

EXFO Inc.
Unaudited Interim Consolidated Balance Sheet

(in thousands of US dollars)

	As at February 28, 2010	As at August 31, 2009
	<u> </u>	<u> </u>
Assets		
Current assets		
Cash	\$ 15,879	\$ 10,611
Short-term investments	55,876	59,105
Accounts receivable (note 4)		
Trade	31,961	22,946
Other	4,442	2,752
Income taxes and tax credits recoverable	3,752	2,353
Inventories (note 5)	35,286	30,863
Prepaid expenses	2,755	2,043
Future income taxes	5,559	5,538
	<u>155,510</u>	<u>136,211</u>
Tax credits recoverable	29,970	26,762
Forward exchange contracts (note 4)	398	428
Property, plant and equipment	18,981	19,100
Intangible assets	15,311	16,859
Goodwill	23,420	22,478
Future income taxes	15,644	18,533
	<u>\$ 259,234</u>	<u>\$ 240,371</u>
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (note 6)	\$ 25,189	\$ 21,650
Deferred revenue	9,193	6,481
	<u>34,382</u>	<u>28,131</u>
Deferred revenue	4,845	4,195
	<u>39,227</u>	<u>32,326</u>
Contingencies (note 7)		
Shareholders' equity		
Share capital (note 8)	105,583	104,846
Contributed surplus	17,992	17,758
Retained earnings	45,397	43,909
Accumulated other comprehensive income	51,035	41,532
	<u>220,007</u>	<u>208,045</u>
	<u>\$ 259,234</u>	<u>\$ 240,371</u>

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

EXFO Inc.

Unaudited Interim Consolidated Statements of Earnings

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

	Three months ended February 28, 2010	Six months ended February 28, 2010	Three months ended February 28, 2009	Six months ended February 28, 2009
Sales	\$ 54,110	\$ 99,670	\$ 46,372	\$ 92,735
Cost of sales ^(1,2) (note 5)	21,633	38,071	18,353	35,833
Gross margin	32,477	61,599	28,019	56,902
Operating expenses				
Selling and administrative ⁽¹⁾	16,919	32,280	15,800	32,891
Net research and development ⁽¹⁾ (note 9)	8,809	17,082	7,325	14,546
Amortization of property, plant and equipment	1,312	2,603	1,049	2,208
Amortization of intangible assets	1,502	2,971	1,246	2,565
Total operating expenses	28,542	54,936	25,420	52,210
Earnings from operations	3,935	6,663	2,599	4,692
Interest income (expense)	(76)	(118)	175	641
Foreign exchange gain (loss)	(1,037)	(2,146)	1,090	5,658
Earnings before income taxes	2,822	4,399	3,864	10,991
Income taxes (note 10)				
Current	(236)	(149)	297	236
Future	1,904	3,060	912	2,813
	1,668	2,911	1,209	3,049
Net earnings for the period	\$ 1,154	\$ 1,488	\$ 2,655	\$ 7,942
Basic net earnings per share	\$ 0.02	\$ 0.03	\$ 0.04	\$ 0.12
Diluted net earnings per share	\$ 0.02	\$ 0.02	\$ 0.04	\$ 0.12
Basic weighted average number of shares outstanding (000's)	59,427	59,406	60,875	64,108
Diluted weighted average number of shares outstanding (000's) (note 11)	60,529	60,325	61,375	64,546
(1) Stock-based compensation costs included in:				
Cost of sales	\$ 43	\$ 84	\$ 31	\$ 60
Selling and administrative	302	570	198	399
Net research and development	124	233	96	188
	\$ 469	\$ 887	\$ 325	\$ 647

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

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

EXFO Inc.
Unaudited Interim Consolidated Statements of Comprehensive Income (Loss)
and Accumulated Other Comprehensive Income

(in thousands of US dollars)

Comprehensive income (loss)

	Three months ended February 28, 2010	Six months ended February 28, 2010	Three months ended February 28, 2009	Six months ended February 28, 2009
Net earnings for the period	\$ 1,154	\$ 1,488	\$ 2,655	\$ 7,942
Foreign currency translation adjustment	989	8,802	(4,646)	(41,579)
Changes in unrealized losses on short-term investments	-	-	-	22
Unrealized gains (losses) on forward exchange contracts	158	1,322	(1,734)	(8,663)
Reclassification of realized gains (losses) on forward exchange contracts in net earnings	(382)	(305)	1,371	1,234
Future income taxes effect of the above items	69	(316)	113	2,303
Comprehensive income (loss)	\$ 1,988	\$ 10,991	\$ (2,241)	\$ (38,741)

Accumulated other comprehensive income

	Six months ended February 28,	
	2010	2009
Foreign currency translation adjustment		
Cumulative effect of prior periods	\$ 40,458	\$ 51,129
Current period	8,802	(41,579)
	<u>49,260</u>	<u>9,550</u>
Unrealized gains (losses) on forward exchange contracts		
Cumulative effect of prior periods	1,076	(96)
Current period, net of realized gains (losses) and future income taxes	701	(5,126)
	<u>1,777</u>	<u>(5,222)</u>
Unrealized losses on short-term investments		
Cumulative effect of prior periods	(2)	(24)
Current period, net of future income taxes	-	22
	<u>(2)</u>	<u>(2)</u>
Accumulated other comprehensive income	\$ 51,035	\$ 4,326

Total retained earnings and accumulated other comprehensive income amounted to \$72,762 and \$96,432 as at February 28, 2009 and 2010, respectively.

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

EXFO Inc.
**Unaudited Interim Consolidated Statements of Retained Earnings
and Contributed Surplus**

(in thousands of US dollars)

Retained earnings

	Six months ended February 28,	
	2010	2009
Balance – Beginning of the period	\$ 43,909	\$ 60,494
Add		
Net earnings for the period	1,488	7,942
Balance – End of the period	\$ 45,397	\$ 68,436

Contributed surplus

	Six months ended February 28,	
	2010	2009
Balance – Beginning of the period	\$ 17,758	\$ 5,226
Add (deduct)		
Stock-based compensation costs	858	639
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards (note 8)	(627)	(452)
Discount on redemption of share capital (note 8)	3	11,257
Balance – End of the period	\$ 17,992	\$ 16,670

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

EXFO Inc.

Unaudited Interim Consolidated Statements of Cash Flows

(in thousands of US dollars)

	Three months ended February 28, 2010	Six months ended February 28, 2010	Three months ended February 28, 2009	Six months ended February 28, 2009
Cash flows from operating activities				
Net earnings for the period	\$ 1,154	\$ 1,488	\$ 2,655	\$ 7,942
Add (deduct) items not affecting cash				
Change in discount on short-term investments	7	9	135	591
Stock-based compensation costs	469	887	325	647
Amortization	2,814	5,574	2,295	4,773
Deferred revenue	3,465	2,923	3,070	3,423
Future income taxes	1,904	3,060	912	2,813
Change in unrealized foreign exchange (gain) loss	273	1,043	(601)	(4,057)
	<u>10,086</u>	<u>14,984</u>	<u>8,791</u>	<u>16,132</u>
Change in non-cash operating items				
Accounts receivable	(5,127)	(9,229)	4,508	(2,817)
Income taxes and tax credits	(1,866)	(3,371)	352	(344)
Inventories	(762)	(3,113)	488	121
Prepaid expenses	(10)	(615)	308	(234)
Accounts payable and accrued liabilities	2,645	3,675	1,849	762
	<u>4,966</u>	<u>2,331</u>	<u>16,296</u>	<u>13,620</u>
Cash flows from investing activities				
Additions to short-term investments	(101,643)	(180,597)	(133,364)	(255,464)
Proceeds from disposal and maturity of short-term investments	104,926	186,262	149,501	276,106
Additions to capital assets ⁽¹⁾	(1,464)	(2,809)	(2,946)	(4,460)
	<u>1,819</u>	<u>2,856</u>	<u>13,191</u>	<u>16,182</u>
Cash flows from financing activities				
Exercise of stock options	127	127	5	31
Redemption of share capital	–	(14)	(25,631)	(26,078)
	<u>127</u>	<u>113</u>	<u>(25,626)</u>	<u>(26,047)</u>
Effect of foreign exchange rate changes on cash	<u>(135)</u>	<u>(32)</u>	<u>(72)</u>	<u>(439)</u>
Change in cash	6,777	5,268	3,789	3,316
Cash – Beginning of period	<u>9,102</u>	<u>10,611</u>	<u>5,441</u>	<u>5,914</u>
Cash – End of period	<u>\$ 15,879</u>	<u>\$ 15,879</u>	<u>\$ 9,230</u>	<u>\$ 9,230</u>

(1) As at February 28, 2009 and 2010, unpaid purchases of capital assets amounted to \$614 and \$67, respectively.

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

EXFO 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 February 28, 2010, and for the three- and six-month periods ended February 28, 2009 and 2010, 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.

In February 2010, the company changed its name from EXFO Electro-Optical Engineering Inc. to EXFO Inc.

2 New Accounting Standards and Pronouncements

Adopted in fiscal 2010

In February 2008, the Canadian Institute of Chartered Accountants (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 adopted this new standard on September 1, 2009, and its adoption had no material effect on its consolidated financial statements.

In June 2009, the CICA amended section 3862, "Financial Instruments – Disclosures", to include enhanced disclosures on liquidity risk of financial instruments and new disclosures on fair value measurements of financial instruments. The amendments apply to fiscal years ending after September 30, 2009, with early adoption permitted. The company adopted amendments on September 1, 2009, and their adoption had no significant impact on its consolidated financial statements. The new requirements are equivalent to the new U.S. GAAP requirement as disclosed in note 13.

To be adopted after fiscal 2010

In January 2009, the CICA issued Section 1582, "Business Combinations", which replaces Section 1581, "Business Combinations". This new section establishes the standards for the accounting of business combinations and states that all assets and liabilities of an acquired business will be recorded at fair value. Obligations for contingent consideration and contingencies will also be recorded at fair value at the acquisition date. The standard also states that acquisition-related costs will be expensed as incurred and that restructuring charges will be expensed in the periods after the acquisition date. This standard applies prospectively to business combinations with acquisition dates on or after September 1, 2011; earlier adoption is permitted.

In January 2009, the CICA issued Section 1601, "Consolidated Financial Statements", which replaces Section 1600, "Consolidated Financial Statements", and establishes the standards for preparing consolidated financial statements. This new section applies to fiscal years beginning on or after January 1, 2011; earlier adoption is permitted. The company has not yet determined the impact that adopting this standard will have on its consolidated financial statements.

EXFO 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)

In January 2009, the CICA issued Section 1602, “Non-controlling Interests”, which establishes standards for the accounting of non-controlling interests of a subsidiary in the preparation of consolidated financial statements subsequent to a business combination. This new section applies to fiscal years beginning on or after January 1, 2011; earlier adoption is permitted as of the beginning of a fiscal year.

Should the company decide to adopt one of these three new sections earlier, it must adopt all three at the same date.

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, market development 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 components are the cumulative foreign currency translation adjustment, which is the result of the translation of the company’s consolidated financial statements into US dollars (the reporting currency), as well as after-tax unrealized gains (losses) on forward exchange contracts.

The capital of the company amounted to \$166,513,000 and \$168,972,000 as at August 31, 2009 and February 28, 2010, respectively.

Of the capital, as at February 28, 2010, an amount of \$71,755,000 represented cash and short-term investments (\$69,716,000 as at August 31, 2009). A portion of that excess cash will be used to fund the acquisition of NetHawk Oyj (note 14). Also, the company can repurchase shares from the open market via a normal course issuer bid through the facilities of the Toronto Stock Exchange and the NASDAQ (note 8).

4 Financial Instruments

Market risk

Currency risk

The principal measurement currency of the company is the Canadian dollar. The company is exposed to a currency risk 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. This risk is partially hedged by forward exchange contracts (US dollars) and certain operating expenses (US dollars and euros). Forward exchange contracts, which are designated as cash flow hedging instruments, qualify for hedge accounting.

EXFO Inc.

Notes to Unaudited Interim Consolidated Financial Statements

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As at February 28, 2010, 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>
March 2010 to August 2010	\$ 17,700	1.1002
September 2010 to August 2011	23,100	1.1017
September 2011 to August 2012	3,500	1.0876
September 2012 to January 2013	1,500	1.0722
Total	<u>\$ 45,800</u>	<u>1.0991</u>

The carrying amount of forward exchange contracts is equal to fair value, which is based on the amount at which they could be settled based on estimated current market rates. The fair value of forward exchange contracts amounted to net gains of \$530,000 as at August 31, 2009 and \$1,929,000 as at February 28, 2010.

Based on the portfolio of forward exchange contracts as at February 28, 2010, the company estimates that the portion of the unrealized gains on these contracts as of that date, which will be realized and reclassified from accumulated other comprehensive income to net earnings over the next 12 months, amounts to \$1,247,000.

As at February 28, 2010, forward exchange contracts in the amount of \$1,247,000 are presented as current assets in other receivable in the balance sheet and forward exchange contracts, in the amount of \$398,000, are presented as long-term assets in forward exchange contracts in the balance sheet. These forward exchange contracts are not yet recorded within sales.

During the three months ended February 28, 2009 and 2010, the company recognized within its sales foreign exchange gains (losses) on forward exchange contracts of \$(1,323,000) and \$432,000, respectively. During the six months ended February 28, 2009 and 2010, the company recognized within its sales foreign exchange gains (losses) on forward exchange contracts of \$(1,534,000) and \$499,000, respectively.

The following table summarizes significant financial assets and liabilities that are subject to currency risk as at February 28, 2010:

	<u>Carrying/nominal amount (in thousands of US dollars)</u>	<u>Carrying/nominal amount (in thousands of euros)</u>
Financial assets		
Cash	\$ 5,011	€ 5,509
Accounts receivable	24,273	2,586
	<u>29,284</u>	<u>8,095</u>
Financial liabilities		
Accounts payable and accrued liabilities	8,693	394
Forward exchange contracts (nominal amount)	6,200	-
	<u>14,893</u>	<u>394</u>
Net exposure	<u>\$ 14,391</u>	<u>€ 7,701</u>

The value of the Canadian dollar compared to the US dollar was CA\$1.0526 = US\$1.00 as at February 28, 2010.

The value of the Canadian dollar compared to the euro was CA\$1.4378 = €1.00 as at February 28, 2010.

EXFO Inc.

Notes to Unaudited Interim Consolidated Financial Statements

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The following sensitivity analysis summarizes the effect that a change in the value of the Canadian dollar (compared to the US dollar and euro) on financial assets and liabilities denominated in US dollars and euros would have on net earnings, net earnings per diluted share and comprehensive income, based on the foreign exchange rates as at February 28, 2010:

- 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 \$1,460,000 or \$0.02 per diluted share.
- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the euro would decrease (increase) net earnings by \$851,000 or \$0.01 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) other comprehensive income by \$2,741,000.

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 other 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 of its 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 is 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 February 28, 2010, the company's short-term investments, in the amount of \$55,876,000, bear interest at rates ranging between 0.2% and 0.5% and mature in March and April 2010.

A change of 0.5% in the interest rate of the company's short-term investments would increase (decrease) net earnings by \$48,000, 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 other comprehensive income.

Cash, accounts receivable and accounts payable and accrued liabilities are non-interest-bearing financial assets and liabilities. Accounts receivable and accounts payable and accrued liabilities are financial instruments whose carrying value approximates their fair value due to their short-term maturity.

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 February 28, 2010, the company's short-term investments consist of debt instruments issued by nine (11 as at August 31, 2009) high-credit quality corporations and trusts. None of these debt instruments are expected to be affected by a significant liquidity risk. 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.

EXFO Inc.

Notes to Unaudited Interim Consolidated Financial Statements

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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 \$1,220,000 and \$1,202,000 as at August 31, 2009 and February 28, 2010, respectively. Bad debt expenses (recovery) amounted to \$315,000 and nil for the three months ended February 28, 2009 and 2010, respectively, and \$355,000 and \$(17,000) for the six months ended February 28, 2009 and 2010, respectively.

For the three and the six months ended February 28, 2010, no customer represented more than 10% of consolidated sales.

The following table summarizes the age of trade accounts receivable as at February 28, 2010:

Current	\$	23,347
Past due, 0 to 30 days		5,585
Past due, 31 to 60 days		2,036
Past due, more than 60 days, less allowance for doubtful accounts of \$1,202		993
Total accounts receivable	\$	<u>31,961</u>

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 derivative and non-derivative financial liabilities as at February 28, 2010:

	<u>0-12 months</u>	<u>13-24 months</u>	<u>25-36 months</u>
Accounts payable and accrued liabilities	\$ 23,972	\$ —	\$ —
Forward exchange contracts			
Outflow	31,700	10,500	3,600
Inflow	(33,079)	(11,077)	(3,666)
Total	<u>\$ 22,593</u>	<u>\$ (577)</u>	<u>\$ (66)</u>

5 Inventories

	<u>As at February 28, 2010</u>	<u>As at August 31, 2009</u>
Raw materials	\$ 16,529	\$ 14,497
Work in progress	2,587	1,955
Finished goods	<u>16,170</u>	<u>14,411</u>
	<u>\$ 35,286</u>	<u>\$ 30,863</u>

EXFO 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)

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

Inventory write-down amounted to \$1,056,000 and \$636,000 for the three months ended February 28, 2009 and 2010, respectively and \$1,973,000 and \$1,239,000 for the six months ended February 28, 2009 and 2010, respectively.

6 Accounts Payable and Accrued Liabilities

	As at February 28, 2010	As at August 31, 2009
Trade	\$ 11,034	\$ 9,063
Salaries and social benefits	10,365	8,863
Warranty	895	699
Commissions	808	647
Restructuring charges	—	24
Forward exchange contracts (note 4)	—	704
Other	2,087	1,650
	<u>\$ 25,189</u>	<u>\$ 21,650</u>

Changes in the warranty provision are as follows:

	Six months ended February 28,	
	2010	2009
Balance – Beginning of period	\$ 699	\$ 974
Provision	472	309
Settlements	(276)	(552)
Balance – End of period	<u>\$ 895</u>	<u>\$ 731</u>

7 Contingencies

Class action

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

EXFO Inc.

Notes to Unaudited Interim Consolidated Financial Statements

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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 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.

EXFO 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)

On April 2, 2009, a stipulation and agreement of settlement between the plaintiffs, issuer defendants and underwriter defendants was submitted to the Court for preliminary approval. The Court granted the plaintiffs' motion for preliminary approval and preliminarily certified the settlement classes on June 10, 2009. The settlement fairness hearing was held on September 10, 2009. On October 6, 2009, the Court entered an opinion granting final approval to the settlement and directing that the Clerk of the Court close these actions. Notices of appeal of the opinion granting final approval have been filed. Given that the settlement remains subject to appeal as of the date of issuance of these financial statements, the ultimate outcome of the contingency is uncertain. However, based on the settlement approved on October 6, 2009, and the related insurance against such claims, management has determined the impact to its financial position and results of operations as at and for the three- and six-month periods ended February 28, 2010 to be immaterial.

Contingent consideration

Following the purchase of assets in fiscal 2009, the company has a contingent cash consideration of up to \$900,000, payable based upon the achievement of a certain booking volume in the next 12 months.

8 Share Capital

On November 6, 2009, the company announced that its Board of Directors had authorized the second 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 2,256,431 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 started on November 10, 2009, and will end on November 9, 2010, or at an earlier date if the company repurchases the maximum number of shares permitted under the bid. The program does not require that the company repurchases 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.

The following tables summarize changes in share capital for the six months ended February 28, 2009 and 2010.

	Six months ended February 28, 2009				
	Multiple voting shares		Subordinate voting shares		Total amount
	Number	Amount	Number	Amount	
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
Exercise of stock options	–	–	2,500	5	5
Redemption of restricted share units	–	–	92,682	–	–
Redemption of share capital	–	–	(7,745,379)	(36,514)	(36,514)
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	–	–	–	452	452
Balance as at February 28, 2009	<u>36,643,000</u>	<u>\$ 1</u>	<u>22,969,094</u>	<u>\$ 105,933</u>	<u>\$ 105,934</u>

EXFO 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)

	Six months ended February 28, 2010				
	Multiple voting shares		Subordinate voting shares		Total amount
	Number	Amount	Number	Amount	
Balance as at August 31, 2009	36,643,000	\$ 1	22,736,302	\$ 104,845	\$ 104,846
Redemption of restricted share units	–	–	13,663	–	–
Redemption of share capital	–	–	(3,600)	(17)	(17)
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	–	–	–	86	86
Balance as at November 30, 2009	36,643,000	1	22,746,365	104,914	104,915
Exercise of stock options	–	–	31,700	127	127
Redemption of restricted share units	–	–	75,537	–	–
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	–	–	–	541	541
Balance as at February 28, 2010	<u>36,643,000</u>	<u>\$ 1</u>	<u>22,853,602</u>	<u>\$ 105,582</u>	<u>\$ 105,583</u>

9 Net Research and Development Expenses

Net research and development expenses comprise the following:

	Three months ended February 28, 2010	Six months ended February 28, 2010	Three months ended February 28, 2009	Six months ended February 28, 2009
Gross research and development expenses	\$ 10,371	\$ 20,151	\$ 8,791	\$ 17,403
Research and development tax credits	(1,562)	(3,069)	(1,466)	(2,857)
	<u>\$ 8,809</u>	<u>\$ 17,082</u>	<u>\$ 7,325</u>	<u>\$ 14,546</u>

EXFO 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)

10 Income Taxes

For the three months ended February 28, 2009 and 2010, 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:

	Three months ended February 28, 2010	Six months ended February 28, 2010	Three months ended February 28, 2009	Six months ended February 28, 2009
Income tax provision at combined Canadian federal and provincial statutory tax rate (31% in 2009 and 30% in 2010)	\$ 853	\$ 1,342	\$ 1,196	\$ 3,399
Increase (decrease) due to:				
Foreign income taxed at different rates	(171)	(180)	55	36
Non-taxable income	(56)	(115)	(66)	(114)
Non-deductible expenses	233	434	196	368
Change in tax rates	16	155	–	–
Foreign exchange effect of translation of foreign integrated subsidiaries	(30)	177	(112)	(948)
Utilization of previously unrecognized future income tax assets	(153)	(243)	(75)	(75)
Unrecognized future income tax assets on temporary deductible differences and unused tax losses and deductions	1,094	1,308	76	267
Other	(118)	33	(61)	116
	\$ 1,668	\$ 2,911	\$ 1,209	\$ 3,049

The income tax provision consists of the following:

Current	\$ (236)	\$ (149)	\$ 297	\$ 236
Future	963	1,995	911	2,621
Valuation allowance	941	1,065	1	192
	1,904	3,060	912	2,813
	\$ 1,668	\$ 2,911	\$ 1,209	\$ 3,049

EXFO 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)

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 February 28, 2010	Six months ended February 28, 2010	Three months ended February 28, 2009	Six months ended February 28, 2009
Basic weighted average number of shares outstanding (000's)	59,427	59,406	60,875	64,108
Plus dilutive effect of:				
Stock options (000's)	212	176	122	124
Restricted share units (000's)	769	599	287	229
Deferred share units (000's)	121	144	91	85
Diluted weighted average number of shares outstanding (000's)	<u>60,529</u>	<u>60,325</u>	<u>61,375</u>	<u>64,546</u>
Stock awards excluded from the calculation of diluted weighted average number of shares because their exercise price was greater than the average market price of the common shares (000's)	<u>934</u>	<u>1,116</u>	<u>1,668</u>	<u>1,858</u>

12 Segment Information

The company is organized under two reportable segments. The Telecom Division, which represents the company's main business activity, offers a wide range of innovative solutions to assess optical networks, from the core to access, as well as next-generation IP infrastructures and related triple-play services. The Life Sciences and Industrial Division offers solutions for medical-device and opto-electronics assembly, fluorescence microscopy and other life sciences sectors.

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

EXFO 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)

The following tables present information by segment:

	Three months ended February 28, 2010			Six months ended February 28, 2010		
	Life Sciences and			Life Sciences and		
	Telecom Division	Industrial Division	Total	Telecom Division	Industrial Division	Total
Sales	\$ 47,951	\$ 6,159	\$ 54,110	\$ 88,243	\$ 11,427	\$ 99,670
Earnings from operations	\$ 2,748	\$ 1,187	\$ 3,935	\$ 4,789	\$ 1,874	\$ 6,663
Unallocated items:						
Interest expense			(76)			(118)
Foreign exchange loss			(1,037)			(2,146)
Earnings before income taxes			2,822			4,399
Income taxes			1,668			2,911
Net earnings for the period			\$ 1,154			\$ 1,488

	Three months ended February 28, 2009			Six months ended February 28, 2009		
	Life Sciences and			Life Sciences and		
	Telecom Division	Industrial Division	Total	Telecom Division	Industrial Division	Total
Sales	\$ 41,367	\$ 5,005	\$ 46,372	\$ 82,526	\$ 10,209	\$ 92,735
Earnings from operations	\$ 2,117	\$ 482	\$ 2,599	\$ 3,472	\$ 1,220	\$ 4,692
Unallocated items:						
Interest income			175			641
Foreign exchange gain			1,090			5,658
Earnings before income taxes			3,864			10,991
Income taxes			1,209			3,049
Net earnings for the period			\$ 2,655			\$ 7,942

Total assets by reportable segment are detailed as follows:

	As at February 28, 2010	As at August 31, 2009
Telecom Division	\$ 151,376	\$ 135,015
Life Sciences and Industrial Division	13,255	10,267
Unallocated assets	94,603	95,089
	\$ 259,234	\$ 240,371

EXFO 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)

Unallocated assets are comprised of cash, short-term investments, receivable on forward exchange contracts as well as 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 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 (SEC) in the United States have not been provided in these interim consolidated financial statements.

Statements of earnings

For the three and six months ended February 28, 2009 and 2010, there were no significant differences in the net earnings under Canadian GAAP as compared to U.S. GAAP.

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

The following summary sets out the significant differences in the company's reported shareholders' equity under Canadian GAAP as compared to U.S. GAAP:

	As at February 28, 2010	As at August 31, 2009
Shareholders' equity in accordance with Canadian GAAP	\$ 220,007	\$ 208,045
Goodwill	(4,041)	(3,879)
Stock appreciation rights	(73)	(73)
Shareholders' equity in accordance with U.S. GAAP	\$ 215,893	\$ 204,093

Research and development tax credits

Under Canadian GAAP, all research and development tax credits are recorded as a reduction of gross research and development expenses in the statements of earnings. Under U.S. GAAP, tax credits that are refundable against taxable income are recorded in the income taxes. These tax credits amounted to \$732,000 and \$1,628,000 for the three and six months ended February 28, 2009, respectively, and \$961,000 and \$1,892,000 for the three and six months ended February 28, 2010, respectively. This difference has no impact on the net earnings and the net earnings per share for the reporting periods.

Statements of cash flows

For the three and six months ended February 28, 2009 and 2010, 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.

EXFO 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)

New accounting standards and pronouncements

Adopted in fiscal 2010

In June 2009, the Financial Accounting Standard Board (FASB) issued guidance now codified as Accounting Standards Codification (ASC) Topic 105, “Generally Accepted Accounting Principles”, which became the single source of authoritative U.S. accounting and reporting standards, along with rules and interpretative releases of the SEC which are considered sources of authoritative GAAP for SEC registrants. All other non-grandfathered, non-SEC accounting literature not included in the ASC became non-authoritative. Topic 105 did not result in any accounting changes. The company adopted Topic 105 in the first quarter of fiscal 2010 and its adoption had no significant impact on its balance sheets or statements of earnings, but has and will continue to impact its reporting process by eliminating all references to pre-codification standards.

In December 2007, the FASB issued guidance now codified as ASC Topic 805, “Business Combinations”, and ASC Topic 810, “Consolidation”. These new standards significantly change the accounting and reporting for business combination transactions and noncontrolling (minority) interests in consolidated financial statements. These topics are required to be adopted simultaneously and are effective for the first annual reporting period beginning on or after December 15, 2008. The company will adopt the provisions of Topic 805 and Topic 810 to the acquisition of NetHawk Oyj (note 14) and any other business combinations entered into in the future.

In March 2008, the FASB issued guidance now codified as ASC Topic 815, “Derivatives and Hedging”, which requires 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 Topic 815, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance and cash flows. Topic 815 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The company adopted Topic 815 on September 1, 2009, and its adoption had no significant impact on its consolidated financial statements.

In April 2008, the FASB issued guidance now codified as ASC Topic 350, “Intangibles – Goodwill and Other”, which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset. The intent of this guidance is to improve the consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure the fair value of the asset under Topic 805. Topic 350 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The guidance for determining the useful life of a recognized intangible asset shall be applied prospectively to intangible assets acquired after the effective date. The disclosure requirements shall be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. The company adopted Topic 350 on September 1, 2009, and its adoption had no significant impact on its consolidated financial statements.

In April 2009, the FASB issued guidance now codified as ASC Topic 825, “Financial Instruments”, which requires disclosures about fair value of financial instruments for annual and interim reporting periods of publicly traded companies and requires those disclosures in summarized financial information at interim reporting periods. The company adopted Topic 825 on September 1, 2009, and its adoption had no significant impact on its consolidated financial statements.

In August 2009, the FASB amended ASC Topic 820, “Fair Value Measurement”, to provide clarification as to how to measure the fair value of liabilities in circumstances when a quoted price in an active market for the identical liability is not available. These amendments are effective for the company in the first quarter of fiscal 2010. The company adopted these amendments on September 1, 2009, and their adoption had no significant impact on its consolidated financial statements.

EXFO 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)

Topic 820 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy under topic 820 are described below:

- Level 1 – Unadjusted quoted prices in active markets that are accessible at the measurement date for identical assets or liabilities;
- Level 2 – Quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;
- Level 3 – Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (supported by little or no market activity).

The company's cash, short-term investments and forward exchange contracts are measured at fair value at each balance sheet date. The company's short-term investments are classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices in active markets. The company's cash and forward exchange contracts are classified within Level 2 of the hierarchy because they are valued using quoted prices and forward foreign exchange rates at the balance sheet date.

To be adopted after fiscal 2010

In October 2009, the FASB issued guidance now codified as ASC Topic 985 "Software", to change the accounting model for revenue arrangements that include both tangible products and software elements. Under this guidance, tangible products containing software components and non-software components that function together to deliver the tangible product's essential functionality are excluded from the software revenue guidance. In addition, hardware components of a tangible product containing software components are always excluded from the software revenue guidance. This guidance is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. The company is currently evaluating the impact that this guidance may have on its consolidated financial statements.

In October 2009, the FASB amended guidance now codified as Topic 605, "Revenue Recognition, to include a consensus relating to multiple-deliverable revenue arrangements. These amendments significantly change certain guidance pertaining to revenue arrangements with multiple deliverables and modify the separation criteria of Topic 605 by eliminating the criterion for objective and reliable evidence of fair value for the undelivered products or services. The amendments also eliminate the use of the residual method of allocation and require, instead, that arrangement consideration be allocated, at the inception of the arrangement, to all deliverables based on their relative selling price. This guidance is effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. The company is currently evaluating the impact that this guidance may have on its consolidated financial statements.

14 Subsequent Events

On March 12, 2010, the company acquired 91% of all issued and outstanding shares of NetHawk Oyj. In addition, on March 15, 2010, the company made a voluntary offer to purchase the remaining issued and outstanding shares; this offer is open for 20 business days starting from March 15, 2010. If the company is not able to acquire all remaining shares under the voluntary offer, it will enter into a statutory procedure under the Finnish Companies Act to acquire the remaining issued and outstanding shares. Headquartered in Oulu, Finland, NetHawk Oyj was a privately held company providing 2G, 3G and 4G/LTE protocol analyzers and simulators aimed mostly at network equipment manufacturers and wireless network operators.

EXFO 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)

This acquisition will be settled for a total cash consideration estimated at €37,300,000 (US\$51,300,000), including acquisition-related costs, or €27,600,000 (US\$38,000,000), excluding NetHawk's net cash estimated at €9,700,000 (US\$13,300,000) at the acquisition date, plus a contingent cash consideration of up to €8,700,000 (US\$12,000,000) based on sales volume of the acquired company over the next three years.

This acquisition will be accounted for using the purchase method under CICA Handbook Section 1581, "Business Combinations" and the requirements of Section 1600, "Consolidated Financial Statements"; consequently, the results of operations of the acquired business will be included in the consolidated financial statements of the company from March 12, 2010, being the acquisition date. For U.S. GAAP purposes, this acquisition will be accounted for under ASC Topic 805, "Business Combinations", and ASC Topic 810, "Consolidation". Accounting for business combinations under U.S. GAAP differs from CICA Handbook Section 1581. Namely, under U.S. GAAP, acquisition-related costs are not part of the purchase price but are rather expensed as incurred. In addition, under U.S. GAAP, any contingent consideration needs to be accounted for at fair value on the acquisition date and remeasured at each reporting period, with any adjustment to its fair value recorded in the statement of earnings. Under Canadian GAAP, contingent considerations are recorded when management can reasonably estimate the amount and the outcome of the contingency is beyond reasonable doubt.

The company expects to complete the purchase price allocation in the fourth quarter of fiscal 2010.

This business, including any acquired goodwill, will report to the Telecom Division.