 1,840	\$ 1,262

# EXFO Electro-Optical Engineering Inc.

## Notes to Consolidated Financial Statements

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

### 11 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,	
	2008	2007
	(unaudited)	
Basic weighted average number of shares outstanding (000's)	67,340	69,000
Plus dilutive effect of:		
Stock options (000's)	125	401
Restricted share units (000's)	173	201
Deferred share units (000's)	79	70
Diluted weighted average number of shares outstanding (000's)	67,717	69,672
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)	2,045	1,118

### 12 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 and network monitoring systems to network service providers, cable TV operators, system vendors and component manufacturers throughout the global telecommunications industry. The Life Sciences and Industrial Division offers solutions in medical-device and opto-electronics assembly, fluorescence microscopy and other life sciences sectors.

The following tables present information by segment:

	Three months ended November 30, 2008		
	Telecom Division	Life Sciences and Industrial Division	Total
	(unaudited)		
Sales	\$ 41,159	\$ 5,204	\$ 46,363
Earnings from operations	\$ 1,355	\$ 738	\$ 2,093
Unallocated items			
Interest income			466
Foreign exchange gain			4,568
Earnings before income taxes			7,127
Income taxes			1,840
Net earnings for the period			\$ 5,287

# EXFO Electro-Optical Engineering Inc.

## Notes to Consolidated Financial Statements

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

	<b>Three months ended November 30, 2007</b>		
	<b>Telecom Division</b>	<b>Life Sciences and Industrial Division</b>	<b>Total</b>
	<b>(unaudited)</b>		
Sales	\$ 35,365	\$ 5,620	\$ 40,985
Earnings from operations	\$ 21	\$ 281	\$ 302
Unallocated items			
Interest income			1,483
Foreign exchange loss			(616)
			1,169
Earnings before income taxes			1,169
Income taxes			1,262
			(93)
Net loss for the period			\$ (93)

Total assets by reportable segment are detailed as follows:

	<b>As at November 30, 2008</b>	<b>As at August 31, 2008</b>
	<b>(unaudited)</b>	
<b>Total assets</b>		
Telecom Division	\$ 132,021	\$ 145,168
Life Sciences and Industrial Division	8,204	9,571
Unallocated assets	117,353	138,327
	\$ 257,578	\$ 293,066

Unallocated assets are comprised of cash, short-term investments, other receivables on forward exchange contracts, income taxes and tax credits recoverable and future income tax assets.

### 13 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 19 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.

#### Statements of earnings

For the three months ended November 30, 2007 and 2008, there were no significant differences between the net earnings (loss) under Canadian GAAP as compared to U.S. GAAP.

# EXFO Electro-Optical Engineering Inc.

## Notes to Consolidated Financial Statements

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

### 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, 2008	As at August 31, 2008
	(unaudited)	
Shareholders' equity in accordance with Canadian GAAP	\$ 222,915	\$ 295,515
Goodwill	(10,856)	(12,640)
Stock appreciation rights	(73)	(73)
Shareholders' equity in accordance with U.S. GAAP	\$ 211,986	\$ 246,802

### 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 utilizable against income taxes payable are recorded in the income taxes. These tax credits amounted to \$980,000 and \$896,000 for the three months ended November 30, 2007 and 2008, respectively. This difference has no impact on the net earnings (loss) and the net earnings (loss) per share for the reporting periods.

### Statements of cash flows

For the three months ended November 30, 2007 and 2008, 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

#### *Adopted in fiscal 2009*

In September 2006, the Financial Accounting Standard Board (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. In February 2008, the FASB amended SFAS 157 to exclude leasing transactions and to delay the effective date by one year for non-financial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a non-recurring basis. This statement is effective for fiscal years beginning after November 15, 2007. The company adopted this statement on September 1, 2008, and its adoption had no effect on its consolidated financial statements.

In February 2007, the FASB issued SFAS 159, "The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115", which permits entities to choose to measure many financial instruments and certain other items at fair value. Most of the provisions of this statement apply only to entities that elect the fair value option. However, the amendment to SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities", applies to all entities with available-for-sale and trading securities. This statement is effective for fiscal years beginning after November 15, 2007. The company adopted this statement on September 1, 2008, and it did not elect to use the fair value option as of the date of adoption.

# **EXFO Electro-Optical Engineering Inc.**

## **Notes to Consolidated Financial Statements**

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

### ***To be adopted after fiscal 2009***

In December 2007, the FASB issued SFAS 141(R), “Business Combinations”, and SFAS 160, “Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51”. These new standards will significantly change the accounting and reporting for business combination transactions and noncontrolling (minority) interests in consolidated financial statements. SFAS 141(R) and SFAS 160 are required to be adopted simultaneously and are effective for the first annual reporting period beginning on or after December 15, 2008. Earlier adoption is prohibited. The company will adopt this statement on September 1, 2009, and is currently evaluating the impact the adoption of SFAS 141(R) and SFAS 160 will have on its consolidated financial statements.

In March 2008, the FASB issued SFAS 161, “Disclosure about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133”, which will require entities to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance and cash flow. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The company will adopt this statement on September 1, 2009, and is currently evaluating the impact its adoption will have on its note disclosures related to derivative instruments and hedging activities.

In April 2008, the FASB issued the FASB staff position (FSP) FAS 142-3, “Determination of the Useful Lives of Intangible Assets”. This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS 142, “Goodwill and Other Intangible Assets”. The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141 (revised 2007), “Business Combinations”, and other U.S. generally accepted accounting principles (GAAP). This FSP shall be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The guidance for determining the useful life of a recognized intangible asset in paragraphs 7–11 of this FSP shall be applied prospectively to intangible assets acquired after the effective date. The disclosure requirements in paragraphs 13–15 shall be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. The company will adopt this FSP on September 1, 2009, and is currently evaluating the impact its adoption will have on its consolidated financial statements.

In May 2008, the FASB issued SFAS 162, “The Hierarchy of Generally Accepted Accounting Principles”. The new standard is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. GAAP for non-governmental entities. For non-governmental entities, the guidance in SFAS 162 replaces that prescribed in Statement on Auditing Standards (SAS) No. 69, “The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles” and will become effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board’s amendments to AU Section 411, “The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles”. The company is currently evaluating the impact the adoption of SFAS 162 will have on its consolidated financial statements.

### **14 Subsequent Event**

On December 18, 2008, pursuant to its substantial issuer bid (note 8), the company purchased for cancellation 7,692,307 subordinated voting shares for an aggregate purchase price of CA\$30,000,000, excluding related fees. The company used cash and short-term investments to fund the repurchase of shares.