

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

*This discussion and analysis contains forward-looking statements within the meaning of the U.S. Private Securities Litigation Reform Act of 1995, and we intend that such forward-looking statements be subject to the safe harbors created thereby. Forward-looking statements are statements other than historical information or statements of current condition. Words such as may, will, expect, believe, plan, anticipate, intend, could, estimate, continue, or similar expressions or the negative of such expressions are intended to identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events and circumstances are considered forward-looking statements. They are not guarantees of future performance and involve risks and uncertainties. Actual results may differ materially from those in forward-looking statements due to various factors including, but not limited to, macro-economic uncertainty and/or recession (including our ability to quickly adapt cost structures with anticipated levels of business and our ability to manage inventory levels with market demand); capital spending and network deployment levels in the telecommunications industry; future economic, competitive, financial and market condition; limited visibility with regards to customer orders and the timing of such orders; fluctuating exchange rates; consolidation in the global telecommunications test and service assurance industry and increased competition among vendors; concentration of sales; timely release and market acceptance of our new products and other upcoming products; our ability to successfully integrate businesses that we acquire; our ability to successfully expand international operations; and the retention of key technical and management personnel. Assumptions relating to the foregoing involve judgments and risks, all of which are difficult or impossible to predict and many of which are beyond our control. Other risk factors that may affect our future performance and operations are detailed in our Annual Report, on Form 20-F, and our other filings with the U.S. Securities and Exchange Commission and the Canadian securities commissions. We believe that the expectations reflected in the forward-looking statements are reasonable based on information currently available to us, but we cannot assure you that the expectations will prove to have been correct. Accordingly, you should not place undue reliance on these forward-looking statements. These statements speak only as of the date of this document. Unless required by law or applicable regulations, we undertake no obligation to revise or update any of them to reflect events or circumstances that occur after the date of this document.*

The following discussion and analysis of financial condition and results of operations is dated November 7, 2012.

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

### **TRANSITION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)**

On September 1, 2011, we adopted International Financial Reporting Standards (IFRS) as issued by the "International Accounting Standards Board" (IASB). Our consolidated financial statements for the year ended August 31, 2012 have been prepared in accordance with IFRS 1, "First-Time Adoption of International Financial Reporting Standards", as issued by the IASB. Previously, we prepared our consolidated financial statements in accordance with Canadian generally accepted accounting principles, in effect prior to September 1, 2011 (previous GAAP). Comparative information as at August 31, 2011 and for the year ended August 31, 2011 has been restated to comply with IFRS. Note 3 to our consolidated financial statements details the most significant adjustments to our reported statement of change in shareholders' equity, statements of earnings, comprehensive income and cash flows for the comparative year.

### **INDUSTRY OVERVIEW**

Market conditions in the telecommunications industry remain difficult due to a sluggish macro-economic environment, the European debt crisis and its ripple effects on other economies, as well as the tightening of capital spending among network operators. In addition, network operators are attempting to monetize their investments in next-generation fixed and mobile networks as data revenue growth is not keeping pace with the required level of expenditures. Consequently, network operators are reassessing their business models and spending levels in efforts to improve profitability.

Despite these constraints, the fundamental drivers toward broadband deployments and fixed-mobile Internet protocol (IP) network convergence are firmly entrenched in the telecommunications industry. Although we do not expect that network operators will significantly increase capital expenditures in fiscal 2013, we believe they will spend more in select, high-growth areas to accommodate bandwidth-intensive broadband applications and to facilitate the migration to more flexible and cost-effective fixed and mobile IP networks.

### ***Growing Bandwidth Demand***

According to Cisco's Visual Networking Index, global IP traffic will nearly quadruple from 2011 to 2016, reaching 1.3 zettabytes per year in 2016. (A zettabyte is equal to 1,000 exabytes or 250 billion DVDs). According to Cisco, global mobile traffic, a subset of this larger group, is expected to increase 18-fold during the same period. We believe this explosive growth is being driven by a proliferation of media-rich mobile communication devices (smart phones and tablets), a growing number of Internet users, faster broadband speeds and increased video usage.

### ***IP-Based Services***

To support such bandwidth growth, wireline networks are being transformed into next-generation IP-based infrastructures. Legacy SONET/SDH networks, which were established in the mid-1980s, do not have the flexibility to seamlessly mix and transport voice, data and video services. These networks are not capable of efficiently carrying triple-play services because they were designed for point-to-point voice communication. As a result, new optical transport network (OTN) standards, which are at the very heart of what the industry is labeling next-generation IP networks, have been defined to carry IP applications over Ethernet. Network operators are increasingly turning to such next-generation, IP-based networks in order to offer customers higher-margin triple-play services while lowering their operating costs.

### ***FTTH and Hybrid Networks***

Fiber-to-the-home (FTTH) has also become the access network architecture of choice for wireline operators wishing to provide a superior user experience for a combined voice, data and video offering. This architecture allows operators to meet heightened bandwidth requirements and future-proof their access networks as residential bandwidth demands grow from 1 to 5 Mbit/s (megabits per second) to 30 to 100 Mbit/s required for the long term. Hybrid architectures, combining copper and fiber (fiber-to-the-curb, or FTTC, and fiber-to-the-node, or FTTN), will also increase in the short term, since they are less expensive methods to increase bandwidth and can be mass-deployed quickly.

### ***Core Network Expansion Initiatives***

As bandwidth growth in access networks continues to increase, it has begun placing a strain on metro rings and core networks. It is also driving the need for higher-speed technologies. For example, 43 Gbit/s (gigabits per second) SONET/SDH is becoming mainstream, while commercial deployments of 100 Gbit/s Ethernet networks are under way. In the long run, we expect these solutions will offer a more economical way to add capacity to congested network links, especially if trenches need to be dug in order to deploy new fiber in metro and long-distance routes.

### ***Wireless Network Investments***

On the wireless side, operators are also faced with major investments to meet soaring bandwidth demand. Wireless operators are accelerating deployments of 3G networks, fast-tracking 4G/LTE adoption, and investing in mobile backhaul networks in order to increase transmission rates for bandwidth-hungry consumers to approach wireline speeds. Furthermore, as these consumers expect wireline and wireless networks to transport any content to any device at any time, both fixed and mobile networks are converging to a common IP-based infrastructure supported by IMS (IP multimedia subsystem) for seamless network interoperability.

These market dynamics affected telecom test and service assurance vendors in fiscal 2012.

## COMPANY OVERVIEW

We are a leading provider of next-generation test and service assurance solutions for wireline and wireless network operators and equipment manufacturers in the global telecommunications industry. We offer core-to-edge solutions that assess the performance and reliability of converged, IP (Internet Protocol) fixed and mobile networks. Our test and service assurance solutions specifically target high-growth market opportunities related to optimizing next-generation networks: wireless backhaul, 4G/LTE (long-term evolution), fiber-to-the-home (FTTH)/fiber-to-the-curb (FTTC)/fiber-to-the-node (FTTN), carrier Ethernet, and 40G/100G network upgrades. Customers on a global basis rely on our test and service assurance solutions to enable their wireline and wireless networks to perform optimally during their complete lifecycles: research, development, manufacturing, installation, maintenance and monitoring. Our success has been largely predicated on our core expertise in developing telecom test equipment for wireline network operators and to a lesser extent equipment manufacturers, but over the years we have expanded our offering to wireless network operators, cable television companies, public utilities, private network operators, third-party installers, equipment rental companies, large enterprises, component vendors and laboratory researchers.

We have a staff of approximately 1700 people in 25 countries, supporting more than 2000 telecom customers in approximately 100 countries around the world. We operate three main manufacturing sites, which are located in Quebec City, Canada, in Shenzhen, China and in Oulu, Finland. We also have five main research and development expertise centers in Boston, Toronto, Montreal, Quebec City and Oulu, supplemented by a software development center in India.

In fiscal 2012, we completed the construction of our new building in Montreal, Canada, which we occupy since June 2012.

In fiscal 2012, we committed to implement a restructuring plan to align our cost structure with the challenging market environment. This plan will result in one-time expenses of approximately US\$3.3 million, mainly for severance expenses. Most of the plan was executed in the fourth quarter of fiscal 2012 and it resulted in charges of \$2.3 million in severance expenses during that period; the remaining of the plan will be executed in the first half of fiscal 2013.

We launched 21 new products in fiscal 2012. Key product introductions in 2012 included amongst others the FTB-85100G Packet Blazer, a multi-rate, multi-service test solution for characterizing high-speed networks reaching 100G; Ethernet One, a centralized Ethernet service activation and monitoring solution that enables operators to improve the operational efficiency of their networks from the core to the last mile; EXFO Apps, a portal offering software applications that boost the capabilities and productivity of FTB platforms and test modules; the QA-805/QA-813 QualityAssurer, the industry's most scalable platform (simulates more than 12 million active subscribers) for load simulation of converged 3G, 4G/LTE and IMS networks; the portable iPro, an intelligent high-performance capture and analysis probe for wireless networks up to 10 Gbit/s; and the MaxTester 600 series for cost-effective VDSL2 (very-high-speed-digital subscriber line 2) installation and repair work on copper links.

We reported sales of \$250.0 million in fiscal 2012, which represents a decrease of 7.3% year-over-year from \$269.7 million in 2011, mainly due to global economic conditions and reduced spending by network operators.

We reported a net loss from continuing operations of \$3.6 million, or \$0.06 per share, in fiscal 2012, compared to net earnings from continuing operations of \$9.2 million, or \$0.15 per diluted share, in 2011. The net loss from continuing operations in fiscal 2012 included \$7.8 million in after-tax amortization of intangible assets, \$1.9 million in stock-based compensation costs, \$1.9 million in after-tax restructuring charges and a gain of \$0.3 million for the changes in the fair value of the cash contingent consideration. Net earnings from continuing operations for fiscal 2011 included \$8.7 million in after-tax amortization of intangible assets, \$2.0 million in stock-based compensation costs and a gain of \$2.7 million for the changes in the fair value of the cash contingent consideration. Earnings from operations (from continuing operations) amounted to \$504,000, or 0.2% of sales in fiscal 2012 compared to \$21.3 million, or 7.9% of sales in 2011.

Adjusted EBITDA (net earnings (loss) before interest, income taxes, depreciation of property, plant and equipment, amortization of intangible assets, changes in the fair value of the cash contingent consideration and gain from disposal of discontinued operations) amounted to \$13.5 million, or 5.4% of sales, in fiscal 2012, compared to \$30.6 million, or 11.3% of sales, in 2011. Adjusted EBITDA in fiscal 2012 included a foreign exchange loss of \$657,000, compared to \$3.8 million in 2011. See further in this document for a complete reconciliation of adjusted EBITDA and IFRS net earnings (loss).

On November 7, 2011, we announced that our Board of Directors had approved the renewal of our share repurchase program, by way of a normal course issuer bid on the open market of up to 2% of the issued and outstanding subordinate voting shares, representing 575,690 subordinate voting shares at the prevailing market price. The normal course issuer bid started on November 10, 2011, and will end on November 9, 2012.

On November 7, 2012, we announced that our Board of Directors approved the renewal of our share repurchase program, by way of a normal course issuer bid on the open market of up to 10% of the issued and outstanding subordinate voting shares, representing 2,072,721 subordinate voting shares at the prevailing market price. We expect to use cash, short-term investments or future cash flow from operations to fund the repurchase of shares. The normal course issuer bid will start on November 12, 2012, and will end on November 11, 2013, or on an earlier date if we repurchase the maximum number of shares permitted under the bid. The program does not require that we 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. We shall provide to any person or company, upon request to our Secretary, at 400 Godin Avenue, Quebec, Province of Quebec, Canada, G1M 2K2, phone number (418) 683-0913 ext. 23704 or fax number (418) 683-9839, a copy of the notice sent to the Toronto Stock Exchange (TSX) according to our normal course issuer bid.

## **Sales**

We sell our products to a diversified customer base in approximately 100 countries through our direct sales force and channel partners, such as sales representatives and distributors. Most of our sales are denominated in US dollars and euros.

In fiscal 2011 and 2012, no customer accounted for more than 10% of our sales, with our top customer representing 7.2% and 4.4% of our sales respectively.

We believe that we have a vast array of products, a diversified customer base, and a good spread across geographical areas, which provides us with reasonable protection against the concentration of sales and credit risk.

## **Cost of Sales**

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

## **Operating Expenses**

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

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

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

## OUR STRATEGY AND KEY PERFORMANCE INDICATORS

### Three-Year Strategic Objectives

Our long-term goal is to become the market leader in the global telecom test and service assurance industry. To help us reach our eventual goal, we had established a growth strategy that took advantage of soaring bandwidth demand and IP network convergence on fixed and mobile networks. This strategy, which was fine-tuned over the years, consisted of:

- Increasing our wireless presence;
- Enable network operators to reduce their operating expenses;
- Expanding our share of wallet with Tier-1 network operators; and
- Accelerating profitability through execution.

To gauge the success of our strategy, we had established three corporate performance objectives for the three-year period ended in fiscal 2012:

- Increase sales by a CAGR\* of at least 25%
- Raise gross margin to 65%
- Increase adjusted EBITDA\*\* in dollars by a CAGR of at least 30%

\* Compound annual growth rate

\*\* EBITDA is defined as net earnings (loss) before interest, income taxes, depreciation of property, plant and equipment, amortization of intangible assets and impairment of goodwill. Adjusted EBITDA represents EBITDA excluding changes in the fair value of the cash contingent consideration and the gain from the disposal of discontinued operations.

### Results Achieved in Fiscal 2012

Our corporate performance objectives take into account the sales and operating results of our Life Sciences and Industrial Division, which are presented as discontinued operations in our figures for fiscal 2009, 2010 and 2011.

Following are our results of our three-year plan:

Corporate Performance Objectives (Fiscal 2010-2012)				
Objectives	Metrics	Results After		
		1 Year	2 Years	3 Years
Increase sales by a CAGR of at least:	<b>25%</b>	32.0%	25.4%	<b>13.1%</b>
Raise gross margin from 61.3% to:	<b>65%</b>	62.4%	62.7%	<b>63.3%</b>
Increase adjusted EBITDA** in dollars by a CAGR of at least:	<b>30%</b>	88.8%	45.4%	<b>-2.2%</b>

In fiscal 2012, our sales amounted to \$250.0 million, which represents a CAGR of 13.1% for the three-year period. Our gross margin, reached 63.3% in fiscal 2012. Finally, adjusted EBITDA amounted to \$13.5 million, or 5.4 % of sales, in fiscal 2012, representing a negative CAGR of 2.2% for the three-year period. See further in this document for a reconciliation of IFRS net earnings (loss) to adjusted EBITDA.

We were on track to achieve our corporate performance objective two years into our three-year plan. In fiscal 2012, however, a sluggish macro-economic environment, combined with the debt crisis in Europe, caused several network operators to hold off on their capital-intensive spending projects; consequently, we fell short of our three-year goals. However, during this three-year period, we remained committed to our growth strategy, which led our actions.

## RESULTS OF OPERATIONS

(in thousands of US dollars, except per share data, and as a percentage of sales for the periods indicated)

<b>Consolidated statements of earnings data:</b>	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Sales.....	\$ 249,966	\$ 269,743	100.0 %	100.0 %
Cost of sales <sup>(1)</sup> .....	91,792	100,296	36.7	37.2
Selling and administrative.....	94,139	87,062	37.7	32.3
Net research and development.....	49,854	47,927	19.9	17.7
Depreciation of property, plant and equipment.....	6,169	6,655	2.5	2.5
Amortization of intangible assets.....	7,819	9,183	3.1	3.4
Changes in the fair value of cash contingent consideration.....	(311)	(2,685)	(0.1)	(1.0)
Earnings from operations.....	504	21,305	0.2	7.9
Interest and other income.....	131	511	0.1	0.2
Foreign exchange loss.....	(657)	(3,808)	(0.3)	(1.4)
Earnings (loss) before income taxes.....	(22)	18,008	–	6.7
Income taxes.....	3,571	8,814	1.4	3.3
Net earnings (loss) from continuing operations.....	(3,593)	9,194	(1.4) %	3.4 %
Net earnings from discontinued operations.....	–	12,926		
Net earnings (loss) for the year.....	\$ (3,593)	\$ 22,120		
Basic and diluted net earnings (loss) from continuing operations per share.....	\$ (0.06)	\$ 0.15		
Basic net earnings (loss) per share.....	\$ (0.06)	\$ 0.37		
Diluted net earnings (loss) per share.....	\$ (0.06)	\$ 0.36		
Other selected information:				
Gross margin <sup>(2)</sup> .....	\$ 158,174	\$ 169,447	63.3 %	62.8 %
Research and development data:				
Gross research and development.....	\$ 59,282	\$ 57,226	23.7 %	21.2 %
Net research and development.....	\$ 49,854	\$ 47,927	19.9 %	17.7 %
Restructuring changes included in:				
Cost of sales.....	\$ 264	\$ –	0.1 %	– %
Selling and administrative expenses.....	\$ 1,181	\$ –	0.5 %	– %
Net research and development expenses.....	\$ 884	\$ –	0.4 %	– %
Adjusted EBITDA <sup>(2)</sup> .....	\$ 13,524	\$ 30,583	5.4 %	11.3 %
<b>Consolidated balance sheets data:</b>				
Total assets.....	\$ 306,683	\$ 322,355		

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

(2) Refer to page 20 for non-IFRS measures.

## RESULTS FROM CONTINUING OPERATIONS (formerly the Telecom Division)

### SALES

In fiscal 2012, our sales decreased 7.3% to a \$250.0 million, compared to \$269.7 million in 2011.

In fiscal 2012, market conditions in the telecommunications industry remained tenuous due to macro-economic uncertainty, the European debt crisis and its ripple effects on other economies, the tightening of capital spending among network operators as well as delays in customers' orders. In addition, Europe turned out to be more impacted than we expected, the anticipated pick-up of spending in the Americas did not materialize, especially with Tier-1 operators, while China has been sluggish. This has rendered our end-markets very difficult in the short term and has resulted in lower sales in fiscal 2012, compared to 2011.

In addition, network operators are grappling with issues of monetizing their investments in next-generation fixed and mobile networks as data revenue growth is not keeping pace with the required level of expenditures. Consequently, network operators are reassessing their business models and spending levels in efforts to improve profitability, as they are increasingly scrutinizing their capital expenditures and even delaying some purchasing decisions. Reduced capital spending and less capital-intensive network deployments mostly affected our physical-layer solutions sales in fiscal 2012, compared to 2011.

Also, in fiscal 2012, as a result of the above-mentioned factors, we did not benefit from the same level of calendar year-end budget spending from some of our customers compared to 2011. The magnitude of customers' calendar year-end budget spending may fluctuate year-over-year.

Furthermore, in fiscal 2011, we received a follow-on order worth over \$6 million from a Tier-1 European operator for our AXS-200/635 triple-play tester. We did not recognize such large single order in fiscal 2012, which reduced our sales of physical-layer solutions year-over-year.

Also, in fiscal 2012, the increase in the average value of the US dollar compared to the euro had a negative impact of approximately \$2 million on our sales compared to 2011 as we report our results in US dollars; this represents a decrease of 0.7% of sales year-over-year.

Finally, in fiscal 2012, we recorded in our sales foreign exchange gains of \$1.1 million on our forward exchange contracts, compared to \$2.8 million in 2011, which contributed to decrease our sales 0.6% year-over-year.

Despite current challenging market conditions on a global basis and the general decrease in our sales year-over-year in fiscal 2012, we delivered a 4.4% sales growth for our protocol products year-over-year. Protocol sales are less dependent on large network rollouts and benefited from system upgrades from 10 Gbit/s to 40 Gbit/s and 100 Gbit/s as well as investments in wireless backhaul networks.

The following table summarizes changes in sales by product lines:

	Years ended		Change in %
	August 31, 2012	August 31, 2011	
Physical-layer solutions	\$ 135,141	\$ 158,002	(14.5) %
Protocol-layer solutions	113,700	108,946	4.4
Foreign exchange gains on forward exchange contracts	1,125	2,795	(59.7)
Total sales	<u>\$ 249,966</u>	<u>\$ 269,743</u>	<u>(7.3) %</u>

## ***Bookings***

Bookings decreased 10.1% year-over-year to \$244.8 million in fiscal 2012 from \$272.3 million in 2011, for a book-to-bill ratio of 0.98 in fiscal 2012.

As mentioned earlier, we believe that difficult market conditions in the telecommunications industry, which led to reduced capital spending and less capital intensive deployments, had a negative impact on our bookings in fiscal 2012 compared to 2011, especially for our physical-layer solutions. Our protocol products bookings, benefited from system upgrades from 10 Gbit/s to 40 Gbit/s and 100 Gbit/s as well as investments in wireless backhaul networks, which limited the year-over-year decrease in bookings for this product line.

## ***Geographic distribution***

In fiscal 2012, sales to the Americas, Europe, Middle-East and Africa (EMEA) and Asia-Pacific (APAC) accounted for 52%, 29% and 19% of sales respectively, compared to 51%, 32% and 17% respectively in 2011.

## **GROSS MARGIN (non-IFRS measure – refer to page 20 of this document)**

Gross margin amounted to 63.3% and 62.8% of sales in fiscal 2012 and 2011 respectively.

The increase in our gross margin in fiscal 2012, compared to 2011, can be explained by the following factors.

First, in fiscal 2012, the product mix was more favorable as we sold more protocol testing products compared to 2011, which resulted in a higher gross margin year-over-year. Protocol testing products deliver higher gross margin than our other product lines. In addition, in fiscal 2011, we reported larger orders for copper-access solutions, which typically deliver lower margins than our other test solutions, and we granted larger volume discounts on a significant part of these sales.

Furthermore, in fiscal 2012, our warranty provision decreased compared to 2011; this resulted in a positive impact on our gross margin year-over-year.

In addition, in fiscal 2012, a larger portion of our sales came from products manufactured in our facilities in China compared to 2011; those products have a lower cost of goods than those manufactured in our facilities in Canada, thus resulting in an improvement in our gross margin year-over-year.

On the other hand, a lower sales volume in fiscal 2012 compared to 2011 (7.3%) resulted in a lower absorption of our fixed manufacturing costs, which prevented us from further improving our gross margin year-over-year.

In addition, in fiscal 2012, we faced increased pricing pressure, which negatively affected our gross margin year-over-year.

Also, in fiscal 2012, we recorded \$264,000 in restructuring charges in the cost of sales, which negatively impacted our gross margin year-over-year.

Furthermore, in fiscal 2012, due to the decrease in the value of the Canadian dollar versus the US dollar, we reported a lower gain on our forward exchange contracts in our sales compared to the same period last year, which negatively affected our gross margin year-over-year.

Finally, the decrease in the value of the Canadian dollar, compared to the US dollar over the last few months had a negative impact on our gross margin in fiscal 2012 compared to 2011; in fact, our procurement costs increased as the Canadian dollar decreased compared to the US dollar, as a significant portion of our raw material purchases are denominated in US dollars and our raw material costs of parts purchased in US dollars are measured in Canadian dollars in our financial statements.

### ***Outlook for fiscal 2013***

Considering the expected sales growth, the expected increase in sales of protocol products as well as software-intensive products and services, the cost-effective design of our products, our increased manufacturing activities in China and our tight control on operating costs, we expect our gross margin to improve in the future. However, our gross margin may fluctuate quarter-over-quarter due to the mix of our products and as our sales may fluctuate. Furthermore, our gross margin can be negatively affected by increased competitive pricing pressure, customer concentration and/or consolidation, increased obsolescence and warranty costs, shifts in customer and product mix, under-absorption of fixed manufacturing costs and increases in product offerings by other suppliers in our industry.

### **SELLING AND ADMINISTRATIVE EXPENSES**

Selling and administrative expenses were \$94.1 million and \$87.1 million for fiscal 2012 and 2011 respectively. As a percentage of sales, selling and administrative expenses amounted to 37.7% and 32.3% for fiscal 2012 and 2011 respectively.

In fiscal 2012, we continued intensifying our sales and marketing efforts, including additional employees, both domestically and internationally, and we incurred bad debt expenses compared to bad debt recovery in 2011; in addition, despite a lower sales volume year-over-year (7.3%), our commission expenses to our sales channels were almost flat compared to 2011 due to the shift in product and territory mix; this caused our expenses to increase as a percentage of sales year-over-year.

In addition, in fiscal 2012, we recorded \$1.2 million, or 0.5% of sales, in restructuring charges in our selling and administrative expenses for the employees laid off as part of our restructuring plan in the fourth quarter of the year.

However, the increase in the average value of the US dollar in fiscal 2012 compared to the Canadian dollar and the euro year-over-year had a positive impact on our selling and administrative expenses, as a portion of these expenses are incurred in Canadian dollars and euros and we report our results in US dollars.

### ***Outlook for fiscal 2013***

For fiscal 2013, we expect our selling and administrative expenses to decrease as percentage of sales and range between 33% and 35% of sales. However, any increase in the strength of the Canadian dollar and the euro versus the US dollar would cause our selling and administrative expenses to increase, as a significant portion of these expenses are incurred in Canadian dollars and euros.

### **RESEARCH AND DEVELOPMENT EXPENSES**

#### ***Gross research and development expenses***

Gross research and development expenses totaled \$59.3 million and \$57.2 million for fiscal 2012 and 2011 respectively. As a percentage of sales, gross research and development expenses amounted to 23.7% and 21.2% for fiscal 2012 and 2011 respectively, while net research and development expenses accounted for 19.9% and 17.7% of sales for these respective years.

In fiscal 2012, we intensified our research and development activities, including additional headcounts, which resulted in increased gross research and development expenses compared to 2011. In addition, in fiscal 2012, the mix and calendar of research and development projects resulted in increased gross research and development expenses compared to 2011.

In addition, in fiscal 2012, we recorded \$884,000, or 0.4% of sales, in restructuring charges in our gross research and development expenses for the employees laid off as part of our restructuring plan implemented in the fourth quarter of the year.

However, the increase in the average value of the US dollar in fiscal 2012 compared to the Canadian dollar, the euro and the Indian rupee year-over-year had a positive impact on our gross research and development expenses, as most of these expenses are incurred in these currencies and we report our results in US dollars.

### ***Tax credits and grants***

We are entitled to tax credits from the Canadian federal and provincial governments for eligible research and development activities conducted in Canada. We are also eligible for grants by a Finnish technology organization on certain research and development projects conducted in Finland.

Tax credits and grants for research and development activities were \$9.4 million and \$9.3 million for fiscal 2012 and 2011 respectively. As a percentage of gross research and development expenses, tax credits reached 15.9% and 16.2% for fiscal 2012 and 2011 respectively.

### ***Outlook for fiscal 2013***

For fiscal 2013, we expect our net research and development expenses to decrease as percentage of sales and range between 16% and 18% of sales. However, any increase in the strength of the Canadian dollar, the euro and the Indian rupee versus the US dollar in the upcoming quarters would cause our net research and development expenses to increase, as most of these expenses are incurred in these currencies.

## **DEPRECIATION OF PROPERTY, PLANT AND EQUIPMENT**

In fiscal 2012, depreciation of property, plant and equipment amounted to \$6.2 million, compared to \$6.7 million in 2011.

The decrease in depreciation expense in fiscal 2012, compared to 2011, is due to the fact that some assets became fully depreciated as well as the increase in the average value of the US dollar versus the Canadian dollar, the euro and the Indian rupee year-over-year, as most of the depreciation expense is incurred in these currencies and we report our results in US dollars.

### ***Outlook for fiscal 2013***

For fiscal 2013, we expect our depreciation expense to slightly decrease compared to 2012.

## **AMORTIZATION OF INTANGIBLE ASSETS**

In conjunction with the business combinations we completed over the past several years, we recorded intangible assets, primarily consisting of core technology and customer relationships. In addition, intangible assets include software. These intangible assets resulted in amortization expenses of \$7.8 million and \$9.2 million for fiscal 2012 and 2011 respectively.

The decrease in amortization expenses in fiscal 2012, compared to 2011, comes from the fact that core technologies related to the acquisition of Consultronics Limited became fully amortized in the second quarter of 2011. In addition, the increase in the average value of the US dollar compared to the Canadian dollar and the euro had to some extent, a positive impact on our amortization expense, as most of this expense is incurred in these currencies.

## **CHANGES IN THE FAIR VALUE OF THE CASH CONTINGENT CONSIDERATION**

In fiscal 2012, changes in the fair value of the cash contingent consideration amounted to \$311,000, compared to \$2.7 million in 2011.

Under the acquisition agreement of NetHawk Oyj, we have a cash contingent consideration of up to €8.7 million (\$11.0 million) based on a sales volume of certain NetHawk products over a three-year period ending on December 2012. We record the cash contingent consideration payable at fair value in each balance sheet date based on actual and forecasted sales over the period of the contingent consideration. Changes in the fair value of the cash contingent consideration payable are recorded in the consolidated statements of earnings.

As at August 31, 2012, the fair value of the cash contingent consideration payable was estimated to nil based on actual and forecasted sales of certain NetHawk products over the period of the contingent consideration; the resulting change in the fair value during the year ended August 31, 2012, in the amount of \$311,000 (€235,000), has been recorded in the consolidated statements of earnings for that year.

As at August 31, 2011, the fair value of the cash contingent consideration payable was estimated to \$338,000 (€235,000), which resulted in a change in the fair value of \$2.7 million, recorded in the statement of earnings in fiscal 2011.

## **INTEREST AND OTHER INCOME**

Our interest income mainly resulted from our short-term investments, less interests and bank charges.

Interest and other income amounted to \$131,000 in fiscal 2012 compared to \$511,000 in 2011.

In fiscal 2011, we sold non-core capital assets for proceeds of \$568,000, which resulted in a gain for the same amount recorded in the interest and other income line item in the statements of earnings for that year. Otherwise, interest and other income would have slightly increased in fiscal 2012 compared to 2011.

## **FOREIGN EXCHANGE GAIN (LOSS)**

Foreign exchange gains and losses are mainly the result of the translation of operating activities denominated in currencies other than our functional currency, which is the Canadian dollar. A large portion of our foreign exchange gains or losses results from the translation of cash balances and deferred income taxes denominated in US dollars. We manage our exposure to currency risks in part with forward exchange contracts. In addition, some of our entities' operating activities are denominated in US dollars, euros or other currencies, which further hedges these risks. However, we remain exposed to currency risks and any increase in the value of the Canadian dollar, compared to the US dollar and the euro, would have a negative impact on our operating results.

We reported a foreign exchange loss of \$657,000 in fiscal 2012, compared to \$3.8 million in 2011.

In fiscal 2012, we witnessed some volatility in the value of the Canadian dollar as it fluctuated compared to the US dollar, which overall resulted in a foreign exchange loss of \$657,000. In fact, the period-end value of the Canadian dollar slightly decreased 0.9% to CA\$0.9863 = US\$1.00 in fiscal 2012, compared to CA\$0.9784 = US\$1.00 in 2011, and the average value of the Canadian dollar compared to the US dollar was CA\$1.0094 = US\$1.00.

In comparison, in fiscal 2011, the value of the Canadian dollar significantly increased versus the US dollar, compared to August 31, 2010, which resulted in a large foreign exchange loss of \$3.8 million during the year. The period-end value of the Canadian dollar increased 9.0% versus the US dollar to CA\$0.9784 = US\$1.00 in fiscal 2011, compared to CA\$1.0665 = US\$1.00 in 2010.

Foreign exchange rate fluctuations also flow through the P&L line items as a significant portion of cost of sales and our operating items are denominated in Canadian dollars, euros and Indian rupees, and we report our results in US dollars. Consequently, the increase in the average value of the US dollar in fiscal 2012, compared to these currencies year-over-year, resulted in a positive impact on our financial results. In fact, the average value of the US dollar in fiscal 2012 increased 2.0%, 6.2% and 12.3% respectively, compared to the Canadian dollar, the euro and the Indian rupee.

## **INCOME TAXES**

We recorded income tax expenses of \$3.6 million and \$8.8 million in fiscal 2012 and 2011 respectively.

In fiscal 2012, we reported income tax expenses of \$3.6 million on a loss before income taxes of \$22,000. This situation mainly resulted from the fact that we did not recognize deferred income tax assets for some of our subsidiaries at loss and we had some non-deductible loss and expenses, such as stock-based compensation costs. However, in fiscal 2012, we recognized previously unrecognized deferred income tax assets of one of our subsidiaries, which resulted in a one-time income tax recovery of \$557,000. In fact, in fiscal 2012, based on available positive and negative evidence, as well as on the level and the nature of cumulative and expected profits of one of our subsidiaries located in Asia, we concluded that it was probable that deferred income tax assets of that subsidiary (mainly operating losses carried forward) would be realizable. Otherwise, the actual tax rate would have been closer to the combined Canadian and provincial statutory tax rate of 27% in fiscal 2012.

In fiscal 2011, we reported an income tax expense of \$8.8 million on earnings before income taxes of \$18.0 million, for an effective income tax rate of 48.9%. Our combined Canadian and provincial statutory tax rate was 29%. This situation mainly resulted from the fact that a significant portion of our foreign exchange loss was created by the translation of financial statements of our foreign operations, and was therefore non-deductible. In addition, we did not recognize deferred income tax assets for some of our subsidiaries at loss and we had some non-deductible expenses, such as stock-based compensation costs. However, the changes in the fair value of the cash consideration, which resulted in a gain of \$2.7 million, were non-taxable. Otherwise, the actual tax rate would have been closer to the statutory tax rate.

Please refer to note 22 to our consolidated financial statements for a full reconciliation of our income tax provision.

## **RESULTS OF DISCONTINUED OPERATIONS (formerly the Life Sciences and Industrial Division)**

On October 1, 2010, we completed the sale of our Life Sciences and Industrial Division and that Division contributed one month to our results of the first quarter of fiscal 2011. Results from operations for that Division for the first quarter of fiscal 2011 were included in net earnings from discontinued operations along with the gain on the sale of the Division.

## **SALES**

In fiscal 2011, sales of the discontinued operations (one-month contribution) amounted to \$2.0 million.

## **NET EARNINGS**

In fiscal 2011, we reported net earnings from discontinued operations of \$12.9 million, which included a gain on disposal of discontinued operations of \$13.2 million and \$264,000 in stock-based compensation costs.

## LIQUIDITY AND CAPITAL RESOURCES

### *Cash requirements and capital resources (from continuing operations)*

As at August 31, 2012, cash and short-term investments totaled \$67.1 million, while our working capital was at \$117.7 million. Our cash and short-term investments decreased \$2.8 million in fiscal 2012, compared to 2011. In fiscal 2012, we made cash payments of \$23.8 million for the purchase of capital assets, mainly for our new building in Montreal, Canada, \$2.2 million for the redemption of share capital under our share repurchase program and \$1.4 million for the repayment of our bank loan and long-term debt. In addition, we recorded an unrealized foreign exchange loss on our cash and short-term investments of \$836,000. This unrealized foreign exchange loss resulted from the translation, in US dollars, of our Canadian-dollar-denominated cash and short-term investments and was included in the accumulated other comprehensive income in the balance sheet. However, operating activities generated \$25.3 million in cash.

Our short-term investments consist of banker acceptances issued by high-credit quality corporations; therefore, we consider the risk of non-performance of these financial instruments to be limited. These debt instruments are not expected to be affected by a significant liquidity risk. For the purpose of managing our cash position, we have established a cash management policy, which we follow and monitor on a regular basis. Our cash and short-term investments will be used for working capital and other general corporate purposes, potential acquisitions as well as our share repurchase program. As at August 31, 2012, cash balances included an amount of \$36.2 million that bears interest at a rate of 1.3%.

We believe that our cash balances and short-term investments will be sufficient to meet our liquidity and capital requirements for the foreseeable future, including the effect of our normal course issuer bid. In addition to these assets, we have unused available lines of credit totaling \$15.8 million for working capital and other general corporate purposes and unused lines of credit of \$26.3 million for foreign currency exposure related to forward exchange contracts. However, possible operating losses, additional restructuring costs and/or possible investments in or acquisitions of complementary businesses, products or technologies may require additional financing. There can be no assurance that additional debt or equity financing will be available when required or, if available, that it can be secured on satisfactory terms.

As at August 31, 2012, our commitments under operating leases amount to \$3.6 million in 2013, \$1.9 million in 2014, \$1.3 million in 2015, \$0.9 million in 2016 and \$1.3 million in 2017 and after, for total commitments of \$9.0 million.

### *Sources and uses of cash*

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

### *Operating activities (including discontinued operations)*

Cash flows provided by operating activities were \$25.3 million in fiscal 2012, compared to \$23.3 million in 2011.

Cash flows provided by operating activities in fiscal 2012 were mainly attributable to the net earnings after items not affecting cash of \$12.0 million and the positive net change in non-cash operating items of \$13.3 million; this was mainly due to the positive effect on cash of the decrease of \$8.0 million in our accounts receivable, due to the decrease in sales year-over-year and the timing of sales within the year, the decrease of \$10.9 million in our inventories due to the decrease in sales year-over-year and an improved inventory turn, as well as the increase of \$538,000 in our accounts payable, accrued liabilities, provisions and other liabilities due to timing of purchases and payments during the year. These positive effects on cash were offset in part by the negative effect of the increase of \$5.6 million in our income taxes and tax credits recoverable due to tax credits earned during the period not yet recovered and the increase of \$589,000 in our prepaid expenses due to the timing of payments during the year.

### *Investing activities (including discontinued operations)*

Cash flows provided by investing activities amounted to \$13.1 million in fiscal 2012, compared to cash flows used of \$25.3 million in 2011.

In fiscal 2012, we disposed (net of acquisitions) of \$36.9 million worth of short-term investments, but we paid \$23.8 million for the purchase of capital assets, mainly for our new building in Montreal, Canada.

### *Financing activities (including discontinued operations)*

Cash flows used by financing activities amounted to \$3.3 million in fiscal 2012, compared to cash flows provided of \$1.6 million in 2011.

In fiscal 2012, we reimbursed our bank loan of \$782,000, we made a repayment of \$577,000 of our long-term debt, and we redeemed share capital for a cash consideration of \$2.2 million. However, we received \$310,000 from the exercise of stock options.

## **FORWARD EXCHANGE CONTRACTS**

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

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

As at August 31, 2012, we held forward exchange contracts to sell US 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>
September 2012 to August 2013	\$ 23,000,000	1.0228
September 2013 to August 2014	3,600,000	1.0439
Total	<u>\$ 26,600,000</u>	<u>1.0256</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 \$2.3 million as at August 31, 2011, and \$932,000 as at August 31, 2012. The year-end exchange rate was CA\$0.9863 = US\$1.00 as at August 31, 2012.

## **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.

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. Appeals of the opinion granting final approval were filed, all of which have been dismissed or settled as of January 9, 2012. The settlement payment on behalf of EXFO has been made by the insurers, the settlement among the parties is final, and the case is concluded.

## **SHARE CAPITAL**

### ***Share capital***

As at November 7, 2012, EXFO had 31,643,000 multiple voting shares outstanding, entitling to 10 votes each and 28,772,915 subordinate voting shares outstanding. The multiple voting shares and the subordinate voting shares are unlimited as to number and without par value.

## **OFF-BALANCE SHEET ARRANGEMENTS**

As at August 31, 2012, our off-balance sheet arrangements consisted of letters of guarantee amounting to \$5.4 million; these letters of guarantee expire at various dates through fiscal 2017. From this amount, we had \$1.0 million worth of letters of guarantee for our own selling and purchasing requirements, which were for the most part reserved from one of our lines of credit. The remainder, in the amount of \$4.4 million, was used to secure our line of credit in CNY (Chinese currency) of \$4.0 million plus any accrued interests. This line of credit was unused as at August 31, 2012.

## **SPECIAL PURPOSE ENTITIES**

As at August 31, 2012, we did not have interests in any special purpose entities.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Our consolidated financial statements have been prepared in accordance with IFRS 1, "*First-Time Adoption of International Financial Reporting Standards (IFRS)*". Note 2 to our consolidated financial statements for the year ended August 31, 2012 details accounting policies that we adopted under IFRS. In addition, note 3 to our consolidated financial statements for fiscal 2012 discloses the impact of the transition to IFRS on our reported financial position, financial performance and cash flows, including the nature and effect of significant changes in accounting policies from those used in our consolidated financial statements for the year ended August 31, 2011, under Canadian GAAP (previous GAAP).

Upon the transition to IFRS on September 1, 2010, we initially elected to discount the carrying value of our long-term tax credits; this initial election resulted in a decrease of our long-term tax credits of \$2.5 million and an increase in deferred tax assets of \$678,000 as at September 1, 2010, with a corresponding net decrease of \$1.8 million in the opening balance of retained earnings. It also resulted in a decrease of \$2.5 million in our long-term tax credits, an increase in deferred tax assets of \$401,000, a decrease in deferred tax liabilities of 276,000 as at August 31, 2011, as well as interest income of \$227,000 and a related deferred income tax expense of \$61,000 for fiscal 2011.

In the fourth quarter of fiscal 2012, prior to issuing our first annual consolidated financial statements under IFRS, we changed our initial choice of accounting policy for measuring our long-term, non-refundable research and development tax credits and finally opted not to discount these tax credits; we retroactively applied this change in accounting policy at the transition date. Consequently, the carrying value of the previously disclosed long-term tax credits, deferred income tax assets and liabilities, and retained earnings as at September 1, 2010 and August 31, 2011, have been adjusted to reflect this change in accounting policy and the reconciliations from Canadian GAAP to IFRS in the following sections have been adjusted accordingly.

The preparation of financial statements in accordance with IFRS requires management to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses and the disclosures of contingent assets and liabilities at the date of the financial statements. On an ongoing basis, we evaluate these estimates and assumptions, including those related to the fair value of financial instruments, the allowance for doubtful accounts receivable, the amount of tax credits recoverable, the provision for excess and obsolete inventories, the estimated useful lives of capital assets, the valuation of long-lived assets, the impairment of goodwill, the recoverable amount of deferred income tax assets, the amount of certain accrued liabilities, provisions and deferred revenue as well as stock-based compensation costs. We base our estimates and assumptions on historical experience and on other factors that we believe to be reasonable under the circumstances, the result of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates and assumptions.

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

*(a) Inventories*

We state our inventories at the lower of cost, determined on an average cost basis and net realizable value, and we provide reserves for excess and obsolete inventories. We determine our reserves for excess and obsolete inventories based on the quantities on hand at the reporting dates compared to foreseeable needs over the next twelve months, taking into account changes in demand, technology or market. It is possible that additional inventory reserves may occur if future sales are less than our forecasts or if there is a significant shift in product mix compared to our forecasts, which could adversely affect our future results.

*(b) Income taxes*

We are subject to income tax laws and regulations in several jurisdictions. Under these laws and regulations, uncertainties exist with respect to the interpretation of complex tax regulations and the amount and timing of future taxable income. We maintain provisions for uncertain tax positions that we believe appropriately reflect our risk based on our interpretation of laws and regulations. In addition, we make reasonable estimates and assumptions to determine the amount of deferred tax assets that can be recognized in our consolidated financial statements, based upon the likely timing and level of anticipated future taxable income together with tax planning strategies. The ultimate realization of our deferred income tax assets is dependent upon the generation of sufficient future taxable income during the periods in which those assets are expected to be realized.

As at August 31, 2012, non-refundable research and development tax credits recognized in the balance sheet amounted to \$41.5 million. In order to realize these non-refundable research and development tax credits, we need to generate approximately \$270 million (CA\$267 million) in pre-tax earnings at the Canadian federal level and approximately \$11 million at the Canadian provincial level. In addition, as at August 31, 2012, we had deferred income tax assets in the balance sheet in amount of \$12.1 million mainly in United States. In order to realize these deferred income tax assets, we need to generate \$30 million at the United States level.

(c) *Impairment of non-financial assets*

Impairment exists when the carrying value of an asset or group of assets (cash generating unit (CGU)) exceeds its recoverable amount, which is the higher of its fair value less costs to sell and its value in use. The fair value less costs to sell calculation is based on available data from binding sales transactions in an arm's length transaction, available data from observable active market prices less incremental costs for disposing of the asset, or data from recent transactions of similar assets, within the same industry, when available. When such information is not available, or to supplement this information, we use discounted cash flows. The establishment of discounted cash flows requires the use of estimates, including management's expectations of future revenue growth, operating costs and profit margins as well as discount rates for each CGU.

i) *Growth rates*

The assumptions used are based on historical growth, our internal budget, expectations of future revenue growth as well as industry and market trends. We projected revenues, operating margins and cash flows for periods of five years, and we applied a perpetual growth rate thereafter.

ii) *Discount rate*

We used a discount rate to calculate the present value of estimated future cash flows, which represents our weighted average cost of capital (WACC).

Prior to fiscal 2012, we performed our annual goodwill impairment test in the third quarter of each fiscal year. In fiscal 2012, we changed the timing of our annual goodwill impairment for the fourth quarter to align the test with the year end and budget process. Consequently, in fiscal 2012, we performed our impairment test in the third quarter and the fourth quarter.

In the fourth quarter of fiscal 2012, we performed our annual goodwill impairment test for our two CGUs, using a combination of a market-based approach (sales multiples), based on recent relevant transactions in our industry, and discounted cash flows.

The sales multiple of recent relevant transactions ranged between 1.2 and 4 times sales.

For the discounted cash-flow calculations, we used a five-year sales compound annual growth rate (CAGR) of 20% for the NetHawk CGU, a five-year sales CAGR of 25% for the Brix CGU and a perpetual growth rate of 2%. For both CGUs, we used a discount rate of 18%.

Based on the market approach and the discounted cash-flow calculations, the recoverable amount for both CGUs exceeded their carrying value.

As at August 31, 2012, the carrying value of goodwill totaled \$29.2 million and was allocated as follows to two CGUs:

NetHawk CGU	\$ 11,520,000
Brix CGU	17,640,000
Total	<u>\$ 29,160,000</u>

## **NEW IFRS PRONOUNCEMENTS AND AMENDMENTS ISSUED BUT NOT YET ADOPTED**

### **Financial Instruments**

IFRS 7, “*Financial Instruments: Disclosures*”, has been amended to enhance disclosure requirements related to offsetting of financial assets and liabilities. The amendments are applicable retrospectively for annual periods beginning on or after January 1, 2013. We will adopt these amendments on September 1, 2013 and expect their adoption to have no significant impact on our consolidated financial statements.

IFRS 9, “*Financial Instruments*”, was issued in November 2009 and addresses classification and measurement of financial assets. It replaces the multiple category and measurement models in IAS 39, “*Financial Instruments – Recognition and Measurement*”, for debt instruments with a new mixed measurement model having only two categories: amortized cost and fair value through profit or loss. IFRS 9 also replaces the models for measuring equity instruments. Such instruments are either recognized at fair value through profit or loss or at fair value through other comprehensive income. Where equity instruments are measured at fair value through other comprehensive income, dividends are recognized in profit or loss to the extent that they do not clearly represent a return on investment; however, other gains and losses (including impairments) associated with such instruments remain in accumulated comprehensive income indefinitely. Requirements for financial liabilities were added to IFRS 9 in October 2010, and they largely carried forward existing requirements in IAS 39, except that fair value changes due to credit risk for liabilities designated at fair value through profit and loss are generally recorded in other comprehensive income. This standard is effective for annual periods beginning on or after January 1, 2015. We have not yet assessed the impact that this new standard is likely to have on our consolidated financial statements.

### **Financial Statement Presentation**

In June 2011, the IASB amended IAS 1, “*Financial Statement Presentation*”. The amendments to IAS 1 require entities to separate items presented in other comprehensive income into two groups, based on whether or not they may be recycled to the statement of earnings in the future. Items that will not be recycled will be presented separately from items that may be recycled in the future, such as unrealized gains and losses on cash-flow hedges. The amendment is effective for annual periods beginning on or after July 1, 2012. Early adoption is permitted and full retrospective application is required. We do not expect the standard to have a significant impact on our consolidated financial statements.

The IASB issued the following standards: IFRS 10, “*Consolidated Financial Statements*”, IFRS 11, “*Joint Arrangements*”, IFRS 12, “*Disclosure of Interests in Other Entities*”, and IFRS 13, “*Fair Value Measurement*”. Each of the new standards is effective for annual periods beginning on or after January 1, 2013, with early adoption permitted. We have not yet assessed the impact that the new and amended standards may have on our consolidated financial statements or whether or not to early adopt any of these new requirements.

The following is a brief summary of these new standards:

### **Consolidation**

IFRS 10, “*Consolidated Financial Statements*”, requires an entity to consolidate an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Under existing IFRS, consolidation is required when a company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. IFRS 10 replaces Standing Interpretations Committee (“SIC”) 12, “*Consolidation – Special Purpose Entities*” and parts of IAS 27, “*Consolidated and Separate Financial Statements*”.

### **Joint Arrangements**

IFRS 11, “*Joint Arrangements*”, requires a venturer to classify its interest in a joint arrangement as a joint venture or joint operations. Joint ventures will be accounted for using the equity method of accounting, whereas for a joint operation the venturer will recognize its share of the assets, liabilities, revenues and expenses of the joint operation. Under existing IFRS, entities have the choice to proportionately consolidate or equity-account for interests in joint ventures. IFRS 11 replaces IAS 31, “*Interests in Joint Ventures*”, and SIC 13, “*Jointly Controlled Entities – Non-Monetary Contributions by Venturers*”.

## **Disclosure of Interests in Other Entities**

IFRS 12, “*Disclosure of Interests in Other Entities*”, establishes disclosure requirements for interests in other entities, such as subsidiaries, joint arrangements, associates and structured entities. This standard carries forward existing disclosures and also introduces significant additional disclosure requirements that address the nature of, and risks associated with, an entity's interests in other entities.

## **Fair Value Measurement**

IFRS 13, “*Fair Value Measurement*”, is a comprehensive standard for fair value measurement and disclosure requirements for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. It also establishes disclosures about fair value measurement. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and, in many cases, does not reflect a clear measurement basis or consistent disclosures.

## **RISKS AND UNCERTAINTIES**

Over the past several years, we have managed our business in a difficult environment; focused on research and development programs for new and innovative solutions aimed at expected growth pockets in our sector; continued the development of our domestic and international markets; and made strategic acquisitions. However, we operate in a highly competitive and complex sector that is in constant evolution and, as a result, we encounter various risks and uncertainties that must be given appropriate consideration in our strategic management plans and policies.

Our business is subject to the effects of general economic conditions in North America and throughout the world and, more particularly, market conditions in the telecommunications industry. In the past, our operating results were adversely affected by reduced capital spending in North America, Europe and Asia and by unfavorable general economic conditions. In particular, sales to network operators in North America were significantly and adversely affected by a downturn in the telecommunications industry in 2001 and by the global economic recession in 2009. Challenging market conditions resurfaced in 2012 with network operators placing a tight rein on capital expenditures as the global economic environment became uncertain and the European debt crisis persisted. In the event of another recession or slowdown in key geographic regions or markets, we may experience a material adverse impact on our business, operating results and financial condition.

In addition, we are exposed to currency risks due to the export of our products manufactured in Canada, China and Finland; the large majority of these sales are denominated in US dollars and euros. These risks are partially hedged by operating expenses denominated in US dollars and euros, the purchase of raw materials in US dollars as well as forward exchange contracts. Any decrease in the value of the US dollar, compared to the Canadian dollar and the euro, in the coming months would negatively affect our results of operations.

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

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

Also, given our strategic goals for growth and competitive positioning in our industry, we are continuously expanding into international markets, such as the operation of our manufacturing facilities in China and our software development center in India as well as operating other subsidiaries in many countries. This exposes us to certain risks and uncertainties, namely changes in local laws and regulations, multiple technological standards, protective legislation, pricing pressure, cultural differences and the management of operations in different countries.

The economic environment of our industry could also result in some of our customers experiencing difficulties, which, consequently, could have a negative effect on our results, especially in terms of future sales and recoverability of accounts receivable. However, the sectorial and geographic diversity of our customer base provides us with a reasonable level of protection in this area. Finally, other financial instruments, which potentially subject us to credit risks, consist mainly of cash, short-term investments and forward exchange contracts. Our short-term investments consist of debt instruments issued by high-credit quality corporations and trusts. Our cash and forward exchange contracts are held with or issued by high-credit quality financial institutions; therefore, we consider the risk of non-performance on these instruments to be limited.

We depend on a limited number of suppliers for some of the parts used to manufacture our products for which alternative sources may not be readily available. In addition, all our orders are placed through individual purchase orders and, therefore, our suppliers may experience difficulties, suffer from natural disasters, delays or stop supplying parts to us at any time. The reliance on a single source or limited number of suppliers could result in increased costs, delivery problems and reduced control over product pricing and quality. Any interruption or delay in the supply of any of these parts could significantly harm our ability to meet scheduled product deliveries to our customers and cause us to lose sales. Furthermore, the process of qualifying a new manufacturer for complex parts designed to our specifications, such as our optical, electronic or mechanical parts, is lengthy and would consume a substantial amount of time for our technical personnel and management. If we were required to change a supplier in a short period of time, our business would be disrupted. In addition, we may be unsuccessful in identifying a new supplier capable of meeting and willing to meet our needs on terms that we would find acceptable.

For a more complete understanding of risk factors that may affect us, please refer to the risk factors set forth in our disclosure documents published with securities commissions at [www.EXFO.com](http://www.EXFO.com), or at [www.sedar.com](http://www.sedar.com) in Canada or [www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml) in the U.S.

## **NON-IFRS FINANCIAL MEASURES**

We provide non-IFRS financial measures (gross margin\*, EBITDA\*\* and adjusted EBITDA\*\*) as supplemental information regarding our operational performance. We use these measures for the purposes of evaluating our historical and prospective financial performance, as well as our performance relative to our competitors. These measures also help us to plan and forecast future periods as well as to make operational and strategic decisions. We believe that providing this information to our investors, in addition to the IFRS measures, allows them to see the company's results through the eyes of management, and to better understand our historical and future financial performance.

The presentation of this additional information is not prepared in accordance with IFRS. Therefore, the information may not necessarily be comparable to that of other companies and should be considered as a supplement to, not a substitute for, the corresponding measures calculated in accordance with IFRS.

\* Gross margin represents sales less cost of sales, excluding depreciation and amortization.

\*\* EBITDA is defined as net earnings (loss) before interest, income taxes, depreciation of property, plant and equipment and amortization of intangible assets. Adjusted EBITDA represents EBITDA excluding changes in the fair value of the cash contingent consideration and the gain from the disposal of discontinued operations.

The following tables summarize the reconciliation of EBITDA and adjusted EBITDA to IFRS net earnings (loss) and additional information, in thousands of US dollars:

**EBITDA and adjusted EBITDA (including discontinued operations)**

	<u>Year ended August 31, 2012</u>	<u>Year ended August 31, 2011</u>
IFRS net earnings (loss) for the year	\$ (3,593)	\$ 22,120
Add (deduct):		
Depreciation of property, plant and equipment		
Continuing operations	6,169	6,655
Discontinued operations	–	14
Amortization of intangible assets		
Continuing operations	7,819	9,183
Discontinued operations	–	4
Interest and other income (continuing operations)	(131)	(511)
Income taxes		
Continuing operations	3,571	8,814
Discontinued operations	–	201
EBITDA for the year	13,835	46,480
Changes in fair value of cash contingent consideration	(311)	(2,685)
Gain on disposal of discontinued operations	–	(13,212)
Adjusted EBITDA for the year	<u>\$ 13,524</u>	<u>\$ 30,583</u>
EBITDA in percentage of total sales	<u>5.5%</u>	<u>17.1%</u>
Adjusted EBITDA in percentage of total sales	<u>5.4%</u>	<u>11.3%</u>

**Additional information**

	<u>Year ended August 31, 2012</u>	<u>Year ended August 31, 2011</u>
Sales from continued operations	\$ 249,966	\$ 269,743
Sales from discontinued operations	–	1,991
Total sales	<u>\$ 249,966</u>	<u>\$ 271,734</u>

**QUARTERLY SUMMARY FINANCIAL INFORMATION (unaudited)**

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

	<u>1<sup>st</sup> quarter <sup>(2)</sup></u>	<u>2<sup>nd</sup> quarter <sup>(2)</sup></u>	<u>3<sup>rd</sup> quarter <sup>(2)</sup></u>	<u>4<sup>th</sup> quarter</u>	<u>Year ended August 31,</u>
<b>2012</b>					
Sales	\$ 66,388	\$ 66,917	\$ 59,505	\$ 57,156	\$ 249,966
Cost of sales <sup>(1)</sup>	\$ 23,370	\$ 23,616	\$ 23,549	\$ 21,257	\$ 91,972
Earnings (loss) from operations	\$ 2,428	\$ 4,109	\$ (4,355)	\$ (1,678)	\$ 504
Net earnings (loss)	\$ 2,887	\$ 954	\$ (3,720)	\$ (3,714)	\$ (3,593)
Basic and diluted net earnings (loss) per share <sup>(3)</sup>	\$ 0.05	\$ 0.02	\$ (0.06)	\$ (0.06)	\$ (0.06)

	1 <sup>st</sup> quarter <sup>(2)</sup>	2 <sup>nd</sup> quarter <sup>(2)</sup>	3 <sup>rd</sup> quarter <sup>(2)</sup>	4 <sup>th</sup> quarter	Year ended August 31,
<b>2011</b>					
Sales	\$ 65,653	\$ 72,046	\$ 67,630	\$ 64,414	\$ 269,743
Cost of sales <sup>(1)</sup>	\$ 24,785	\$ 27,821	\$ 24,243	\$ 23,447	\$ 100,296
Earnings from operations	\$ 5,156	\$ 6,782	\$ 3,489	\$ 5,878	\$ 21,305
Net earnings from continuing operations	\$ 1,166	\$ 1,674	\$ 1,757	\$ 4,597	\$ 9,194
Net earnings	\$ 14,092	\$ 1,674	\$ 1,757	\$ 4,597	\$ 22,120
Basic net earnings from continuing operations per share <sup>(3)</sup>	\$ 0.02	\$ 0.03	\$ 0.03	\$ 0.08	\$ 0.15
Diluted net earnings from continuing operations per share	\$ 0.02	\$ 0.03	\$ 0.03	\$ 0.07	\$ 0.15
Basic net earnings per share <sup>(3)</sup>	\$ 0.24	\$ 0.03	\$ 0.03	\$ 0.08	\$ 0.37
Diluted net earnings per share	\$ 0.23	\$ 0.03	\$ 0.03	\$ 0.07	\$ 0.36

(1) The cost of sales is exclusive of depreciation and amortization.

(2) IFRS net earnings (loss) for these periods, previously disclosed, have been adjusted to reflect the final choice of first-year adoption of IFRS of the accounting policy for measuring long-term, non-refundable research and development tax credits in the fourth quarter of fiscal 2012. Please refer to note 3 to our fiscal 2012 consolidated financial statements for details about this change of accounting policy.

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

#### ***Fourth-quarter results***

In the fourth quarter of fiscal 2012, sales were \$57.2 million, compared to \$64.4 million in 2011.

In the fourth quarter of fiscal 2012, we reported a year-over-year decrease in sales for the following reasons.

In fiscal 2012, including the fourth quarter, market conditions in the telecommunications industry remained tenuous due to macro-economic uncertainty, the European debt crisis and its ripple effects on other economies, the tightening of capital spending among network operators as well as delays in customers' orders. In fact, Europe turned out to be more impacted than we expected, the anticipated pick-up of spending in the Americas did not materialize, especially with Tier-1 operators, while China has been sluggish. This has rendered our end-markets very difficult in the short term and has resulted in lower sales in the fourth quarter of fiscal 2012, compared to the same period last year.

In addition, in the fourth quarter of fiscal 2012, we recorded in our sales foreign exchange losses of \$26,000 on our forward exchange contracts, compared to gains of \$781,000 during the same period last year, which further contributed to the decrease of our sales year-over-year.

In the fourth quarter of fiscal 2012, our gross margin reached 62.8% compared to 63.6% for the same period last year. First, in the fourth quarter of fiscal 2012, we recorded in our sales foreign exchange losses of \$26,000 on our forward exchange contracts, compared to gains of \$781,000 in 2011, which contributed to decreasing our gross margin year-over-year. In addition, we recorded restructuring charges of \$264,000 in the cost of sales in the fourth quarter of fiscal 2012 (nil in 2011), which reduced our gross margin sequentially. In addition, a lower sales volume in the fourth quarter of fiscal 2012, compared to the same period last year, resulted in lower absorption of our fixed manufacturing costs, which reduced our gross margin year-over-year. Finally, in the fourth quarter of fiscal 2012, there was an unfavorable product mix, which resulted in lower margins compared to the same period last year. However, in the fourth quarter of fiscal 2012, our warranty and recycling provisions decreased compared to the same period last year; this resulted in a positive impact on our gross margin year-over-year.

In the fourth quarter of fiscal 2012, the loss from operations amounted to \$1.7 million, compared to earnings from operations of \$5.9 million for the same period last year. The loss from operations in the fourth included restructuring charges in the amount of \$2.3 million (nil in 2011). In addition, earnings from operations in the fourth quarter of fiscal 2011 included a gain of \$2.7 million (nil in 2012) to account for the changes in the cash contingent consideration payable. Otherwise, lower margins on lower sales resulted in lower earnings from operations in the fourth quarter of fiscal 2012 compared to the same period last year, as our operating expenses, excluding restructuring charges, decreased \$2.2 million year-over-year due to lower commission expenses on lower sales, the increase in the value of the US dollar compared to the Canadian dollar, the euro and the Indian rupee, as a significant portion of our operating expenses are denominated in these currencies and we report our results in US dollars, as well as the impact of our restructuring plan in the fourth quarter.

Net loss amounted to \$3.7 million, or \$0.06 per share, in the fourth quarter of fiscal 2012, compared to net earnings of \$4.6 million, or \$0.07 per diluted share, for the same period last year. In addition to the above-mentioned factors in the earnings from operations section, in the fourth quarter of fiscal 2012, we recorded a foreign exchange loss of \$1.9 million compared to \$57,000 for the same period last year. In addition, in the fourth quarter of fiscal 2012, we recorded an income tax expense of \$159,000, although we reported a loss before income taxes as we did not recognize deferred income taxes for some of our subsidiaries at loss and as a significant portion of our foreign exchange loss is created by the translation of financial statements of our foreign operations, and is therefore non-deductible; in the same period last year, the income tax expense was closer to our statutory income tax rate of 27%.