EXFO INC.
Form 6-K
November 23, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 6-K

Report of Foreign Private Issuer Pursuant to Rule 13a-16 or 15d-16
Under the Securities Exchange Act of 1934

For the month of November 2011

EXFO Inc.
(Translation of registrant's name into English)

400 Godin Avenue, Quebec City, Quebec, Canada G1M 2K2
(Address of principal executive offices)

Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F.

Form 20-F xForm 40-F o

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes oNo x

If "Yes" is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82-______.

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In November 2011, EXFO Inc., a Canadian corporation, issued its annual audited financial statements and management's discussion and analysis thereof for its fiscal year ended August 31, 2011. At the same time, it also issued a cover letter, its notice of its annual shareholders' meeting, its form of proxy and its management proxy circular. This report of Form 6-K sets forth said documents.

The Form 6-K containing the Corporation's annual audited financial statements and management's discussion and analysis for its fiscal year ended August 31, 2011, a cover letter, its notice of annual shareholders' meeting, its form of proxy and its management proxy circular are hereby incorporated as documents by reference to Form F-3 (Registration Statement under the Securities Act of 1933) declared effective as of July 30, 2001 and to Form F-3 (Registration Statement under the Securities Act of 1933) declared effective as of March 11, 2002 and to amend certain material information as set forth in these two Form F-3 documents.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

EXFO INC.

By:	/s/ Germain Lamonde
Name:	Germain Lamonde
Title:	President and Chief Executive Officer

Date: November 23, 2011

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Independent Auditor's Report

To the Shareholders of
EXFO Inc.

We have completed integrated audits of EXFO Inc. and its subsidiaries' 2011, 2010 and 2009 consolidated financial statements and their internal control over financial reporting as at August 31, 2011. Our opinions, based on our audits, are presented below.

Report on the consolidated financial statements
We have audited the accompanying consolidated financial statements of EXFO Inc. and its subsidiaries, which comprise the consolidated balance sheets as at August 31, 2011 and August 31, 2010 and the consolidated statement of accumulated other comprehensive income for each of the two years in the period ended August 31, 2011, and the consolidated statements of earnings, comprehensive income (loss), retained earnings and contributed surplus and cash flows for each of the three years in the period ended August 31, 2011, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements
Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility
Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform an audit to obtain reasonable assurance whether the consolidated financial statements are free from material misstatement. Canadian generally accepted auditing standards also require that we comply with ethical requirements.

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An audit involves performing procedures to obtain audit evidence, on a test basis, about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting principles and policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion on the consolidated financial statements.

Opinion
In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of EXFO Inc. and its subsidiaries as at August 31, 2011 and August 31, 2010 and the results of their operations and cash flows for each of the three years in the period ended August 31, 2011 in accordance with Canadian generally accepted accounting principles.

Report on internal control over financial reporting
We have also audited EXFO Inc. and its subsidiaries' internal control over financial reporting as at August 31, 2011, based on criteria established in Internal Control - Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Management's responsibility for internal control over financial reporting
Management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting.

Auditor's responsibility
Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control, based on the assessed risk, and performing such other procedures as we consider necessary in the circumstances.

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We believe that our audit provides a reasonable basis for our opinion on the company's internal control over financial reporting.

Definition of internal control over financial reporting
A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Inherent limitations
Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Opinion
In our opinion, EXFO Inc. and its subsidiaries maintained, in all material respects, effective internal control over financial reporting as at August 31, 2011 based on criteria established in Internal Control – Integrated Framework, issued by COSO.

/s/ PricewaterhouseCoopers LLP 1

Quebec City, Quebec, Canada
October 11, 2011, except Note 16 (e) which is as of November 7, 2011

1 Chartered accountant auditor permit No. 18144

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EXFO Inc.
Consolidated Balance Sheets

(in thousands of US dollars)

	As at August 31,	
	2011	2010
Assets		
Current assets		
Cash	$22,771	$21,440
Short-term investments (note 7)	47,091	10,379
Accounts receivable (note 7)		
Trade	45,151	50,190
Other	6,329	5,217
Income taxes and tax credits recoverable	5,414	2,604
Inventories (note 8)	52,754	40,328
Prepaid expenses	3,237	2,816
Future income taxes (note 19)	6,130	6,191
Current assets held for sale (note 4)	–	3,991
	188,877	143,156
Tax credits recoverable	36,627	29,397
Forward exchange contracts (note 7)	149	–
Property, plant and equipment (note 9)	30,566	23,455
Intangible assets (note 10)	22,901	27,947
Goodwill (notes 3, 5 and 10)	30,942	29,355
Future income taxes (note 19)	11,024	12,884
Long-term assets held for sale (note 4)	–	7,308
	$321,086	$273,502
Liabilities		
Current liabilities		
Bank loan	$784	$–
Accounts payable and accrued liabilities (note 12)	32,137	30,870
Income taxes payable	876	426
Current portion of long-term debt (note 13)	645	568
Deferred revenue	10,590	10,354
Current liabilities related to assets held for sale (note 4)	–	2,531
	45,032	44,749
Deferred revenue	5,704	5,775
Long-term debt (note 13)	968	1,419
Other liabilities	723	603
Future income taxes (note 19)	4,913	–

Long-term liabilities related to assets held for sale (note 4)	–	537
	57,340	53,083
Commitments (note 14)		
Contingency (note 15)		
Shareholders' equity		
Share capital (note 16)	110,341	106,126
Contributed surplus	18,017	18,563
Retained earnings	69,877	50,528
Accumulated other comprehensive income	65,511	45,202
	263,746	220,419
	$321,086	$273,502

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

On behalf of the Board

/s/ Germain Lamonde
GERMAIN LAMONDE
Chairman, President and CEO

/s/ Guy Marier
GUY MARIER
Chairman, Audit Committee

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EXFO Inc.
Consolidated Statements of Earnings

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

	Years ended August 31,		
	2011	2010	2009
Sales (note 21)	$269,743	$202,757	$153,082
Cost of sales (1,2) (note 8)	100,296	73,901	57,897
Gross margin	169,447	128,856	95,185
Operating expenses			
Selling and administrative (1)	87,062	66,612	58,067
Net research and development (1) (note 18)	47,927	37,847	27,213
Amortization of property, plant and equipment	6,772	5,757	4,453
Amortization of intangible assets	9,183	7,773	5,033
Restructuring charges (note 5)	–	–	963
Impairment of goodwill (note 5)	–	–	21,713
Total operating expenses	150,944	117,989	117,442
Earnings (loss) from operations	18,503	10,867	(22,257)
Interest and other income (expenses)	511	(292)	592
Foreign exchange gain (loss)	(3,808)	(1,496)	1,074
Earnings (loss) before income taxes (note 19)	15,206	9,079	(20,591)
Income taxes (note 19)	8,783	5,529	266
Net earnings (loss) from continuing operations	6,423	3,550	(20,857)
Net earnings from discontinued operations (note 4)	12,926	3,069	4,272
Net earnings (loss) for the year	$19,349	$6,619	$(16,585)
Basic net earnings (loss) from continuing operations per share	$0.11	$0.06	$(0.34)
Diluted net earnings (loss) from continuing operations per share	$0.10	$0.06	$(0.34)
Basic net earnings (loss) per share	$0.32	$0.11	$(0.27)
Diluted net earnings (loss) per share	$0.31	$0.11	$(0.27)
Basic weighted average number of shares outstanding (000's)	60,000	59,479	61,845

Diluted weighted average number of shares outstanding (000's) (note 20)	61,488	60,616	61,845

(1) Stock-based compensation costs included in:

Cost of sales	$224	$138	$133
Selling and administrative	$1,281	$1,042	$782
Net research and development	$487	$470	$383
Net earnings from discontinued operations	$264	$136	$111

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

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

(in thousands of US dollars)

Comprehensive income (loss)

	Years ended August 31,		
	2011	2010	2009
Net earnings (loss) for the year	$19,349	$6,619	$(16,585)
Foreign currency translation adjustment	19,399	3,728	(10,671)
Changes in unrealized losses on short-term investments	2	–	22
Unrealized gains (losses) on forward exchange contracts	3,413	940	(1,467)
Reclassification of realized (gains) losses on forward exchange contracts in net earnings (loss)	(2,191)	(1,022)	3,167
Future income tax effect of the above items	(314)	24	(528)
Comprehensive income (loss)	$39,658	$10,289	$(26,062)

Accumulated other comprehensive income

	Years ended August 31,	
	2011	2010
Foreign currency translation adjustment		
Cumulative effect of prior years	$44,186	$40,458
Current year	19,399	3,728
	63,585	44,186
Unrealized gains on forward exchange contracts		
Cumulative effect of prior years	1,018	1,076
Current year, net of realized gains and future income taxes	908	(58)
	1,926	1,018
Unrealized losses on short-term investments		
Cumulative effect of prior years	(2)	(2)
Current year	2	–
	–	(2)
Accumulated other comprehensive income	$65,511	$45,202

Total retained earnings and accumulated other comprehensive income amounted to $95,730 and $135,388 as at August 31, 2010 and 2011, respectively.

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EXFO Inc.
Consolidated Statements of Retained Earnings and Contributed Surplus

(in thousands of US dollars)

Retained earnings

	Years ended August 31,		
	2011	2010	2009
Balance – Beginning of year	$50,528	$43,909	$60,494
Add (deduct)			
Net earnings (loss) for the year	19,349	6,619	(16,585)
Balance – End of year	$69,877	$50,528	$43,909

Contributed surplus

	Years ended August 31,		
	2011	2010	2009
Balance – Beginning of year	$18,563	$17,758	$5,226
Add (deduct)			
Stock-based compensation costs	2,217	1,756	1,407
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards (note 16)	(2,763)	(954)	(540)
Discount on redemption of share capital (note 16)	–	3	11,665
Balance – End of year	$18,017	$18,563	$17,758

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EXFO Inc.
Consolidated Statements of Cash Flows

(in thousands of US dollars)

	Years ended August 31,		
	2011	2010	2009
Cash flows from operating activities			
Net earnings (loss) for the year	$19,349	$6,619	$(16,585)
Add (deduct) items not affecting cash			
Change in discount on short-term investments	(42)	19	597
Stock-based compensation costs	2,256	1,786	1,409
Amortization	15,973	13,729	9,674
Deferred revenue	(1,262)	3,672	1,706
Gain on disposal of discontinued operations (note 4)	(13,212)	–	–
(Gain) loss on disposal of capital assets	(568)	–	237
Impairment of goodwill (note 5)	–	–	21,713
Future income taxes	7,032	5,787	(300)
Change in unrealized foreign exchange gain/loss	2,130	471	(1,955)
	31,656	32,083	16,496
Change in non-cash operating items			
Accounts receivable	10,066	(22,522)	9,654
Income taxes and tax credits	(6,714)	(4,073)	(3,391)
Inventories	(8,751)	(9,302)	2,624
Prepaid expenses	(232)	105	(350)
Accounts payable and accrued liabilities	(2,775)	5,168	(2,409)
Other liabilities	60	308	–
	23,310	1,767	22,624
Cash flows from investing activities			
Additions to short-term investments	(516,674)	(233,388)	(438,460)
Proceeds from disposal and maturity of short-term investments	481,945	285,805	456,612
Additions to capital assets	(12,164)	(8,966)	(6,945)
Proceeds from disposal of capital assets	568	–	–
Net proceeds from disposal of discontinued operations (note 4)	22,063	–	–
Business combinations, net of cash acquired (note 3)	(1,049)	(33,042)	(2,414)
	(25,311)	10,409	8,793
Cash flows from financing activities			
Bank loan	772	–	–
Repayment of long-term debt	(619)	(274)	–
Redemption of share capital	–	(14)	(26,871)
Exercise of stock options	1,452	343	56
	1,605	55	(26,815)
Effect of foreign exchange rate changes on cash	1,058	(733)	95
Change in cash	662	11,498	4,697
Cash – Beginning of year	22,109	10,611	5,914
Cash – End of year	$22,771	$22,109	$10,611

Supplementary information			
Interest paid	$159	$34	$23
Income taxes paid	$1,878	$796	$86
Cash related to:			
Continuing operations	$22,771	$21,440	$9,777
Discontinued operations (note 4)	–	669	834
	$22,771	$22,109	$10,611

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EXFO Inc.
Notes to Consolidated Financial Statements

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

1 Nature of Activities

EXFO Inc. ("EXFO") designs, manufactures and markets test and service assurance solutions for wireless and wireline network operators and equipment manufacturers in the global telecommunications industry. The company offers core-to-edge solutions to assess the performance and reliability of converged IP (Internet protocol) fixed and mobile networks. EXFO's products are sold in approximately 100 countries around the world.

2 Summary of Significant Accounting Policies

Basis of presentation

These consolidated financial statements have been prepared in accordance with generally accepted accounting principles ("GAAP") in Canada, and significant differences in measurement and disclosure from U.S. GAAP are set out in note 22. These consolidated financial statements include the accounts of the company and its domestic and international subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Accounting estimates

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting years. Significant estimates include 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 valuation allowance for future income taxes, the amount of certain accrued liabilities and deferred revenue, as well as stock-based compensation costs. Actual results could differ from those estimates.

Foreign currency translation

Reporting currency and self-sustaining foreign operations

The principal measurement currency of the company is the Canadian dollar. The company has adopted the US dollar as its reporting currency. The financial statements are translated into the reporting currency using the current rate method. Under this method, assets and liabilities of the company and its self-sustaining foreign operations with functional currency other than the US dollar are translated in US dollars using the exchange rate in effect at the balance sheet date. Revenues and expenses are translated at the monthly average exchange rate. The cumulative foreign currency translation adjustment arising from such translation is included in accumulated other comprehensive income in shareholders' equity.

Foreign currency transactions

Transactions denominated in currencies other than the measurement currency are translated into the relevant measurement currency as follows: monetary assets and liabilities are translated at the exchange rate in effect on the date of the balance sheet, and revenues and expenses are translated at the exchange rate in effect on the date of the transaction. Non-monetary assets and liabilities are translated at historical rates. Foreign exchange gains and losses arising from such translation are reflected in the statements of earnings.

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EXFO Inc.
Notes to Consolidated Financial Statements

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

Integrated foreign operations

The financial statements of integrated foreign operations are remeasured into the relevant measurement currency using the temporal method. Under this method, monetary assets and liabilities are remeasured at the exchange rate in effect on the date of the balance sheet. Non-monetary assets and liabilities are remeasured at historical rates, unless such assets and liabilities are carried at market value, in which case they are remeasured at the exchange rate in effect on the date of the balance sheet. Revenues and expenses are remeasured at the monthly average exchange rate. Foreign exchange gains and losses arising from such remeasurement are reflected in the statements of earnings.

In the event that management decides to declare dividends, such dividends would be declared in Canadian dollars.

Forward exchange contracts

Forward exchange contracts are utilized by the company to manage its foreign currency exposure. Forward exchange contracts, which are designated as cash flow hedging instruments, qualify for hedge accounting. They are entered into by the company to hedge anticipated US dollar-denominated sales and the related accounts receivable. The company’s policy is not to utilize those derivative financial instruments for trading or speculative purposes.

The company’s forward exchange contracts are recorded at fair value in the balance sheet, and changes in their fair value are reported in other comprehensive income. Any ineffective portion is recognized immediately in the statements of earnings. Upon the recognition of related hedged sales, accumulated changes in fair value are reclassified in sales in the statements of earnings.

Short-term investments

All investments with original terms to maturity of three months or less and that are not required for the purposes of meeting short-term cash requirements are classified as short-term investments. Short-term investments are classified as available-for-sale securities; therefore, they are carried at fair value in the balance sheet, and any changes in their fair value are reflected in other comprehensive income. Upon the disposal or maturity of these assets, accumulated changes in their fair value are reclassified in the statements of earnings.

Interest income on short-term investments is recorded in the interest and other income (expenses) line item in the statements of earnings and in cash flows from operating activities in the statements of cash flows.

Inventories

Inventories are valued on an average cost basis, at the lower of cost and net realizable value.

Property, plant and equipment and amortization

Property, plant and equipment are recorded at cost, less related government grants and research and development tax credits. Amortization is provided on a straight-line basis over the estimated useful lives as follows:

	Term
Land improvements	5 years
Buildings	20 and 25 years
Equipment	2 to 10 years
Leasehold improvements	The lesser of useful life and remaining lease term

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EXFO Inc.
Notes to Consolidated Financial Statements

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

Intangible assets, goodwill and amortization

Intangible assets primarily include the cost of core technology, customer relationships and software, net of accumulated amortization. Amortization is provided on a straight-line basis over the estimated useful lives of five years for core technology and customer relationships and four and nine years for software.

Goodwill represents the excess of the purchase price of acquired businesses over the fair value of net identifiable assets acquired. Goodwill is not amortized but must be tested for impairment on an annual basis or more frequently if events or circumstances indicate that it might be impaired. Recoverability of goodwill is determined at the reporting unit level, using a two-step approach. First, the carrying value of a reporting unit is compared to its fair value, which is usually determined based on discounted future cash flows. If the carrying value of a reporting unit exceeds its fair value, the second step is performed. In this step, the amount of impairment loss, if any, represents the excess of the carrying value of goodwill over its fair value, and the loss is charged to earnings in the period in which it is incurred. For the purposes of the impairment test, the fair value of goodwill is estimated in the same way as goodwill is determined in business combinations; that is, the excess of the fair value of a reporting unit over the fair value of its net identifiable assets. The company performs its annual impairment test in the third quarter of each fiscal year for all its existing reporting units (note 5).

Impairment of long-lived assets

Long-lived assets are reviewed for impairment when events or circumstances indicate that cost may not be recoverable, and in the period in which they are classified as held for sale. Impairment exists when the carrying value of an asset or group of assets is greater than the undiscounted future cash flows expected to be provided by the asset or group of assets. The amount of impairment loss, if any, is the excess of the carrying value over the fair value. The company usually assesses fair value of long-lived assets based on discounted future cash flows.

Warranty

The company offers its customers warranties of one to three years, depending on the specific products and terms of the purchase agreement. The company's typical warranties require it to repair or replace defective products during the warranty period at no cost to the customer. Costs related to original warranties are accrued at the time of shipment, based upon estimates of expected rework and warranty costs to be incurred. Costs associated with separately priced extended warranties are expensed as incurred.

Revenue recognition

For all sales, the company uses a binding purchase order as evidence that a sales arrangement exists.

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

At the time of the transaction, the company assesses whether the price associated with its revenue transaction is fixed or determinable and whether or not collection is reasonably assured. The company assesses whether the price is fixed

or determinable based on the payment terms associated with the transaction. The company assesses collection based on a number of factors, including past transaction history and the creditworthiness of the customer. Generally, collateral or other security is not requested from customers.

Sales arrangements may include acceptance clauses. When a sales arrangement does include an acceptance provision, acceptance occurs upon the earliest of receipt of a written customer acceptance or expiration of the acceptance period. For these sales arrangements, the sale is recognized when acceptance occurs.

The company's multiple deliverable revenue arrangements may include tangible products (software and/or non-software components), extended warranties, maintenance contracts, post-contract customer support (PCS) on software components as well as installation.

EXFO Inc.
Notes to Consolidated Financial Statements

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

Since September 1, 2010, when a sales arrangement contains multiple elements and software and non-software components function together to deliver the tangible products' essential functionality, the company allocates revenue to each element based on the relative selling price of each element. Under this approach, the selling price of a deliverable is determined by using a selling price hierarchy which requires the use of vendor-specific objective evidence ("VSOE") of fair value if available, third-party evidence ("TPE") if VSOE is not available, or best estimated selling price ("BESP") if neither VSOE nor TPE are available.

The company establishes VSOE of selling price using the price charged for a deliverable when sold separately and, in some instances, using the price established by management having the relevant authority. TPE of selling price is established by evaluating similar and interchangeable competitor goods or services in sales to similarly situated customers. When VSOE or TPE are not available, the company uses BESP. The company establishes BESP using historical selling price trends, if available, and considering multiple factors including, but not limited to, geography, market conditions, competitive landscape, internal costs and pricing practices. When determining BESP, the company's management applies judgment when establishing pricing strategies and evaluating market conditions and product lifecycles. The determination of BESP is made through consultation with and approval by the company's management. The company may modify or develop new pricing practices and strategies in the future. As these pricing strategies evolve, the company may modify its pricing practices in the future, which may result in changes in BESP. The aforementioned factors may result in a different allocation of revenue to the deliverables in multiple-element arrangements from the current period, which may change the pattern and timing of revenue recognition for these elements but will not change the total revenue recognized for the arrangement.

Maintenance contracts are usually offered to customers for periods of twelve to thirty-six months. They generally include the right to unspecified upgrades and enhancements on a when-and-if-available basis as well as customer service. They qualify as a separate unit of accounting. Revenue from these contracts is recognized ratably over the terms of the maintenance contracts on a straight-line basis. The selling price of the maintenance contracts is determined using VSOE.

Extended warranties are usually offered to customers for periods of twelve to forty-eight months. They qualify as a separate unit of accounting. Revenue from these extended warranties is recognized ratably over the warranty period on a straight-line basis. The selling price of the extended warranties is determined using BESP.

When a sales arrangement contains multiple elements and software and non-software components do not function together to deliver the tangible products' essential functionality, the company allocates revenue between the tangible products and the PCS, if any, based on VSOE of selling price of each element. PCS revenues are deferred and recognized ratably over the years of the support arrangement. PCS revenues are recognized at the time the product is delivered when provided substantially within one year of delivery, the costs of providing this support are insignificant (and accrued at the time of delivery), and no (or infrequent) software upgrades or enhancements are provided.

Prior to September 1, 2010, for products in which software was incidental, the company recognized revenue when persuasive evidence of an arrangement existed, the product had been delivered, the price was fixed or determinable, and collection of the resulting receivable was reasonably assured. Provisions were made for estimated returns, warranties and support obligations.

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

Advertising costs

Advertising costs are expensed as incurred.

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EXFO Inc.
Notes to Consolidated Financial Statements

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

Government grants

Grants related to operating expenses are included in earnings when the related expenses are incurred. Grants related to capital expenditures are deducted from the related assets. Grants are included in earnings or deducted from the related assets, provided there is reasonable assurance that the company has complied and will comply with all the conditions related to the grant.

Research and development expenses

All expenses related to research, as well as development activities that do not meet generally accepted criteria for deferral are expensed as incurred, net of related tax credits and grants. Development expenses that meet generally accepted criteria for deferral are capitalized, net of related tax credits and grants, and are amortized against earnings over the estimated benefit period. Research and development expenses are mainly comprised of salaries and related expenses, material costs as well as fees paid to third-party consultants.

As at August 31, 2010 and 2011, the company had not deferred any development costs.

Income taxes

The company provides for income taxes using the liability method of tax allocation. Under this method, future income tax assets and liabilities are determined based on deductible or taxable temporary differences between financial statement values and tax values of assets and liabilities as well as the carry-forward of unused tax losses and deductions, using substantively enacted income tax rates expected to be in effect for the years in which the assets are expected to be realized or the liabilities to be settled.

The company establishes a valuation allowance against future income tax assets if, based on available information, it is more likely than not that some or all of the future income tax assets will not be realized.

Earnings per share

Basic earnings per share are determined using the weighted average number of common shares outstanding during the year.

Diluted earnings per share are determined using the weighted average number of common shares outstanding during the year, plus the effect of dilutive potential common shares outstanding during the year. This method requires that diluted earnings per share be calculated (using the treasury stock method) as if all dilutive potential common shares had been exercised at the latest at the beginning of the year or on the date of issuance, as the case may be, and that the funds obtained thereby (plus an amount equivalent to the unamortized portion of related stock-based compensation costs) be used to purchase common shares of the company at the average market price of the common shares during the year.

Stock-based compensation costs

The company accounts for stock-based compensation on stock options, restricted share units and deferred share units, using the fair value-based method. The company accounts for stock-based compensation on stock appreciation rights, using the intrinsic value method. Stock-based compensation costs are amortized to expense over the vesting periods.

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New accounting standards and pronouncements

Adopted in fiscal 2011

In December 2009, the Canadian Institute of Chartered Accountants' (CICA) Emerging Issues Committee (EIC) issued EIC-175, "Multiple Deliverable Revenue Arrangements", which is applicable prospectively (with retrospective adoption permitted) to revenue arrangements with multiple deliverables entered into or materially modified in the first annual period beginning on January 1, 2011. EIC-175 amends the guidance contained in EIC-142, "Revenue Arrangements with Multiple Deliverables", and establishes additional requirements regarding revenue recognition related to multiple deliverables as well as supplementary disclosures. The company adopted this standard prospectively to arrangements entered into on or after September 1, 2010 and at the same time it adopted similar new U.S. GAAP requirements (note 22); its adoption had no material effect on its consolidated financial statements. However, the description of the company's revenue recognition policy has been modified accordingly.

To be adopted after fiscal 2011

The company will cease to prepare its consolidated financial statements in accordance with Canadian GAAP as set out in Part V of the CICA Handbook – Accounting ("Canadian GAAP") for the periods beginning on September 1, 2011, when it will start to apply as its primary basis of accounting the International Financial Reporting Standards published by the International Accounting Standards Board and set out in Part I of the CICA Handbook – Accounting. Consequently, future accounting changes to Canadian GAAP are not discussed in these consolidated financial statements as they will never be applied by the company.

3 Business Combination

On March 12, 2010, the company acquired 91% of the issued and outstanding common shares of NetHawk Oyj. Headquartered in Oulu, Finland, NetHawk Oyj was a privately owned company providing 2G, 3G and 4G/LTE protocol analyzers and simulators aimed mostly at network equipment manufacturers and wireless network operators.

On March 15, 2010, the company made a voluntary offer to purchase the remaining issued and outstanding shares; this offer expired on April 30, 2010. Simultaneously, the company entered into a statutory procedure under the Finnish Companies Act by which it acquired the remaining issued and outstanding common shares that were not tendered under the voluntary offer.

Total consideration was comprised of a cash consideration of €37,264,000 (US$51,139,000), including acquisition-related costs of $2,842,000, or €25,121,000 (US$34,438,000), excluding NetHawk's cash of €12,143,000 (US$16,701,000) at the acquisition date, plus a cash contingent consideration of up to €8,700,000 (US$11,000,000) based on a certain sales volume of NetHawk products over the three years following the acquisition. The cash contingent consideration will be accounted for as additional goodwill when the amounts of any contingent consideration can be reasonably estimated and the outcome of the contingency is resolved. Acquisition-related costs included an amount of $780,000 for a statutory transfer tax payable in Finland based on the purchase price of shares.

This acquisition was accounted for using the purchase method under CICA Handbook Section 1581, “Business Combinations”, and the requirements of Section 1600, “Consolidated Financial Statements”; consequently, the purchase price was allocated to the assets acquired and liabilities assumed based on management’s best estimate of their fair value as of the acquisition date. The results of operations of the acquired business have been included in the consolidated financial statements of the company since March 12, 2010, being the date of acquisition.

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The purchase price, including acquisition related costs, was allocated based on the estimated fair value of acquired net assets at the date of acquisition as follows:

Assets acquired, net of cash acquired	
Accounts receivable	$7,710
Inventories	2,315
Other current assets	797
Property, plant and equipment	2,994
Core technology	8,638
Customer relationships	7,180
Other intangible assets	2,033
Current liabilities assumed	
Accounts payable and accrued liabilities	(5,710)
Deferred revenue	(1,615)
Long-term debt	(2,464)
Net identifiable assets acquired	21,878
Goodwill	12,560
Purchase price, net of cash acquired	$34,438

Acquired intangible assets are amortized on a straight-line basis over their estimated useful life of five years.

Future income tax assets at the acquisition date amounted to $8,066,000 and were mainly comprised of net operating losses and research and development expenses carried forward. A valuation allowance of $3,065,000 was recorded against these assets at the acquisition date. In the event that the company would reverse a portion or all of the valuation allowance, the amount of such reversal would reduce the amount of goodwill recognized at the date of acquisition.

Acquired goodwill mainly reflects NetHawk Oyj's acquired work force. It also reflects the competitive advantages the company expected to realize from NetHawk Oyj's standing in the wireless protocol testing industry as well as certain synergies with the company's service assurance products. Acquired goodwill is not deductible for tax purposes.

4 Discontinued Operations

In fiscal 2010, the company engaged in a plan to sell its Life Sciences and Industrial Division to focus its activities in the telecom test and service assurance market. On October 1, 2010, the company closed the sale of that Division for total proceeds of $21,623,000, net of a bank overdraft of $303,000, selling costs of $909,000 and future income taxes of $141,000. As such, this Division has been presented as a discontinued operation in these financial statements. Assets and liabilities for the comparative year ended August 31, 2010 have been reclassified as assets held for sale and liabilities related to assets held for sale; revenues and expenses have been classified as discontinued operations for all years presented.

The results of the discontinued operations are as follows:

	Years ended August 31,		
	2011 (30 days)	2010	2009
Sales	$1,991	$25,359	$19,796
Gross margin	$989	$13,563	$10,801
Earnings (loss) from operations	$(6)	$4,281	$4,179
Gain from disposal of discontinued operations	$13,212	$–	$–
Net earnings from discontinued operations	$12,926	$3,069	$4,272
Basic net earnings from discontinued operations per share	$0.22	$0.05	$0.07
Diluted net earnings from discontinued operations per share	$0.21	$0.05	$0.07

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The assets and liabilities of the discontinued operations as at August 31, 2010 have been reclassified and are presented as assets held for sale and liabilities related to assets held for sale as follows:

Assets	
Current assets	
Cash	$669
Accounts receivable	84
Income taxes and tax credits recoverable	188
Inventories	2,670
Prepaid expenses	158
Future income taxes	222
Current assets held for sale	3,991
Tax credits recoverable	2,142
Property, plant and equipment	349
Intangible assets	48
Goodwill	4,769
Long-term assets held for sale	7,308
	$11,299
Liabilities	
Current liabilities related to assets held for sale	$2,531
Long-term liabilities related to assets held for sale	537
	$3,068

5 Special Charges

Impairment of goodwill

Recoverability of goodwill is determined at the reporting unit level, using a two-step approach. First, the carrying value of the reporting units is compared to their fair value. If the carrying value of a reporting unit exceeds its fair value, the second step is performed to determine the amount of the impairment loss. Following the decrease in the company’s stock price in June 2009, the company came to the conclusion that the carrying value of one of its reporting units exceeded its fair value, and it recorded an impairment charge of $21,713,000 in fiscal 2009, to bring the goodwill of this reporting unit to its fair value. This impairment resulted in a future income tax recovery of

$2,070,000.

Restructuring charges

During fiscal 2009, the company implemented a restructuring plan to align its cost structure to the existing economic and market conditions. Under that plan, the company recorded charges of $1,171,000 in severance expenses for the 65 employees who were terminated throughout the company. From that amount, $963,000 were included in the restructuring charges in the statement of earnings for the year ended August 31, 2009 and the remaining amount of $208,000 was included in net earnings from discontinued operations in the statement of earnings for that year.

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The following tables summarize changes in restructuring charges payable since August 31, 2008:

Year ended August 31, 2010

	Balance as at August 31, 2009	Additions	Payments	Balance as at August 31, 2010
Fiscal 2009 plan				
Severance expenses	$ 24	$–	$(24)	$ –

Year ended August 31, 2009

	Balance as at August 31, 2008	Additions	Payments	Balance as at August 31, 2009
Fiscal 2009 plan				
Severance expenses	$ –	$963	$(939)	$ 24
Fiscal 2008 plan				
Severance expenses	292	–	(292)	–
Total for all plans	$ 292	$963	$(1,231)	$ 24

6 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 that 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 (loss) on forward exchange contracts.

The capital of the company amounted to $175,217,000 and $198,235,000 as at August 31, 2010 and 2011, respectively.

7 Financial Instruments

Financial assets and liabilities are initially recognized at fair value and their subsequent measurement depends on their classification, as described below. Their classification depends on the intended purpose when the financial instruments have been acquired or issued, as well as on their characteristics and their designation by the company.

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Classification

Financial assets

Cash	Held for trading
Short-term investments	Available for sale
Accounts receivable	Loans and receivables
Forward exchange contracts	Cash flow hedge

Financial liabilities

Bank loan	Other financial liabilities
Accounts payable and accrued liabilities	Other financial liabilities
Long-term debt	Other financial liabilities
Other liabilities	Other financial liabilities
Forward exchange contracts	Cash flow hedge

Held for trading, available for sale and forward exchange contracts are subsequently measured at fair value. Loans and receivables and other financial liabilities are subsequently measured at amortized cost using the effective interest method.

Fair value hierarchy

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.

Market risk

Currency risk

The principal measurement currency of the company is the Canadian dollar. The company is exposed to currency risks as a result of its export sales of products manufactured in Canada, China and Finland, 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.

As at August 31, 2011, the company held contracts to sell US dollars for Canadian dollars at various forward rates, which are summarized as follows:

Expiry dates	Contractual amounts	Weighted average contractual forward rates
September 2011 to August 2012	$ 27,500	1.0555
September 2012 to July 2013	11,400	1.0063
Total	$ 38,900	1.0411

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 $597,000 and $2,278,000 as at August 31, 2010 and 2011, respectively.

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Based on the portfolio of forward exchange contracts as at August 31, 2011, 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 $1,701,000.

As at August 31, 2011, forward exchange contracts, in the amount of $1,701,000, are presented as current assets in other receivable in the balance sheet and forward exchange contracts, in the amount of $149,000, are presented as long-term assets in forward exchange contracts in the balance sheet. As at August 31, 2010, forward exchange contracts, in the amount of $754,000, were presented as current assets in other receivable in the balance sheet and forward exchange contracts, in the amount of $232,000, were presented as current liabilities in the accounts payable and accrued liabilities in the balance sheet (note 12).

During the years ended August 31, 2009, 2010 and 2011, the company recognized within its sales foreign exchange gains (losses) on forward exchange contracts of ($3,178,000), $1,517,000 and $2,795,000, respectively.

The following table summarizes significant derivative and non-derivative financial assets and liabilities that are subject to currency risk as at August 31, 2010 and 2011:

	As at August 31,			
	2011		2010	
	Carrying/ nominal amount (in thousands of US dollars)	Carrying/ nominal amount (in thousands of euros)	Carrying/ nominal amount (in thousands of US dollars)	Carrying/ nominal amount (in thousands of euros)
Financial assets				
Cash	$10,553	€1,502	$6,947	€1,287
Accounts receivable	25,040	4,332	30,218	3,860
	35,593	5,834	37,165	5,147
Financial liabilities				
Accounts payable and accrued liabilities	8,706	37	8,932	438
Forward exchange contracts (nominal value)	5,400	–	5,900	–
	14,106	37	14,832	438
Net exposure	$21,487	€5,797	$22,333	€4,709

The value of the Canadian dollar compared to the US dollar was CA$1.0665 = US$1.00 and CA$0.9784 = US$1.00 as at August 31, 2010 and 2011, respectively.

The value of the Canadian dollar compared to the euro was CA$1.3515 = €1.00 and CA$1.4094 = €1.00 as at August 31, 2010 and 2011, respectively.

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 August 31, 2010 and 2011:

- 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 $2,101,000, or $0.03 per diluted share, and $1,943,000, or $0.03 per diluted share, as at August 31, 2010 and 2011, respectively.

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- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the euro would decrease (increase) net earnings by $621,000, or $0.01 per diluted share, and $831,000, or $0.01 per diluted share, as at August 31, 2010 and 2011, respectively.
- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the US dollar would increase (decrease) comprehensive income by $3,238,000 and $2,404,000 as at August 31, 2010 and 2011, respectively.

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 related to integrated foreign subsidiaries; this may result in additional and significant foreign exchange gain or loss. However, these assets and liabilities are not considered financial instruments and are excluded from the sensitivity analysis above. The foreign exchange rate fluctuations also flow through the statements of earnings line items, as a significant portion of the company's operating expenses is denominated in Canadian dollars and euros, 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, its bank loan and its long-term debt.

Short-term investments

Short-term investments consist of the following:

	As at August 31,	
	2011	2010
Commercial paper denominated in Canadian dollars, bearing interest at annual rates of 1.0% to 1.3% in fiscal 2011 and 0.6% to 0.9% in fiscal 2010, maturing between September and November 2011 in fiscal 2011, and in September and October 2010 in fiscal 2010	$31,765	$6,383
Bankers acceptance denominated in Canadian dollars, bearing interest at annual rates of 1.0% to 1.2% in fiscal 2011 and 0.8% in fiscal 2010, maturing in September and November 2011 in fiscal 2011 and in September 2010 in fiscal 2010	15,326	3,996
	$47,091	$10,379

The fair value of short-term investments based on market value amounted to $10,379,000 and $47,091,000 as at August 31, 2010 and 2011, respectively.

Due to their short-term maturity of usually three months or less, the company's short-term investments are not subject to a 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.

Bank loan

As at August 31, 2011, the company's bank loan, in the amount of $784,000, bears interest at 7.2%. The fair value of the bank loan approximates its carrying value due to its short-term maturity.

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Long-term debt

As at August 31, 2011, the company's long-term debt, in the amount of $1,613,000, bears interest at an annual rate of 2.95% and matures in December 2013 (note 13). The fair value of the long-term debt approximates its carrying value due to its relatively short-term maturity.

Other financial instruments

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

Credit risk

Financial instruments that potentially subject the company to credit risk consist of cash, short-term investments, accounts receivable and forward exchange contracts (with a positive fair value). As at August 31, 2011, the company's short-term investments consist of debt instruments issued by twelve (nine as at August 31, 2010) 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.

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 $1,243,000 and $1,245,000 as at August 31, 2010 and 2011, respectively. Bad debt expense amounted to $967,000, $24,000 and $91,000 for the years ended August 31, 2009, 2010 and 2011, respectively.

In fiscal 2010 and 2011, no customer represented more than 10% of sales. In fiscal 2009, one customer represented more than 10% of sales with 13.1% ($20,049,000).

The following table summarizes the age of trade accounts receivable:

	As at August 31,	
	2011	2010
Current	$33,149	$38,663
Past due, 0 to 30 days	7,299	6,787
Past due, 31 to 60 days	2,590	1,991
Past due, more than 60 days, less allowance for doubtful accounts of $1,243 and $1,245 as at August 31, 2010 and 2011, respectively	2,113	2,749

Total accounts receivable	$45,151	$50,190

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Changes in the allowance for doubtful accounts are as follows:

	Years ended August 31,	
	2011	2010
Balance – Beginning of year	$1,243	$1,220
Addition charged to earnings	148	150
Write-off of uncollectible accounts	(111)	–
Recovery of uncollectible accounts	(35)	(127)
Balance – End of year	$1,245	$1,243

Liquidity risk

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

The following tables summarize the contractual maturity of the company's derivative and non-derivative financial liabilities:

	As at August 31, 2011		
	0-12 months	13-24 months	25-36 months
Bank loan	$784	$–	$–
Accounts payable and accrued liabilities	30,319	–	–
Long-term debt	645	645	323
Other liabilities	–	201	–
Forward exchange contracts			
Outflow	27,500	11,400	–
Inflow	(29,668)	(11,725)	–
Total	$29,580		