EXFO ELECTRO OPTICAL ENGINEERING INC
Form 6-K
December 03, 2003

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 December 2003

EXFO ELECTRO-OPTICAL ENGINEERING INC.
(Translation of registrant's name into English)

400 GODIN AVENUE, VANIER, 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 [X] Form 40-F [_]

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 [_] No [X]

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

In December 2003, EXFO Electro-Optical Engineering Inc., a Canadian corporation, issued its annual report containing its annual audited financial statements and management's discussion and analysis thereof for its fiscal year ended August 31, 2003. At the same time, it also issued its notice of its annual and special shareholders' meeting, its form of proxy, its management proxy circular and a cover letter. This report on Form 6-K sets forth said documents.

The annual report containing the Corporation's annual audited financial statements and management's discussion and analysis for its fiscal year ended August 31, 2003, its notice of annual and special shareholders' meeting, its form of proxy, its management proxy circular and cover letter 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.

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 ELECTRO-OPTICAL ENGINEERING INC.

By: /s/ Germain Lamonde

Name: Germain Lamonde
Title: President and Chief Executive Officer

Date: December 3, 2003

2003 ANNUAL REPORT

[GRAPHIC OMITTED]
[PHOTOGRAPHS]

Communications test and measurement experts

[GRAPHIC OMITTED]
[LOGO - EXFO]

CORPORATE PROFILE

EXFO is the recognized expert in the global optical communications industry through the design and manufacture of advanced and innovative test and measurement solutions. The Telecom Division, which represents our main business activity, offers fully integrated and complete test solutions to network service providers, system vendors and component manufacturers in approximately 70 countries. One of our strongest competitive advantages is our modular platform design, providing PC-based, Windows-centric test solutions that maximize technology reuse across several market segments. The Photonics and Life Sciences Division mainly leverages core telecom technologies to offer value-added solutions in high-tech industrial manufacturing and research sectors. For more information about EXFO, visit www.exfo.com.

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FORWARD-LOOKING STATEMENTS

This Annual Report may contain 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," "anticipate," "intend," "could," "estimate" or "continue" or the negative or comparable terminology are intended to identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forwardlooking statements. Forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and actual results may differ materially from those in the forward-looking statements as a result of various factors, including economic uncertainty, capital spending in the telecommunications sector, fluctuating exchange rates and our ability to execute successfully in these uncertain conditions; the effects of the additional actions we have taken in response to such economic uncertainty (including workforce reductions, ability to quickly adapt cost structures to align with decreased levels of business, ability to manage inventory levels to adapt to slowdowns); market acceptance of our new products and other upcoming new products; limited visibility with regards to customer orders and the timing of such orders; our ability to successfully integrate and run our acquired and to-be-acquired companies; the retention of key technical and management personnel; and future economic, competitive and market conditions. Assumptions relating to the foregoing involve judgments and risks, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Other risk factors that may affect our future performance and our 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. Although we believe that the expectations reflected in the forward-looking statements are reasonable based on information currently available to us, 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. In any event, these statements speak only as of the date of this document. We undertake no obligation to revise or update any of them to reflect events or circumstances after the date of this document.

TRADEMARKS AND LOGOS

EXFO and the EXFO logo are registered trademarks of EXFO Electro-Optical Engineering Inc. in Canada, the United States and/or other countries. Other EXFO product names or logos referenced in this document are either trademarks or registered trademarks of EXFO Electro-Optical Engineering Inc. or of its affiliated companies. All other product names and trademarks mentioned herein are trademarks of their respective owners. However, neither the presence nor absence of the identification symbols (R) or TM affects the legal status of any trademark.

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

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

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

CONSOLIDATED STATEMENTS OF EARNINGS DATA	2003	2002	2001	
Sales	$ 61,930	$ 68,330	$ 146,013	$
Gross margin (1,2)	$ 25,733	$ 15,964	$ 89,806	$
	41.6%	23.4%	61.5%	
Gross research and development	$ 17,133	$ 17,005	$ 17,601	$
	27.7%	24.9%	12.1%	
Earnings (loss) from operations (3)	$(35,079)	$ (74,783)	$ 14,507	$
	(56.6%)	(109.4%)	9.9%	
Net earnings (loss)	$(54,950)	$(308,524)	$ (15,294)	$
	(88.7%)	(451.5%)	(10.5%)	
Basic and diluted net earnings (loss) per share	$ (0.87)	$ (5.09)	$ (0.29)	$
OTHER STATEMENTS OF EARNINGS DATA (UNAUDITED)(4)				
Pro forma net earnings (loss)	$(11,476)	$ (11,248)	$ 24,500	$
	(18.5%)	(16.5%)	16.8%	
Basic and diluted pro forma net earnings (loss) per share	$ (0.18)	$ (0.19)	$ 0.46	$
CONSOLIDATED BALANCE SHEETS DATA				
Cash and cash equivalents and short-term investments	$ 57,376	$ 49,681	$ 74,590	$
Working capital	$ 76,659	$ 91,374	$ 130,289	$
Total assets	$146,254	$ 177,926	$ 442,577	$
Long-term debt (excluding current portion)	$ 453	$ 564	$ 664	$
Shareholders' equity	$129,826	$ 165,406	$ 414,805	$

(1) Including inventory write-offs of $4,121 and $18,463 for the years ended August 31, 2003 and 2002, respectively, and nil for the years ended August 31, 2001, 2000 and 1999. Including a non-recurring gain of $473 for the

year ended August 31, 2003, and nil for the years ended August 31, 2002, 2001, 2000 and 1999. Excluding inventory write-offs and the non-recurring gain, gross margin would have reached 47.4% for the year ended August 31, 2003. Excluding inventory write-offs, gross margin would have reached 50.4% for the year ended August 31, 2002. This latter information is unaudited and is a non-GAAP measure.

(2) A new presentation was adopted in 2003 with certain expenses reclassified from selling and administrative expenses to cost of sales. Consequently, comparative figures have been reclassified.

(3) Including charges for inventory and tax credit write-offs, non-recurring grants recovery, amortization and write-down of intangible assets as well as restructuring and other charges of $17,509, $56,615, $13,164, $47 and nil for the years ended August 31, 2003, 2002, 2001, 2000 and 1999, respectively.

(4) Net earnings (loss) excluding amortization and write-down of goodwill, non-recurring tax recovery, future income tax assets valuation allowance and the after-tax effect of amortization and write-down of intangible assets, restructuring and other charges, inventory and tax credit write-offs and non-recurring grants recovery. This information may not be comparable to similarly titled measures reported by other companies because it is non-GAAP information. Please refer to page 17 of this Annual Report for a detailed quantitative reconciliation.

TOTAL SALES (in thousands of U.S. dollars)

2003	2002	2001
$61,930	$68,330	$146,013

[GRAPHIC OMITTED]
[PIE CHARTS]

GEOGRAPHIC SALES

	2003	2002	2001
North America	59%	57%	58%
Europe	15%	19%	21%
Asia	16%	14%	13%
Rest of the world	10%	10%	8%

DIVISIONAL SALES

- Portable and Monitoring
- Industrial and Scientific

	2003	2002	2001
Portable and Monitoring	65%	57%	48%
Industrial and Scientific	35%	43%	52%

DEAR FELLOW SHAREHOLDERS,

Kites rise highest against the wind - not with it.
-- Sir Winston Churchill

Fiscal 2003 proved to be a transition year for EXFO, filled with challenges and opportunities that will make the company stronger in the long term. The severe two-and-a-half year downturn in the global communications industry -- compounded by economic uncertainty -- has led to a very challenging environment for many test and measurement players, but a select few have moved ahead to improve their competitive position.

[GRAPHIC OMITTED]
[PHOTOGRAPH - GERMAIN LAMONDE
CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER]

I believe EXFO belongs to the latter group. Midway into fiscal 2001, we began refocusing our test and measurement business back toward network service providers (NSPs), our traditional customer segment. Our thinking was based on the premise that NSPs would continue spending moderately during the downturn and, eventually, they would be the first market segment to recover. On the other hand, we expected component vendors, with their colossal inventories and excess manufacturing capacity, to be destined for a late recovery, given that consolidation first had to occur. Accordingly, we directed our R&D efforts toward field-testing applications and acquired Avantas Networks in November 2001, thus entering the protocol-layer test market and complementing our product offering. The end result is that sales of our Portable and Monitoring product lines, which progressed from approximately 40% of total revenues at our peak in fiscal 2001 to two-thirds in 2003, increased 3% in the past year, despite depressed spending levels. Meanwhile, optical component manufacturing test solutions, which traditionally had represented the vast majority of our Industrial and Scientific sales, were no longer significant in 2003.

Secondly, we expanded our presence in the system manufacturer market by acquiring the assets of gnubi communications in October 2002. At the industry level, we expected system manufacturers would be the next market segment to rebound. Bandwidth demand, after all, continues to increase with new investments required to build and deploy highly efficient, IP-based networks. This ongoing trend enables the convergence of voice and data over a broadening range of consumer devices. At the company level, this acquisition not only allows us to extend our protocol-layer test portfolio to system manufacturers, but also to reuse technologies across multiple market segments.

[GRAPHIC OMITTED]
COMMUNICATIONS SUPPLY CHAIN

Network Service Providers > System Vendors > Component Manufacturers > EXFO

Perhaps, the one point we underestimated was the duration of the market downturn that swept across the entire communications industry. Consequently, we were forced to implement a series of restructuring plans to adjust our cost structure to existing spending levels. We froze salaries and trimmed our workforce by 15% in 2001. We reduced our staff by 30% and rationalized our operations in 2002. In 2003, we pared down our workforce by 30%, exited the optical component manufacturing automation business, and streamlined the number of our production facilities. Overall, EXFO has gone from a peak of approximately 1400 employees in 2001 to 600 in 2003, of which almost 30% remain dedicated to R&D activities.

[GRAPHIC OMITTED]
[PHOTOGRAPH]

With continued quality of execution, protocol-layer activities are expected to play a larger role and contribute to our growth in 2004.

To summarize our fiscal 2004 strategy, we plan to increase sales through market-share gains, maximize profitability and growth on a long-term basis, innovate our way out of this downturn, and maintain a sound financial position.

NEW BUSINESS STRUCTURE

Although I am confident we adopted the right strategy during the downturn, I am hardly satisfied with our financial performance. We reported total sales of $61.9 million and a pro forma net loss of $0.18 per share, or $0.87 per share on a GAAP basis, in fiscal 2003 compared to sales of $68.3 million and a pro forma net loss of $0.19 per share, or $5.09 per share on a GAAP basis, in 2002. With that in mind, we have reorganized our business under two new reportable market segments: Telecom Division and Photonics and Life Sciences Division. Our Telecom Division, consisting of former Portable and Monitoring and telecom-related Industrial and Scientific product lines, would have represented 79% of total sales in 2003. Our Photonics and Life Sciences Division includes previous non-telecom Industrial and Scientific product lines. This simplified business structure--with respective sales, marketing, manufacturing, R&D and management teams for each division--will enable us to better serve our diverse customer base and maximize shareholder value.

We are more than ever committed to becoming a dominant player in the global communications test and measurement industry, while leveraging our technology base toward targeted photonics and life sciences markets. To summarize our fiscal 2004 strategy, we plan to increase sales through market-share gains, maximize profitability and growth on a long-term basis, innovate our way out of this downturn, and maintain a sound financial position.

INCREASE SALES THROUGH MARKET-SHARE GAINS

In fiscal 2004, we are focusing on continued market-share gains to achieve targeted growth, since we have based our scenario on a declining communications market; hopefully, our forecast will prove to be too conservative. In 2003, we believe that we gained market share among NSPs by strengthening the leadership position of our FTB-400 field-testing platform and by extending its reach to telecom and datacom protocol-layer test applications. We also leveraged our protocol-layer acquisitions (formerly Avantas Networks and gnubi communications) to enhance our strategic position and sales results in this mission-critical sector for our targeted end-markets. Evidence of this newfound traction is reflected in our protocol-layer test sales, which reached more than 10% of total revenues in each of the last three quarters of 2003. With continued quality of execution, protocol-layer activities are expected to play a larger role and contribute to our growth in 2004.

Looking ahead, we intend to further expand our presence with NSPs, who are increasingly focusing on reducing operating expenditures (OPEX) as capital expenditures (CAPEX) draw nearer to maintenance-level run rates. The unique value proposition inherent to our FTB-400 platform and related suite of test technologies reduces both CAPEX and OPEX, aptly matching the priorities of NSPs and installation teams of system vendors. Speaking of system vendors, we also started to target their R&D and manufacturing teams in 2003--as evidenced by the acquisition of gnubi communications. Following significant balance sheet restructuring, system vendors are gradually recovering with positive cash flow and even profits. We believe they will continue to improve their financial

position in 2004, resume their role as innovation drivers and become a major end-market for EXFO in the long term. In addition, we intend to leverage synergies across our entire protocol R&D activities to accelerate the development of innovative, advanced and differentiated test solutions that maximize the reuse of technologies over multiple market segments. The design, manufacturing and deployment of next-generation SONET/SDH networks, coupled with the convergence of multiple applications on simplified architectures, represent a significant market opportunity for our Telecom Division as we continue to expand our addressable markets.

As indicated by the realignment of our operations, we also intend to maximize revenue streams by leveraging our core telecom expertise into select adjacent markets. For example, we recently launched the X-Cite(TM) 120 Fluorescence Illumination System that was based on our adhesive curing technology for optical component manufacturing. Through joint development and reseller agreements with market-leading microscope manufacturers, we plan to take advantage of their large sales organizations and established base of microscopes to grow revenues in our Photonics and Life Sciences Division.

LETTER TO SHAREHOLDERS (CONTINUED)

MAXIMIZE PROFITABILITY AND GROWTH ON A LONG-TERM BASIS

Returning to profitability represents another top priority. We plan to keep a tight control on operating costs with a leaner and more flexible workforce. We will also continue to design differentiated, higher-margin products in our R&D labs, streamline our manufacturing operations and review our supply chain to reduce our cost of goods. As well, we will keep fine-tuning our sales process to offset ongoing pricing pressure from some competitors. These initiatives should help us improve our gross margin--which fell to 47.4% (excluding inventory write-offs and a non-recurring gain) in 2003 versus our historical level of about 60%--and accelerate our return to profitability, but not at the expense of sacrificing long-term growth. Maximizing profitability and growth on a long-term basis is critical to ensure the success of our company.

INNOVATE OUR WAY OUT OF THE DOWNTURN

Ever since we founded EXFO in 1985, innovation strategies were focused on being first to market with unique solutions that anticipate and better address customer requirements. Our market-driven approach can be demonstrated through a long history of industry firsts--first modular optical test platform, first all-in-one field-testing platform, first portable polarization mode dispersion (PMD) analyzer, etc. This focus on delivering a unique value proposition to the marketplace is of strategic importance to improve our gross margin in the upcoming year. Despite reductions in 2003, we maintained gross R&D spending at $17.1 million compared to $17.0 million in 2002 and $17.6 million in 2001. As a result, our strong product pipeline delivered 15 new solutions to the marketplace, including the next-generation PMD Analyzer that can characterize PMD levels in high-speed optical networks, the 2.5+ Gigabit Multi-Rate Transceiver for protocol-layer test applications, and the Packet Blazer(TM) Fibre Channel test module for installation and commissioning of storage area networks. Sales of new products (on the market two years or less) accounted for 49% of total sales in 2003. These numbers reflect our commitment to the future and indicate that our innovation strategy is working at EXFO. We intend to keep innovating our way out of this downturn in 2004. As NSPs and system manufacturers turn their attention to metro, access and fiber-to-the-home networks and as systems converge toward data-centric, Internet Protocol-based

technologies, we are developing the sophisticated test solutions required to match heightened network complexity.

MAINTAIN A SOUND FINANCIAL POSITION

For more than 18 years, we have maintained a solid balance sheet and, as of August 31, 2003, we had a cash position of approximately $57.4 million and practically no debt. This fiscal responsibility, in turn, provides our customers with the assurance that they can count on EXFO as a solid, long-term partner.

CONCLUSION

I would like to thank our employees for their dedication and hard work during what can best be described as a challenging year; our customers, for the confidence they have demonstrated in our products and services; our Board of Directors, for its diligent governance and wise counsel; and our shareholders, for supporting our long-term vision and profitable growth strategy. With the continued support of everyone, I am more than ever committed to the long-term success of the company and am confident we will soar to new heights.

Sincerely,

/s/ Germain Lamonde

Germain Lamonde
Chairman, President and Chief Executive Officer
October 27, 2003

CORPORATE HIGHLIGHTS

INNOVATION LIVES HERE

[GRAPHIC OMITTED]
[PHOTOGRAPH]

OCTOBER 2002

- Releases X-Cite 120 Illumination System for fluorescence microscopy applications
- Completes acquisition of the business of gnubi communications, based near Dallas, Texas

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NOVEMBER 2002

- Launches Channel Selector for commissioning and lighting channels in DWDM networks
- Announces established base of more than 10,000 modular test platforms worldwide

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FEBRUARY 2003

- Introduces next-generation PMD Analyzer

MARCH 2003

- Receives Market Penetration Award from Frost and Sullivan for expanding into the protocol-layer test market
- Accepts Growth Strategy Award from Frost and Sullivan for gaining market share in a highly competitive and turbulent marketplace
- Obtains $1.6 million protocol order from Tier-1 network service provider
- Launches 2.5+ Gigabit Multi-Rate Transceiver for system manufacturer market
- Raises field-testing platform to a new level with launch of Integrated Applications Suite
- Introduces Packet Blazer Fibre Channel test module for emerging storage area networks

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APRIL 2003

- Signs reseller agreements for X-Cite 120 Fluorescence Illumination System with Nikon Instruments and Zeiss MicroImaging

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MAY 2003

- Field-testing platform carries out dual PMD-CD tests on Hibernia Atlantic's undersea transatlantic network

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JUNE 2003

- Announces major restructuring plan
- Exits optical component manufacturing automation business

[GRAPHIC OMITTED]
X-Cite(TM) 120
Fluorescence Illumination System

[GRAPHIC OMITTED]
FTB-5500B
PMD Analyzer

[GRAPHIC OMITTED]
FTB-8515 Packet Blazer(TM)
SAN Test Module

TELECOM DIVISION

THINKING INSIDE THE BOX

As bandwidth requirements and network complexity increase year in and year out, so have residential and business expectations for quality of service, uptime and network reliability. These heightened requirements, increasingly becoming mission-critical throughout the global communications industry, are addressed with cost-effective, best-of-class solutions that only an experienced test and measurement vendor like EXFO can deliver.

Customers rely on our expertise to ensure their optical networks perform impeccably during each phase of the network life cycle-- research, development, manufacturing, installation, maintenance and full-time monitoring. Our field-testing solutions provide the utmost efficiency, cost-effectiveness and productivity to minimize the capital (CAPEX) and operating expenditures (OPEX) of network service providers (NSPs). Our advanced optical instruments and test systems enable telecom/datacom system manufacturers as well as component vendors to design and build better networks and related components.

CONSOLIDATING OUR LEADERSHIP POSITION

We have earned our leadership position in the physical-layer NSP market by anticipating customer needs for 18-plus years. When customers encountered problems upgrading their networks to 10 Gb/s, we were first to market with a unique polarization mode dispersion (PMD) analyzer that detected this limiting physical phenomenon. When customers faced test and measurement issues for their dense wavelength-division multiplexing (DWDM) networks, we introduced the best portable optical spectrum analyzer (OSA) and chromatic dispersion (CD) analyzer on the market. With fiber-to-the-home (FTTH) about to become a reality, lead customers are turning to us for another ready-made test solution. These are merely a few examples of the value-added solutions that customers have come to expect from a reliable, long-term partner such as EXFO, but they provide ample evidence of why our customer list reads like a Who's Who in the global NSP market.

At EXFO, we have reorganized our business under two new divisions--with respective sales, marketing, R&D, manufacturing and management teams--to better serve the needs of end-customers in different markets. Our Telecom Division consists of former Portable and Monitoring and telecom-related Industrial and Scientific product lines. This division is focused on network service providers, system manufacturers and component vendors on a global basis. Our Photonics and Life Sciences Division, which mainly leverages our core technologies, includes former Industrial and Scientific non-telecom product lines. This division has been created to maximize value from developed and acquired technologies. Beginning in 2004, we will report segmented information along these separate divisions.

[GRAPHIC OMITTED]
FTB-400 Universal Test System

[GRAPHIC OMITTED]
[PHOTOGRAPH]

Our PC-centric, Windows-driven platform, supported by more than a dozen next-generation test technologies, addresses complete service provisioning needs

for DWDM, SONET/SDH, Gigabit Ethernet and, most recently, storage area network (SAN) applications.

RAISING OUR FIELD-TESTING PLATFORM TO A NEW LEVEL

EXFO has been thinking inside the box since 1996, when we launched the original modular optical test platform. We expanded our leadership position in 2002 by releasing the first all-in-one test set that covers physical-, optical- and protocol-layer field-testing requirements for long-haul, metropolitan and access networks. In 2003, we raised the bar to a new level with the introduction of fully integrated software suites that automate the operation of test modules within our FTB-400 field-testing platform. This latest innovation allows complex testing routines to be carried out with a simple touch of a button. Our PC-centric, Windowsdriven platform, supported by more than a dozen next-generation test technologies, addresses complete service provisioning needs for DWDM, SONET/SDH, Gigabit Ethernet and, most recently, storage area network (SAN) applications. We recently released a Fibre Channel test module that provides NSPs with highly accurate bit-error-rate (BER) values, which reflect the quality of their SAN networks. The one-two combination of best-in-class modular platform and broadest suite of test technologies has left competitors little choice but to play catch-up.

ADDRESSING CAPEX AND OPEX CONCERNS

It's a matter of dollars and sense. To improve cash-flow requirements and lower debt loads, NSPs are constantly looking for ways to reduce their short-term CAPEX and long-term OPEX budgets. EXFO proves to be the vendor of choice with solutions that characterize high-speed optical networks with a superior level of accuracy and repeatability, while helping NSPs improve their financials.

- Our modular platform design allows several test modules to be used inside a single box, providing significant cost savings. (CAPEX)

- Our proprietary PMD and CD analyzers sweep through optical amplifiers along networks, while conventional methods require dispersion levels to be measured between one amplifier and another. The end result is considerable savings in testing time. (OPEX)

- The Dual Test Set feature on our Packet Blazer(TM) test module provides end-to-end Ethernet traffic testing using a remote unit, thus eliminating the need for an extra technician in the field. (OPEX)

EXTENDING INNOVATION TO SYSTEM MANUFACTURERS

Innovation is not limited to field-testing solutions at EXFO. Our R&D/manufacturing-floor platforms, namely the IQS-500 Intelligent Test System and EPX Multi-Channel Test Systems, are designed for testing converging telecom and datacom networks increasingly based on IP technology. The next-generation IQS-500 platform can efficiently run as many as 100 physical-layer test modules using a single controller unit. The flexible and scalable EPX platforms support multi-channel testing, which is critical for characterizing high-speed optical networks with multiple wavelengths, speeds and protocols. Physical- and protocol-layer modules can be stacked in these respective platforms to produce high-performance test stations for networks and related elements including multiplexers, cross-connects, transponders, lambda routers, optical switches and DWDM systems.

In 2003, we leveraged our IQS-500 platform to design a new Cable Assembly Test System for multimode patchcord assemblies and added three test modules to our high-performance power meter series. We also introduced the 2.5+ Gigabit Multi-Rate Transceiver for our EPX platforms to help system manufacturers reduce test time and increase test thoroughness on the production floor. This

protocol-layer test module simulates and monitors live traffic on each individual channel, enabling customers to carry out critical tests like BER, hybrid concatenation and service-disruption switch time. Subsequent to the year-end, we released the 10+ Gigabit Multi-Rate Transceiver with deep channelization and mixed payload concatenations for next-generation networks. We also launched a tunable external-cavity laser (ECL), whose broad wavelength range is optimized for coarse wavelength-division multiplexing (CWDM) and fiber-to-the-premises (FTTP) testing. These latest innovations point to one undeniable conclusion about EXFO: Innovation lives here!

[GRAPHIC OMITTED]
EPX16 Multi-Channel Test System

[GRAPHIC OMITTED]
IQS-500 Intelligent Test System

PHOTONICS AND LIFE SCIENCES DIVISION

LEVERAGING EXISTING TECHNOLOGIES

Over the years, EXFO has developed and acquired a number of telecom-related technologies that we are leveraging in selected photonics and life science applications for high-tech industrial manufacturing and research markets. For example, we offer several light-based curing solutions for optical component manufacturing and have optimized our approach for other industries, such as semiconductor, electronic, and medical device manufacturing, to maximize revenues. Our Novacure(R) and Acticure(R) spot-curing systems deliver precise doses of the appropriate spectral light onto photosensitive adhesives to significantly reduce bonding time and increase repeatability. These light-based curing systems, supported by patented StepCure(R) technology, produce a high-quality bonding solution that is unmatched in the industry.

DEVELOPING UNIQUE FLUORESCENCE MICROSCOPY SOLUTIONS

In 2003, we took advantage of our light-based curing technology to jointly develop a unique fluorescence microscopy solution with leading manufacturers. The X-Cite(TM) 120 Fluorescence Illumination System is an indispensable microscope accessory, offering greater image quality, convenience and lamp life than conventional solutions in the life sciences market. Market response proved to be very positive following the signing of reseller agreements with industry leaders such as Nikon Instruments and Zeiss MicroImaging, who are offering the X-Cite 120 through their own sales channels to new and existing microscope owners.

DEPLOYING NANOTECHNOLOGY FOR LIFE SCIENCE RESEARCH

To meet the growing demand for precision positioning instrumentation in life science research, we have drawn on our telecom expertise in nanometer-scale positioning to offer a unique array of piezoelectric-based positioning systems. The stability of piezoelectric (PZT) technology provides extremely smooth and predictable instrument motion used for applications as varied as micromanipulation and patch-clamp experimentation, ultra-fast solution switching, nuclear transfer and intracytoplasmic sperm injection.

[GRAPHIC OMITTED]
PCS-5000
Patch-Clamp Manipulation System

EXTENDING OUR WAVEMETER(R) TECHNOLOGY

Our Wavemeter test solutions are recognized around the world for characterizing optical networks with the highest degree of accuracy. We take full advantage of our leading-edge technology by extending it to non-telecom applications that require the use of a laser. Scientists and engineers, after all, need to know the absolute wavelength of a laser for their particular line of work such as high-resolution laser spectroscopy, photochemistry and optical remote sensing.

[GRAPHIC OMITTED]
WA-1650
Wavemeter

As demonstrated in the above examples, we're constantly finding new ways to leverage our technology base and maximize revenues.

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X-Cite(TM) 120
Fluorescence Illumination System

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of the consolidated financial condition and results of operations of EXFO Electro-Optical Engineering Inc. for the fiscal years ended August 31, 2003, 2002 and 2001, should be read in conjunction with our consolidated financial statements and the related notes included elsewhere in this Annual Report. Our consolidated financial statements are reported in US dollars and have been prepared in accordance with generally accepted accounting principles in Canada, or Canadian GAAP. To the extent applicable to our consolidated financial statements included elsewhere in this Annual Report, these principles conform in all material respects with generally accepted accounting principles in the United States, or U.S. GAAP, except for significant differences, as described in Note 20 to our consolidated financial statements.

INDUSTRY OVERVIEW

Communications companies, still dealing with reduced spending levels, were affected by a number of external forces during fiscal 2003, including geo-political and economic uncertainty, the outbreak of SARS in Asia, as well as the declining strength of the US dollar. To cope with these market realities, network service providers, the first link in the communications supply chain, continued to service their debt loads and conserve cash. Moreover, as capital expenditure (CAPEX) budgets increasingly drew nearer to maintenance-level run rates, network service providers turned their attention to operating expenditures (OPEX) for further savings.

Lower spending levels necessarily produced a trickle-down effect throughout the communications industry, namely for system vendors, component manufacturers as well as for test and measurement equipment vendors. System manufacturers were negatively affected by the significant reduction in the deployment of long-haul optical networks, but benefited from some activity in metro and access networks. Optical component manufacturers were hardest hit by the downturn, given their position in the supply chain, the relative stability of technology and the

excess manufacturing capacity in this sector. The ongoing consolidation within the component manufacturing market provides an inkling of its weaker health.

Test and measurement equipment vendors also felt the impact of reduced network service provider spending with less demand for orders. In addition, some competitors increasingly applied pricing pressure to obtain contracts, which eroded margins across the board. The gray market for test and measurement instruments, especially involving optical component manufacturing applications, further compounded the soft market. On the other hand, test and measurement vendors--whose products enable customers to lower CAPEX and OPEX, as well as deploy nextgeneration architecture--still attracted the attention of network service providers and system manufacturers for certain projects.

COMPANY OVERVIEW

EXFO is a leading designer and manufacturer of fiber-optic test, measurement and monitoring solutions for the global telecommunications industry.We market more than 90 product families to a diverse customer base in approximately 70 countries around the world. We develop products for two main markets. The Portable and Monitoring Division provides handheld and modular instruments for the physical-, optical- and protocol-layer testing needs of telecommunications carriers and network service providers. The Industrial and Scientific Division offers an extensive line of high-performance instruments and test systems for optical transmission system and component vendors as well as for research and development labs.

EXFO was founded in Quebec City, Canada, in 1985. Our original products were focused on the needs of installers and operators of fiber-optic networks. Customers use these field-testing products for the installation, maintenance, monitoring and troubleshooting of optical networks. In 1996, we supplemented our product portfolio with an extensive line of high-end products that are mainly dedicated to research and development as well as manufacturing activities. These products, namely modular and benchtop units, tend to be more complex and higher-priced than field-testing ones. In 1999, we entered the remote fiber test system (RFTS) market. This type of system allows network service providers to monitor the integrity of their fiber-optic systems in real time, twenty-four hours a day, seven days a week.

In the last two years, we have strengthened our competitive position through the acquisition of two protocol-layer test businesses. In November 2001, we expanded into protocol-layer testing with the acquisition of Avantas Networks Corporation (renamed EXFO Protocol Inc.), a supplier of fiber-optic testing and optical-network-performance management equipment for network service providers. This transaction was highly strategic because it enabled us to combine protocol-, optical- and physical-layer testing inside a single platform--the FTB-400 Universal Test System-- to help our customers increase revenues and reduce operational costs.

In October 2002, our newly created wholly-owned subsidiary, EXFO Gnubi, purchased substantially all the assets of gnubi communications, L.P., a supplier of multi-channel telecom and datacom testing solutions for the system manufacturer market. EXFO Gnubi's protocol-layer test equipment targets the fully complementary system manufacturer market, while EXFO Protocol's offering focuses on the network service provider market. Jointly, these strategic acquisitions enabled us to double our addressable market as we expanded from physical- and optical-layer testing to also cover protocol-layer testing applications in the telecom and datacom market, while offering a more complete fiber-optic test solution to customers.

Previously, we completed two acquisitions to bolster growth in the optical component manufacturing market.We acquired Burleigh Instruments, Inc. (renamed EXFO Burleigh Products Group Inc.) in December 2000 for its wavelength

measurement instruments and nanopositioning alignment systems.We also added EFOS Inc. (renamed EXFO Photonic Solutions Inc.) in March 2001 for its precision light-based, adhesive spot-curing technology.We have since exited the optical component manufacturing automation business, a market addressed by an EXFO Burleigh product line.

One of our strongest competitive advantages is our modular platform design, which we first launched in 1996; and with the introduction of all-in-one test sets that cover physical-, optical- and protocol-layer test requirements in 2002, we believe that we remain the industry leader in this area. In 2003, we raised our field-testing platform to a new level by enabling field technicians to seamlessly automate their test applications. The first software product within EXFO's Integrated Applications Suite, the Lambda Auto-Sweeper, automates the interaction and common reporting of three test modules within our FTB-400 field-testing platform: SONET/SDH Analyzer, Optical Spectrum Analyzer and DWDM Channel Selector.

As described above, we have faced difficult market conditions in the telecommunications industry in the last two years; we experienced a decrease in sales and incurred significant operating losses. To cope with these realities, we implemented several restructuring actions since the last quarter of fiscal 2001. These actions resulted in workforce reductions of 245, 350 and 172 employees in fiscal 2001, 2002 and 2003, respectively.We also adopted rigorous cost-control measures and rationalized our business model. In addition, we incurred significant asset impairment charges related to these market conditions, namely for inventories, goodwill, intangible assets and future income tax assets.

To better serve the needs of end-customers in different markets and simplify our business model, we reorganized our business under two new divisions at the beginning of fiscal 2004. Our Telecom Division consists of former Portable and Monitoring and telecom-related Industrial and Scientific product lines. This division is focused on network service providers, communication system manufacturers and optical component vendors on a global basis. Our Photonics and Life Sciences Division, which mainly leverages our core technologies, includes former Industrial and Scientific non-telecom product lines. This division has been created to maximize value from developed and acquired telecom technologies.

Following this reorganization, our two new divisions now have respective sales, marketing, R&D, manufacturing and management teams and will, therefore, be presented under two corresponding operating segments. Under CICA handbook section 1701, we will provide the required segmented disclosures in our interim consolidated financial statements beginning in the first quarter of fiscal 2004. However, we will not provide comparative information for previous periods about each reportable segment, except for sales and long-lived assets, because this information is not available.

SALES

We sell our products to a diversified customer base in approximately 70 countries around the world through our direct sales force and, indirectly, through distribution channels. Our customers are comprised of telecommunications carriers, network service providers, system and optical component manufacturers, as well as research and development laboratories.We have a diversified customer base, both in terms of sector and geographical area, which provides us with reasonable protection regarding concentration of credit risk. As for customer breakdown, no customer accounted for more than 9.2%, 10.2% and 6.4% of sales in fiscal 2003, 2002 and 2001, respectively. In fiscal 2003, our three most

significant customers represented 17.5% of sales, compared to 15.4% of sales in 2002 and 12.8% of sales in 2001.

COST OF SALES

Cost of sales includes raw materials, salaries and related expenses for direct and indirect manufacturing personnel (net of government grants) as well as overhead costs. Excess, obsolete or scrapped materials are also included in cost of sales.

In 2003, we reclassified certain expenses from selling and administrative expenses to cost of sales. Comparative figures have been reclassified accordingly.

OPERATING EXPENSES

We classify our operating expenses into three general categories: selling and administrative expenses, research and development expenses and amortization expenses.

Selling and administrative expenses consist primarily of salaries and related expenses for personnel (net of government grants), 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 thirdparty consultants.We are eligible to receive research and development tax credits and government grants on research and development carried out in Canada. Related research and development tax credits and government grants are recorded as a reduction of gross research and development expenses. Tax credit write-offs are included in net research and development expenses.

Operating expenses related to our restructuring plans have been recorded as a separate component of operating expenses. These expenses consist primarily of severance expenses, costs to exit leased facilities as well as write-offs of unused long-lived assets.

OUR STRATEGY

We are more than ever committed to becoming a dominant player in the global communications test and measurement industry, while leveraging our technology base in targeted photonics and life science markets. To summarize our fiscal 2004 strategy, we plan to increase sales through market-share gains, maximize profitability and growth on a long-term basis, innovate our way out of this downturn, and maintain a sound financial position.

INCREASE SALES THROUGH MARKET-SHARE GAINS

In fiscal 2004, we will focus on continued market-share gains to achieve growth, considering a scenario based on a slightly declining communications market. In 2003, we believe that we gained market share among network service providers by strengthening the leadership position of our FTB-400 field-testing platform and by extending its reach to telecom and datacom protocol-layer test applications.

We also leveraged our protocol-layer acquisitions (formerly Avantas Networks and gnubi communications) to enhance our strategic position and sales results in this mission-critical sector for our targeted end-markets. Evidence of this newfound traction is reflected in our protocol-layer test sales, which accounted for more than 10% of total revenues in each of the last three quarters of 2003. With continued quality of execution, protocol-layer activities are expected to

play a larger role and contribute to our growth in 2004.

Looking ahead, we intend to further expand our presence with network service providers, who are increasingly focusing on reducing operating expenditures (OPEX) as capital expenditures (CAPEX) draw nearer to maintenance-level run rates. The unique value proposition inherent to our flexible, PC-based FTB-400 modular test platform and related suite of test technologies reduces both CAPEX and OPEX, aptly matching the priorities of network service providers and installation teams of system vendors.

Speaking of system vendors, we also started to target their R&D and manufacturing teams in fiscal 2003--as evidenced by the acquisition of gnubi communications. Following significant balance sheet restructuring, system vendors are gradually recovering, showing positive cash flow and even profits.We believe they will continue to recover in 2004 and will represent a major end-market for EXFO in the long term.

In addition, we intend to leverage synergies across our entire protocol R&D activities to accelerate the development of innovative, advanced and differentiated test solutions that maximize the reuse of technologies over multiple market segments. The design, manufacturing and deployment of next-generation SONET/SDH networks, combined with the convergence of multiple applications on simplified architectures and our strong market position on the physical-layer side, represent a significant market opportunity for our Telecom Division as we continue to expand our addressable markets.

As indicated by the realignment of our operations, we also intend to maximize revenue streams by leveraging our core telecom expertise into select adjacent markets. For example, we recently launched the X-Cite 120 Fluorescence Illumination System that was based on our adhesive curing technology for optical component manufacturing. Through joint development and reseller agreements with market-leading microscope manufacturers, we plan to take advantage of their large sales organizations and established base of microscopes to grow revenues in our Photonics and Life Sciences Division.

MAXIMIZE PROFITABILITY AND GROWTH ON A LONG-TERM BASIS

Returning to profitability is also a key priority for EXFO.We intend to design differentiated, higher-margin products in our R&D labs, streamline our manufacturing operations and review our supply chain in order to reduce our cost of goods. As well, we will keep fine-tuning our sales process to offset ongoing pricing pressure by some competitors. These initiatives should help us improve our gross margin, which fell to 47.4% (excluding inventory write-offs and a non-recurring gain) in fiscal 2003, to at least 50% in fiscal 2004 and accelerate our return to profitability. A balance between profitability and growth, however, is critical to ensure the long-term success of the company. We believe that our operating expenses have reached a level in which we cannot make additional significant reductions without compromising our medium- and long-term growth prospects. We reduced our selling and general administrative expenses by 20% to $27.0 million in fiscal 2003, from $33.9 million in 2002 and by 25% in 2002, from $45.0 million in 2001. On the other hand, we maintained our gross R&D expenses at $17.1 million in 2003 compared to $17.0 million in 2002 and $17.6 million in 2001. We plan to keep a tight control on operating costs with leaner and more flexible operations. However, the ongoing strength of the Canadian dollar (compared to the US dollar) may have a negative impact on our operating costs in 2004 and may offset some of our restructuring efforts.

INNOVATE OUR WAY OUT OF THE DOWNTURN

Ever since we founded EXFO in 1985, innovation strategies were focused on being first to market with unique solutions that anticipate and better address customer requirements. Our marketdriven approach can be demonstrated through a long history of industry firsts--first modular optical test platform, first all-in-one field-testing platform, first portable polarization mode dispersion (PMD) analyzer, etc. This focus on delivering a unique value proposition to the marketplace is of strategic importance to improve our gross margin in the upcoming year. Our strong product pipeline delivered 15 new products to the marketplace in 2003, most of which include telecom-related solutions such as a next-generation PMD analyzer that can characterize PMD levels in high-speed optical networks, a Fibre Channel test module for installation and commissioning of storage area networks, and a 2.5+ Gigabit multi-rate transceiver for protocol-layer test applications. Sales of new products (on the market two years or less) accounted for 49% of total sales in 2003. These numbers reflect our commitment to the future and indicate that our innovation strategy is working at EXFO. We intend to keep innovating our way out of this downturn in 2004. As network service providers and system manufacturers turn their attention to metro, access and fiber-to-the-home networks and as systems converge toward data-centric, Internet Protocol-based technologies, we are developing the sophisticated test solutions required to match heightened network complexity.

MAINTAIN A SOUND FINANCIAL POSITION

For more than 18 years, we have maintained a solid balance sheet and, at the end of fiscal 2003, we had a cash position of $57.4 million and practically no debt. This fiscal responsibility provides our customers with the assurance that they can count on EXFO as a solid, long-term partner.

Our cash position will allow us to continue investing significantly in R&D in order to develop new solutions and tap into new markets, while some of our competitors face more significant financial pressure.

KEY PERFORMANCE INDICATORS

As measures to assess the realization of our strategic plan and its objectives, we have set out four consolidated key performance indicators, which are summarized as follows:

STRATEGIC OBJECTIVES	KEY PERFORMANCE INDICATORS
Increase sales through market-share gains	10% sales growth year-over-year, assuming a stable or slightly declining communications market
Maximize profitability and growth on a long-term basis	50% gross margin in fiscal 2004
Innovate our way out of the downturn	45% of our sales from new products (on the market two years or less) during fiscal 2004
Maintain a sound financial position	Positive cash flows from operating activities during fiscal 2004*

* Assuming no major acquisitions of businesses and/or technologies and stability in the value of the Canadian dollar compared to the US dollar.

CAPABILITY TO DELIVER RESULTS

At EXFO, we believe that we have the capabilities to deliver expected results thanks to outstanding products, an excellent reputation in the marketplace, a sound financial position, as well as an experienced workforce and management team.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Management's discussion and analysis of financial conditions and results of operations is based on our consolidated financial statements included elsewhere in this Annual Report. As previously mentioned, they have been prepared in accordance with Canadian GAAP. The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting years. On an ongoing basis, we evaluate these estimates and assumptions, including those related to revenue recognition, allowance for doubtful accounts, allowance for excess and obsolete inventories, research and development tax credits and government grants, impairment of long-lived assets and goodwill, valuation allowance of future income tax assets, warranty obligations, restructuring charges as well as contingencies and other obligations. 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.

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

REVENUE RECOGNITION. For products in which software is incidental, we recognize revenue when persuasive evidence of an arrangement exists, the product has been delivered, the price is fixed and determinable and collection of the resulting receivable is reasonably assured. In addition, provisions are made for estimated returns, warranties and support obligations.

For products in which software is not incidental, revenues are separated into two categories: product and customer support revenues based upon vendor-specific objective evidence of fair value. Product revenues for these sales are recognized as described above. Customer support revenues are deferred and recognized ratably over the years of the support arrangement. Except when provided within one year of delivery, costs of providing this support are insignificant and accrued at the time of delivery and no software upgrades are provided.

For all sales, we use a binding purchase order as evidence that a sales arrangement exists.

Delivery generally occurs when the product is shipped to a transporter.

At the time of the transaction, we assess whether the price associated with our revenue transaction is fixed and determinable, and whether or not collection is reasonably assured. We assess whether the price is fixed and determinable based on the payment terms associated with the transaction. We assess 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.

Most sales arrangements do not generally include acceptance clauses. However, if a sales arrangement includes an acceptance provision, acceptance occurs upon the earliest of the receipt of a written customer acceptance or the expiration of the acceptance period. For these sales arrangements, the sale is recognized when acceptance occurs.

ALLOWANCE FOR DOUBTFUL ACCOUNTS. We estimate collectibility of accounts receivable on an ongoing basis by periodically reviewing balances outstanding over a certain period of time.We determine our allowance for doubtful accounts receivable based on our historical accounts receivable collection experience and on the information that we have about the status of our accounts receivable balances. If the financial conditions of our customers deteriorate, resulting in an impairment of their ability to make required payments, additional allowance may be required, which could adversely affect our future results.

ALLOWANCE FOR EXCESS AND OBSOLETE INVENTORIES. We state our inventories at the lower of cost, determined on an average cost basis and replacement cost or net realizable value, and provide reserves for excess and obsolete inventories.We determine our reserves for excess and obsolete inventories based on the quantities we have on hand versus expected needs for these inventories, so as to support future sales of our products. 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.

RESEARCH AND DEVELOPMENT TAX CREDITS AND GOVERNMENT GRANTS. We record research and development tax credits and government grants based on our interpretation of tax laws and grant programs, especially regarding related eligible projects and expenses, and when there is reasonable assurance that we have complied and will continue to comply with all conditions and laws. Also, our judgment and estimates are based on historical experience. It is possible, however, that the tax authorities have a different interpretation of laws and application of conditions related to the programs or that we will not comply with all conditions related to grants in the future, which could adversely affect our future results. Furthermore, a large part of our tax credits are refundable against income taxes payable, causing their ultimate realization to be dependent upon the generation of taxable income. If we obtain information that causes our forecast of future taxable income to change or if actual taxable income differs from our forecast, we may have to revise the carrying value of these tax credits, which would affect our results in the period in which the change was made. We review the recoverability of such tax credits on a quarterly basis. Please refer to the "Research and development" section further in this document.

IMPAIRMENT OF GOODWILL AND INTANGIBLE ASSETS. We assess impairment of goodwill on an annual basis, or more frequently, if events or circumstances occur that more likely than not reduce the fair value of a reporting unit below its carrying value. Goodwill impairment exists when the carrying value of a reporting unit exceeds its fair value. The amount of impairment loss, if any, is the excess of the carrying value of goodwill over its fair value. On September 1, 2002, upon the adoption of section 3062 of the Canadian Institute of Chartered Accountants (CICA) handbook, "Goodwill and Other Intangible Assets", we performed an initial impairment test of goodwill based on a fair value method. For the purposes of this test, we allocated our existing goodwill to our reporting units and completed an evaluation of the fair value of such reporting units. For the purposes of this evaluation, we used discounted future cash flows as well as sales multiples to estimate the fair value of each reporting unit. The assumptions used reflect our best estimates. Based on the comparison of the fair value of the reporting units to their carrying value, goodwill was not

considered impaired at that moment.

Furthermore, on September 1, 2002, we prospectively adopted section 3063 of the CICA handbook, "Impairment of Long-Lived Assets". Based on this new standard, we assess impairment of intangible assets when events or circumstances indicate that costs may not be recoverable. Impairment exists when the carrying value of the asset is greater than the pre-tax undiscounted future cash flows expected to be provided by the asset. The amount of impairment loss, if any, based on the recoverability test, is the excess of the carrying value over its fair value. We assess fair value of intangible assets based on discounted future cash flows.

In the third quarter of fiscal 2003, we assessed impairment of goodwill and intangible assets based on these new standards. Please refer to the "Write-down of goodwill and intangible assets" section further in this document.

FUTURE INCOME TAXES. We account 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, using enacted income tax rates for the years in which the differences are expected to reverse. In assessing the recoverability of our future income tax assets, we consider whether it is more likely than not that some or all of the future income tax assets will not be realized. The ultimate realization of certain future income tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences will become deductible. If we obtain information that causes our forecast of future taxable income to change or if actual taxable income differs from our forecast, we may have to revise the carrying value of our future income tax assets, which would affect our results in the period in which the change was made.We review the recoverability of our future income tax assets on a quarterly basis. Please refer to the "Income Taxes" section further in this document.

In addition to the two above-mentioned CICA handbook sections, we also adopted the following new handbook sections and guideline in fiscal 2003:

- Section 3475 "Disposal of Long-Lived Assets and Discontinued Operations"
- Section 3870 "Stock-Based Compensation and Other Stock-Based Payments"
- Accounting Guideline 14 "Disclosure of Guarantees"

Please refer to note 2 to our consolidated financial statements included elsewhere in this Annual Report for further information about these new standards and their impact on our financial statements.

RESULTS OF OPERATIONS

The following table sets forth certain Canadian GAAP consolidated statements of earnings data in thousands of US dollars, except per share data, and as a percentage of sales for the years indicated:

Years ended August 31,	2003	2002	2001	2003

Sales	$ 61,930	$ 68,330	$ 146,013	100.0%
Cost of sales (1)	36,197	52,366	56,207	58.4
Gross margin (2)	25,733	15,964	89,806	41.6
Operating expenses				
Selling and administrative (1)	26,991	33,881	44,975	43.6
Net research and development	15,879	12,782	13,601	25.6
Amortization of property, plant and equipment	6,139	5,932	3,559	9.9
Amortization of intangible assets	4,747	11,615	9,876	7.7
Write-down of intangible assets	2,922	23,657	--	4.7
Restructuring and other charges	4,134	2,880	3,288	6.7
Total operating expenses	60,812	90,747	75,299	98.2
Earnings (loss) from operations	(35,079)	(74,783)	14,507	(56.6)
Interest income, net	1,245	1,456	6,098	2.0
Foreign exchange gain (loss)	(1,552)	(458)	3,327	(2.5)
Earnings (loss) before income taxes and amortization and write-down of goodwill	(35,386)	(73,785)	23,932	(57.1)
Income taxes	15,059	(25,451)	8,150	24.3
Earnings (loss) before amortization and write-down of goodwill	(50,445)	(48,334)	15,782	(81.4)
Amortization of goodwill	--	38,021	31,076	--
Write-down of goodwill	4,505	222,169	--	7.3
Net loss for the year	$(54,950)	$(308,524)	$ (15,294)	(88.7)%
Basic and diluted net loss per share	$ (0.87)	$ (5.09)	$ (0.29)	
Research and development data:				
Gross research and development	$ 17,133	$ 17,005	$ 17,601	27.7%
Net research and development	$ 15,879	$ 12,782	$ 13,601	25.6%
OTHER DATA (UNAUDITED) (3):				
Pro forma net earnings (loss)	$(11,476)	$ (11,248)	$ 24,500	(18.5)%
Basic and diluted pro forma net earnings (loss) per share	$ (0.18)	$ (0.19)	$ 0.46	

(1) Certain comparative figures have been reclassified to conform to the current-year presentation.

(2) Including inventory write-offs of $4,121, $18,463 and nil for the years ended August 31, 2003, 2002 and 2001, respectively, and a non-recurring gain of $473 for the year ended August 31, 2003. Excluding inventory write-offs and the non-recurring gain, gross margin would have reached 47.4% for the year ended August 31, 2003. Excluding inventory write-offs, gross margin would have reached 50.4% for the year ended August 31, 2002. This latter information is unaudited and is a non-GAAP measure.

(3) Net earnings (loss) excluding amortization and write-down of goodwill, non-recurring tax recovery, future income tax assets valuation allowance and the after-tax effect of amortization and write-down of intangible assets, restructuring and other charges, inventory and tax credit write-offs and non-recurring grants recovery. This information may not be comparable to similarly titled measures reported by other companies because it is non-GAAP information. Please refer to page 17 of this document for a detailed quantitative reconciliation.

SALES

Sales totaled $61.9 million, $68.3 million and $146.0 million in fiscal 2003, 2002 and 2001, respectively.

Compared to fiscal 2002, sales decreased 9% in 2003 due to increased pricing pressure by vendors and the continued slowdown in the global telecommunications industry.

Despite depressed spending levels in the telecommunications industry and the overall decrease of our sales in fiscal 2003, our sales of Portable and Monitoring products increased 3%, compared to 2002, mainly because of heightened traction in the protocol-layer test sector. On the other hand, our Industrial and Scientific product sales decreased 26% in fiscal 2003, compared to 2002, mainly due to the collapsed market for optical components and the resulting gray market. Overall for fiscal 2003, it was a 65%-35% sales split in favor of our Portable and Monitoring products compared to a 57%-43% split in favor of our Portable and Monitoring products in 2002.

It should be noted that the exited component manufacturing automation business generated nominal sales in fiscal 2003. Therefore, the exit of this business will not have a significant impact on our future sales.

With respect to the new business organization outlined earlier in this document, it would have been a 79%-21% sales split in favor of our Telecom Division in fiscal 2003. We expect this split to remain relatively unchanged in fiscal 2004.

[GRAPHIC OMITTED]
[BAR CHART]

	$ Millions
03	61.9
02	68.3
01	146.0
00	71.6
99	42.2

Net accepted orders decreased 4% to $55.7 million in fiscal 2003 from $58.3 million in 2002. Our net book-to-bill ratio increased to 0.90 in fiscal 2003 compared to 0.85 in 2002. In fiscal 2003, our net accepted orders were more stable quarter-over-quarter, compared to fiscal 2002, despite the continued decline in most of our end-markets. We believe that this is a clear indication that we gained market share overall.

Sales decreased 53% in fiscal 2002, compared to 2001, due to a reduced demand for our products and pricing pressure attributable to the severe downturn in the

telecommunications industry. Despite the acquisitions of EXFO Burleigh, EXFO Photonic Solutions and EXFO Protocol, we were not able to maintain our sales level year-over-year. Both our Portable and Monitoring products and our Industrial and Scientific products suffered from this lack of demand and pricing pressure. Our Industrial and Scientific products, however, were the most affected by the downturn, especially the optical component manufacturer end-market, given significant industry consolidation and reduced sales volume following the telecom peak. With regard to sales distribution, it was a 57%-43% sales split in favor of our Portable and Monitoring products in fiscal 2002 compared to 52%-48% in favor of our Industrial and Scientific products in 2001.

Net accepted orders decreased 56% to $58.3 million in fiscal 2002 from $132.1 million in 2001. Our book-to-bill ratio decreased to 0.85 in fiscal 2002 from 0.90 in 2001.

North American sales accounted for 59%, 57% and 58% of global sales in fiscal 2003, 2002 and 2001, respectively. International sales represented 41%, 43% and 42% of global sales in fiscal 2003, 2002 and 2001, respectively. Despite the relative stability in our international sales between fiscal 2003 and 2002, as a percentage of total sales, sales to the Asian market decreased to 16% of global sales in fiscal 2003 compared to 19% in 2002. On the other hand, sales to the Latin American market increased to 7% of global sales in fiscal 2003 compared to 4% of sales in 2002. Most of our sales to these two markets are made through tenders, which may vary in number and significance from period to period. In addition, the SARS outbreak also affected our sales in Asia to some extent.

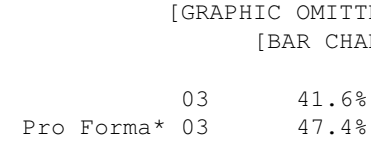
The increase in international sales in fiscal 2002, compared to 2001, mainly reflects our sustained efforts to develop the Asian market. Sales to the Asian market reached 19% of global sales in fiscal 2002 compared to 13% in 2001.

We expect a similar split in favor of our North American sales in fiscal 2004, considering the current state of the market and our past results.

GROSS MARGIN

Gross margin amounted to 41.6%, 23.4% and 61.5% of sales for fiscal 2003, 2002 and 2001, respectively.

In fiscal 2003, we recorded inventory write-offs of $4.1 million for obsolete and excess inventories. These special charges were required considering product phase-outs, reduced needs for the 12 months following the time of the write-offs, current market conditions as well as our exit from the optical component manufacturing automation business. In 2003, we also recorded a non-recurring gain of $473,000 related to a grant recovery upon a tax assessment received in 2003. Excluding these special items, gross margin would have reached 47.4% of sales. Even excluding these special items, gross margin decreased 3% in fiscal 2003, compared to 2002, as adjusted on the same basis. The decrease is attributable to several reasons. First, existing market conditions and the competitive landscape inevitably led to increased pricing pressure. This, combined with a lower sales level in fiscal 2003, prevented a better absorption of our fixed manufacturing costs, which ultimately caused margin erosion. In addition, shift in product mix in favor of our Portable and Monitoring products caused our gross margin to decrease, as these products tend to have lower margins than our Industrial and Scientific products. However, the decrease in our gross margin was offset in part by our increased efficiency and restructuring efforts in 2002 and 2003.



	02	23.4%
Pro Forma**	02	50.4%
	01	61.5%
	00	64.6%
	99	63.3%

* Excluding inventory write-offs of $4.1 million and a non-recurring gain of $473,000

** excluding inventory write-offs of $18.5 million

In fiscal 2002, we recorded inventory write-offs of $18.5 million for obsolete and excess inventories. These special charges were recorded due to weaker demand for our products and our expected needs for the 24 months following the time of the write-offs. Excluding these special charges, our gross margin would have reached 50.4% of sales. Even excluding these special charges, our gross margin decreased 11.1% in fiscal 2002, from 61.5% in 2001, mainly because of the significant decrease in sales in 2002. Weaker demand for our products and pricing pressure prevented a better absorption of our fixed manufacturing costs. Also, our manufacturing capacity in Quebec City, Quebec, and Victor, New York, almost doubled in fiscal 2001, while sales decreased significantly in 2002.

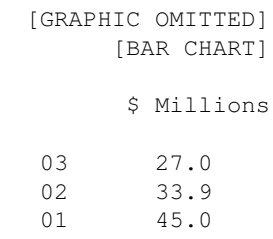
With our recent cost-reduction measures and tight control on operating costs, we believe that our gross margin should improve to at least 50% of sales in fiscal 2004 compared to 47.4% in fiscal 2003. However, our gross margin may fluctuate quarter-over-quarter as our sales may fluctuate. Furthermore, our gross margin can be negatively affected by increased competitive pricing pressure, increased obsolescence and excess costs, shifts in product mix, under-absorption of fixed manufacturing costs and increases in product offerings by other suppliers in the communications test and measurement industry.

It should be noted that a new presentation was adopted in 2003, in which certain expenses were reclassified from selling and administrative expenses to cost of sales. Consequently, comparative figures have also been reclassified, resulting in cost of sales increases of 2.3% and 0.9%, respectively for fiscal 2002 and 2001, with comparable decreases in selling and administrative expenses for these same years.

SELLING AND ADMINISTRATIVE

Selling and administrative expenses reached $27.0 million, $33.9 million and $45.0 million for fiscal 2003, 2002 and 2001, respectively. As a percentage of sales, selling and administrative expenses amounted to 43.6%, 49.6% and 30.8% for fiscal 2003, 2002 and 2001, respectively.

As a result of our restructuring plans implemented during the second and the third quarters of fiscal 2002 and in the third quarter of 2003, we were able to reduce our selling and administrative expenses by 20% year-over-year. The decrease in sales in fiscal 2003 also resulted in lower commissions and marketing expenses. Finally, in fiscal 2003, we recorded a non-recurring gain of $239,000, related to a grant recovery upon a tax assessment. However, the decrease in our selling and administrative expenses was offset in part by the impact of the acquisitions of EXFO Protocol and EXFO Gnubi in November 2001 and October 2002, respectively.



00	23.6
99	12.8

Also, the increased strength of the Canadian dollar, compared to the US dollar, in fiscal 2003, prevented us from further reducing our selling and administrative expenses. A large portion of our selling and administrative expenses are incurred in Canadian dollars. Consequently, the increase in the average value of the Canadian dollar, compared to the US dollar, in 2003, caused our selling and administrative expenses to increase since we report our financial results in US dollars. Overall, despite the latter reasons, we were able to reduce our selling and administrative expenses by nearly $7 million year-over-year, mainly because of the impact of our recent restructuring efforts and cost-control measures on these expenses.

As a result of the restructuring plans we implemented since June 2001, combined with the significant sales decrease in fiscal 2002, we were able to reduce our selling and administrative expenses, including lower commission expenses in fiscal 2002 compared to 2001. However, this decrease was offset in part by the impact of the acquisition of EXFO Protocol in November 2001. On the other hand, the significant drop in sales in fiscal 2002 caused the selling and administrative expenses percentage to increase since a large portion of these expenses tend to be fixed and because sales decreased at a faster rate than selling and administrative expenses.

For fiscal 2004, we expect our selling and administrative expenses in US dollars to remain flat compared to 2003.We believe that such a level represents a good balance between cost reduction and an acceptable cost structure to improve sales, provide quality service to customers, as well as integrate and run our acquired businesses, thus strategically positioning our company. Overall, our selling and administrative expenses in Canadian dollars will decrease as a result of our recent restructuring efforts and tight cost-control measures. However, the rapid and significant 6.9% increase of the Canadian dollar at the end of fiscal 2003, compared to its average value of US$0.675 during that same year, will negatively affect our selling and administrative expenses.

RESEARCH AND DEVELOPMENT

Gross research and development expenses totaled $17.1 million, $17.0 million and $17.6 million for fiscal 2003, 2002 and 2001, respectively. As a percentage of sales, gross research and development expenses amounted to 27.7%, 24.9% and 12.1% for fiscal 2003, 2002 and 2001, respectively.

[GRAPHIC OMITTED]
[BAR CHART]

$ Millions

03	17.1
02	17.0
01	17.6
00	9.4
99	6.4

Although restructuring actions were fully offset by the impact of the acquisitions of EXFO Protocol and EXFO Gnubi, our dollar-amount gross research and development expenses remained flat in fiscal 2003 compared to 2002. These two subsidiaries' significant level of research and development activities,

combined with the strength of the Canadian dollar, compared to the US dollar, increased our research and development costs in Canada. The percentage increase in fiscal 2003, compared to 2002, can be explained by the fact that despite challenging market conditions, we continued investing heavily in research and development, especially in the protocol-layer sector. In fact, in 2003, we launched 15 new products, most of which were telecom-related solutions. Furthermore, in that same year, 49% of sales originated from products that have been on the market two years or less.

The slight decrease in gross research and development dollars in fiscal 2002, compared to 2001, is mainly due to the mix and timing of research and development projects and the effect of our restructuring plans implemented in 2002; these factors were partially offset by the impact of the acquisition of EXFO Protocol. In fiscal 2002, we released 25 new products and 48% of sales originated from products that have been on the market two years or less.

Tax credits and grants from Canadian federal and provincial governments for research and development activities were $3.6 million, $4.2 million and $4.0 million for fiscal 2003, 2002 and 2001, respectively. The dollar-amount decrease in tax credits and grants in fiscal 2003, compared to fiscal 2002, is mainly due to three reasons. First, our government grant programs came to an end. Second, the recent acquisition of U.S.-based EXFO Gnubi led to a larger portion of our R&D activities being conducted in the U.S., where such activities are not eligible for tax credits. And, finally, we did not record Canadian federal tax credits for EXFO Protocol in the fourth quarter of 2003 because it is more likely than not that those credits will be recovered in the medium term.

Considering current- and past-year tax losses, as well as current market conditions, we concluded (according to GAAP) that it was more likely than not that some tax credits will not be recovered and that a write-off was required. Accordingly, in the third quarter of fiscal 2003, we wrote off $2.3 million in Canadian federal tax credits related to EXFO Protocol and, as mentioned above, we did not record such credits for this subsidiary in the fourth quarter of 2003. All tax credits written off can be carried forward against future years' income taxes payable over the next ten years. Canadian federal tax credits are only refundable against income taxes payable.

Our tax credits and grants remained relatively flat between fiscal 2002 and 2001 since our gross research and development expenses were relatively unchanged year-over-year and since we were entitled to the same grant programs and tax credits.

Although we intend to reduce our research and development expenses (as a percentage of sales) in the future and despite our recent cost-reduction measures, we expect to continue investing significantly in research and development in the next year, reflecting our focus on innovation, our desire to gain market share and our goal to exceed customer needs and expectations. This investment in R&D will be focused on solutions for the network-service-provider and system-vendor markets as they are the first two links in the global communications supply chain that are expected to recover. More specifically, we intend to expand our protocol-layer product offering to complement our physical-layer product portfolio and selectively reduce our cost of goods while improving performance.

AMORTIZATION OF INTANGIBLE ASSETS

In conjunction with the four strategic acquisitions we completed in the last three fiscal years, we recorded $62.0 million in intangible assets, primarily consisting of core technology. These intangible assets, which are amortized over periods from five months to five years from the respective dates of acquisition, resulted in amortization expenses of $4.7 million, $11.6 million and $9.9 million in fiscal 2003, 2002 and 2001, respectively.

Considering respective impairment charges of $2.9 million and $23.7 million for intangible assets recorded in fiscal 2003 and 2002, the amortization expense decreased by approximately $6.4 million year-over-year. Also, as at August 31, 2002, acquired in-process research and development and workforce related to the acquisitions made in fiscal 2001 and 2002 were fully amortized, reducing current-year amortization expenses as well.

We expect the amortization of intangible assets to be approximately $1.0 million per quarter in fiscal 2004, assuming no acquisitions are made during this time.

WRITE-DOWN OF GOODWILL AND INTANGIBLE ASSETS

In May 2003, we performed our annual impairment test of goodwill for all our reporting units, except for newly acquired EXFO Gnubi. Also, considering the persisting unfavorable market conditions affecting our subsidiaries' industries, we reviewed the carrying value of intangible assets related to these reporting units.

As a result of this assessment, we concluded that the carrying value of goodwill related to EXFO Burleigh and the carrying value of intangible assets related to EXFO Burleigh and EXFO Photonic Solutions were impaired and we recorded an impairment charge of $4.5 million for goodwill and a pre-tax impairment charge of $2.9 million for acquired core technology. Of the total impairment charge, an amount of $6.9 million was related to EXFO Burleigh for goodwill and acquired core technology and $555,000 was related to EXFO Photonic Solutions for acquired core technology.

The write-down of goodwill and acquired core technology of EXFO Burleigh was required, considering that we exited the optical component manufacturing automation business, whose revenue potential represented a long-term prospect. The write-down of acquired core technology from EXFO Photonic Solutions was required because revenue potential related to this long-lived asset was less than expected in the short and medium term due to the current state of the market.

However, no impairment of goodwill and intangible assets was required for EXFO Protocol since we believe that revenue potential from the protocol-layer testing market will remain strong in the short and medium term.

For the purposes of estimating fair values, we used a combination of discounted future cash flows and a market approach (sales multiples). The discounted cash flows were estimated using periods ranging between eight and ten years, discount rates ranging between 15% and 20%, and an annual growth rate ranging between nil and 35%. The sales multiples used in the market approach ranged between 0.7 and 2.3. The assumptions used reflect our best estimates.

Goodwill will be reviewed for impairment in May 2004, or prior to that date if events or circumstances occur that more likely than not reduce the fair value of a reporting unit below its carrying value.

In May 2002, as part of our review of financial results, we performed an assessment of the carrying value of goodwill and intangible assets recorded in conjunction with the acquisitions of EXFO Burleigh, EXFO Photonic Solutions and EXFO Protocol. The assessment was performed because of the severe and continued downturn in the telecommunications industry, the persisting unfavorable market conditions affecting our subsidiaries' industries and the decline in technology

valuations. The growth prospects for our subsidiaries were significantly lower than previously expected and less than those of historical periods. In addition, the decline in market conditions affecting the subsidiaries was significant and other than temporary. As a result, we concluded that the carrying value of goodwill and certain acquired intangible assets was impaired and we recorded a charge of $222.2 million to write down a significant portion of goodwill and a pre-tax charge of $23.7 million to write down a significant portion of acquired core technology. Of the total impairment loss of $245.8 million, an amount of $125.0 million was related to EXFO Burleigh for goodwill and acquired core technology, $71.5 million was related to EXFO Photonic Solutions for goodwill and acquired core technology and $49.3 million was related to EXFO Protocol for goodwill.

The impairment loss was calculated as the excess of the carrying value of the assets over the pre-tax undiscounted future cash flows. The pre-tax undiscounted future cash flows were estimated at the subsidiaries' level, since we had distinct cash flows for each of them and because they were not fully integrated into our activities. The cash flow periods used ranged from three to five years and the annual growth rates ranged between 15% and 30%.

RESTRUCTURING AND OTHER CHARGES

In fiscal 2001, we implemented a structured plan to reduce our costs and increase our efficiency. Under that plan, we recorded charges of $3.3 million, including $0.8 million in severance expenses for the 245 employees who were terminated throughout the company, $1.5 million for unused long-lived assets and $1.0 million for future payments on exited leased facilities located in the United States.

In fiscal 2002, we implemented additional structured plans to further reduce our costs. Under these plans, we recorded charges of $2.9 million, including $2.0 million in severance expenses for the 350 employees who were terminated throughout the company and $900,000 for unused long-lived assets.

In fiscal 2003, we implemented another structured plan to realign our cost structure to current market conditions. Under this new plan, we recorded additional charges of $4.1 million, including $2.8 million in severance expenses for the 172 employees who were terminated throughout the company, $512,000 for unused long-lived assets and $855,000 for future payments on exited leased facilities located around the world. Our estimation of the fair value of such future payments takes into account the estimated sublease rentals over the remaining terms of the exited leases.

All these special charges are included in the restructuring and other charges in the statements of earnings of the reporting years.

Our cost-reduction measures represent our best efforts to respond to the difficult market conditions and we expect that they will enable us to reach positive cash flows from operating activities at the end of fiscal 2004. However, these efforts may be inappropriate or insufficient. Our actions in this regard may not be successful in achieving the cost reductions or other benefits expected, may be insufficient to align our cost structure to market conditions, or may be more costly or extensive than anticipated.

INTEREST INCOME, NET

Our interest income mainly resulted from our short-term investments, less interest and bank charges. Net interest income amounted to $1.2 million, $1.5 million and $6.1 million for fiscal 2003, 2002 and 2001, respectively. Our net interest income remained relatively flat in fiscal 2003, compared to 2002, while it significantly decreased in 2002 compared to 2001. This decrease was due to the decline in interest rates during 2002 as well as our use of short-term

investments to finance strategic acquisitions, operating activities and the purchase of property, plant and equipment.

We expect our net interest income to remain relatively flat in fiscal 2004, compared to 2003, as we anticipate our cash position and interest rates to remain relatively unchanged.

FOREIGN EXCHANGE GAIN (LOSS)

Foreign exchange loss amounted to $1.6 million in fiscal 2003 compared to a foreign exchange loss of $458,000 in 2002 and a foreign exchange gain of $3.3 million in 2001.

The foreign exchange losses in fiscal 2003 and 2002 are the result of the translation of operating activities denominated in currencies other than the Canadian dollar. During fiscal 2003, the Canadian dollar value increased significantly, as compared to the US dollar, resulting in significant foreign exchange losses during the second and third quarters of 2003.

The foreign exchange gain in fiscal 2001 can be mostly attributed to the disposal of short-term investments denominated in US dollars and the translation of operating activities denominated in currencies other than the Canadian dollar.

We manage our exposure to currency risk with forward exchange contracts and operating activities of Canadian entities denominated in currencies other than the Canadian dollar. Please refer to note 18 to our consolidated financial statements included elsewhere in this Annual Report.

INCOME TAXES

Our effective income tax recovery rate was 35.8% (before the future income tax assets valuation allowance and the non-recurring tax recovery) in fiscal 2003, compared to 34.5% in 2002 and compared to our effective income tax rate in fiscal 2001, which was 34.1%.

Compared to fiscal 2002, our effective income tax recovery rate increased in 2003 because a larger portion of our tax losses were incurred in jurisdictions, such as in the U.S., where the recovery rates were higher.

In the third quarter of 2003, we reviewed the carrying value of our future income tax assets. Considering existing market conditions, as well as the fact that we recorded losses for the current and past years, and that we exited the optical component manufacturing automation business, we concluded that it was more likely than not that all our future income tax assets will not be recoverable and that a valuation allowance was required. Even though the carrying periods of our future income tax assets are very long or indefinite, we recorded a valuation allowance of $28.4 million to write off all our future income tax assets, mainly related to the parent company, EXFO Protocol and EXFO Burleigh. Future income tax assets written off consisted mainly in deferred tax losses, research and development expenses, share issue expenses as well as non-deductible provisions and accruals.

From the $28.4 million valuation allowance, most of which is related to our domestic and U.S. companies, an amount of $13.8 million is related to deferred tax losses that can be carried forward against taxable income in several jurisdictions and $13.4 million is related to research and development expenses

as well as provisions and accruals that can be carried forward indefinitely against future years' taxable income. Note 15 to our consolidated financial statements outlines significant components of future income tax assets and liabilities and the valuation allowance.

The valuation allowance recognized in fiscal 2003 will be reversed once management concludes that realization of these assets is more likely than not. Consequently, our future period tax rates will be distorted compared to previous periods.

AMORTIZATION OF GOODWILL

In conjunction with the four strategic acquisitions that we completed over the last three fiscal years, we recorded $312.0 million in goodwill. The goodwill related to the acquisitions of EXFO Burleigh and EXFO Photonic Solutions was amortized over five years until August 31, 2002. This resulted in amortization expenses of $38.0 million and $31.1 million in fiscal 2002 and 2001, respectively. The acquisitions of EXFO Protocol and EXFO Gnubi have been accounted for using new accounting standards contained in CICA handbook sections 1581 and 3062 and, consequently, goodwill resulting from these acquisitions was not amortized.

Since September 1, 2002, goodwill related to the acquisitions of EXFO Burleigh and EXFO Photonic Solutions is no longer amortized under new accounting standards. Consequently, we no longer have amortization expenses for goodwill.

NET LOSS AND PRO FORMA NET EARNINGS (LOSS)

Net loss amounted to $55.0 million, $308.5 million and $15.3 million in fiscal 2003, 2002 and 2001, respectively. In terms of per share amounts, we recorded a net loss of $0.87, $5.09 and $0.29 in fiscal 2003, 2002 and 2001, respectively.

Also, as a measure to assess financial performance, we use pro forma net earnings (loss) and pro forma net earnings (loss) per share. Pro forma net earnings (loss) represent net earnings (loss) excluding amortization and write-down of goodwill, non-recurring tax recovery, future income tax assets valuation allowance and the after-tax effect of amortization and write-down of intangible assets, restructuring and other charges, inventory and tax credit write-offs and non-recurring grants recovery.

Pro forma net loss amounted to $11.5 million and $11.2 million in fiscal 2003 and 2002 compared to pro forma net earnings of $24.5 million in 2001. In terms of pro forma per share amounts, we recorded a net loss of $0.18 and $0.19 in fiscal 2003 and 2002 compared to net earnings of $0.46 in 2001.

Pro forma net earnings (loss) are reconciled as follows:

YEARS ENDED AUGUST 31,	2003	2002	2001
	(unaudited)	(unaudited)	(unaudited)
Net loss in accordance with GAAP	$ (54,950)	$ (308,524)	$ (15,294)
Pro forma adjustments:			
Amortization of goodwill	--	38,021	31,076
Amortization of intangible assets	4,747	11,615	9,876
Write-down of goodwill	4,505	222,169	--
Write-down of intangible assets	2,922	3,657	--
Tax effect on amortization and write-down of intangible assets	(2,745)	(12,167)	(3,363)
Restructuring and other charges			

and inventory and tax credit write-offs	10,549	21,343	3,288
Tax effect on restructuring and other charges and inventory and tax credit write-offs	(3,777)	(7,362)	(1,083)
Non-recurring tax and grants recovery	(1,357)	--	--
Tax effect on non-recurring grants recovery	245	--	--
Future income tax assets valuation allowance	28,385	--	--
Pro forma net earnings (loss)	$ (11,476)	$ (11,248)	$ 24,500
Basic and diluted net loss per share	$ (0.87)	$ (5.09)	$ (0.29)
Basic and diluted pro forma net earning (loss) per share	$ (0.18)	$ (0.19)	$ 0.46

The financial information we provide is pro forma, thus helping the investor better understand our normalized operating results as non-recurring and special items are excluded. This information is not in accordance with, or an alternative for, generally accepted accounting principles and may not be comparable to similarly titled measures reported by other companies.

LIQUIDITY AND CAPITAL RESOURCES

Over the past years, we have financed our operations and major investments and met our capital expenditure requirements mainly through cash flows from operating activities, the use of cash and short-term investments and the issuance of subordinate voting shares. For the upcoming year, we will finance our operations and capital expenditure requirements mainly through cash flows from operating activities and cash and short-term investments.

As mentioned earlier, maintaining a sound financial position is one of the four main objectives of our strategic plan. We believe that such an objective is in line with a strong cash position. As at August 31, 2003, our cash and short-term investments amounted to $57.4 million and we had almost no debt. Our working capital was at $76.7 million. Our cash and short-term investments increased by $7.7 million in fiscal 2003, compared to 2002, mainly due to an unrealized foreign exchange gain on cash and short-term investments of $6.8 million and cash flows from operating activities of $5.6 million, less cash payments of $1.9 million and $2.7 million for the acquisition of EXFO Gnubi and the purchase of property, plant and equipment. The unrealized foreign exchange gain resulted from the translation of our cash and short-term investments in US dollars, which is our reporting currency, and was recorded in the cumulative translation adjustment in the balance sheet.

We believe that our cash balances and short-term investments, combined with an available line of credit of $6.2 million, will be sufficient to meet our expected liquidity and capital requirements for at least the next 18 months. Our line of credit bears interest at prime rate. However, possible additional operating losses and/or possible investments in or acquisitions of complementary businesses, products or technologies may require additional financing prior to such time. There can be no assurance that additional debt or equity financing

will be available when required or, if available, it can be secured on satisfactory terms.

The following table summarizes our commitments as at August 31, 2003:

YEARS ENDING AUGUST 31,	2004	2005	2006	2007	2008 and
Long-term debt	$ 110,000	$ 122,000	$ 135,000	$ 146,000	$ 5
Operating leases	1,078,000	908,000	898,000	764,000	1,66
Contingent cash consideration in business combination*	200,000	--	--	--	
Total commitments	$1,388,000	$1,030,000	$1,033,000	$ 910,000	$1,71

* estimated amount

OPERATING ACTIVITIES

Cash flows provided by operating activities amounted to $5.6 million in fiscal 2003, compared to cash flows used of $8.7 million in 2002 and cash flows provided of $3.9 million in 2001.

Cash flows provided by operating activities in fiscal 2003 were mainly the result of a decrease in some of our working capital items; that is, our accounts receivable decreased by $4.0 million, our income taxes and tax credits recoverable decreased by $13.9 million and our inventories decreased by $7.9 million (excluding write-offs). These positive effects on cash were offset in part by the net loss after items not affecting cash of $19.7 million. The decrease in our accounts receivable is directly related to the reduction in our sales. The decrease in our income taxes and tax credits recoverable is related to the recovery, during the year, of income taxes and research and development tax credits recoverable from previous periods. Finally, the decrease in our inventories is due to our efforts to maintain them at the lowest acceptable level considering the decrease in sales.

Cash flows used by operating activities in fiscal 2002 were primarily due to the net loss after items not affecting cash of $1.1 million, combined with the increase of income taxes and tax credits receivable of $19.7 million and the decrease in accounts payable and accrued liabilities of $7.5 million. These figures were partially offset by the result of the net decrease in accounts receivable and inventories of $19.7 million. The increase in our income taxes and tax credits receivable is related to income tax recoverable following the carry-back to previous years' taxable income of our consolidated tax loss, while the decrease in our accounts payable and accrued liabilities is due to the reduction in our purchases following the slowdown in our industry. The decrease in our accounts receivable is due to the reduction in our sales level and to the improvement in our days of sales outstanding ("DSOs"), while the decrease in our inventories is due to our efforts to maintain them at the lowest acceptable level considering the decrease in sales.

FINANCING ACTIVITIES

Cash flows used by financing activities amounted to $56,000, $90,000 and $4.6 million in fiscal 2003, 2002 and 2001, respectively. Cash flows used by financing activities over the last two years were mainly due to the repayment of our long-term debt. As at August 31, 2003, our long-term debt amounted to

$563,000.

INVESTING ACTIVITIES

Cash flows used by investing activities totaled $9.9 million in fiscal 2003 compared to cash flows provided of $10.5 million and $8.4 million in 2002 and 2001.

In fiscal 2003, we acquired $5.4 million in short-term investments with proceeds from the recovery of income taxes and tax credits.We also made cash payments of $1.9 million and $2.6 million for the acquisition of EXFO Gnubi and the purchases of property, plant and equipment.

In fiscal 2002, we disposed of $25.5 million in short-term investments to finance operating activities of $8.7 million as well as the respective cash payments of $9.8 million and $5.2 million for the acquisition of EXFO Protocol and the purchase of property, plant and equipment.

CONTINGENCY

As discussed in note 12 to our consolidated financial statements included elsewhere in this Annual Report, in November 2001, the company was named as a defendant in a U.S. securities class action related to its initial public offering (IPO) in June 2000. The complaints allege that the prospectus and the registration statement for the IPO failed to disclose that the underwriters allegedly received excessive commissions and that the underwriters and some investors collaborated in order to inflate the price of EXFO's stock in the aftermarket.

On June 26, 2003, the Plaintiff's Executive Committee announced that a proposed settlement between the issuers and their directors and officers and the plaintiffs had been structured. A Memorandum of Understanding ("MOU") to settle the plaintiffs' claims against the issuers and their directors and officers has now been approved as to form and the process of obtaining approval by all parties to the MOU is now underway. The parties will be required to prepare many complex documents necessary to consummate the settlement, which will be submitted to the Court for preliminary approval. Final approval will be required by the Court following notice to class members and a fairness hearing. If this tentative settlement is successfully finalized, the company and the individual defendants will be released from the litigation. Any direct financial impact of the proposed settlement is expected to be borne by our insurance carriers.

Since the settlement process is subject to a fairness hearing and final court approval, it is possible that it could fail. Therefore, it is not possible to predict the final outcome of the case, nor determine the amount of any possible losses. If the settlement process fails, the company will continue to defend its position in this litigation that the claims against EXFO, and its officers, are without merit. Accordingly, no provision for this case has been made in the consolidated financial statements as of August 31, 2003.

STOCK OPTION PLAN

The aggregate number of subordinate voting shares covered by options granted under the stock option plan was 3,176,613 as at August 31, 2003. The weighted average exercise price of those stock options was $15, compared to the market price of $2.64 per share as at August 31, 2003. A total of 1,068,095 options were exercisable as at August 31, 2003, with a weighted average exercise price

of $22. The maximum number of subordinate voting shares issuable under the plan cannot exceed 4,470,961 shares. The following table summarizes information about stock options granted to the members of the Board of Directors and to Management and Corporate Officers of the company and its subsidiaries as at August 31, 2003:

	NUMBER	% OF ISSUED AND OUTSTANDING	WEIGHTED AVERAGE EXERCISE PRICE
Chairman of the Board, President and CEO (one individual)	150,482	4.74%	$ 9.91
Board of Directors (four individuals)	131,875	4.15%	$ 7.41
Management and Corporate Officers (nine individuals)	350,775	11.04%	$ 13.90
	633,132	19.93%	$ 11.60

As permitted by section 3870 of the CICA handbook, we choose not to account for stock-based compensation costs arising from awards to employees, but we complied with the required pro forma disclosures with respect to net loss and net loss per share in our consolidated financial statements. Please refer to note 13 to our consolidated financial statements included elsewhere in this Annual Report for further disclosure about our stock-based compensation plans.

RISKS AND UNCERTAINTIES

Over the past few years, we have managed our business activities, focused on research and development of new and innovative products, prospered in international markets and closed strategic acquisitions. However, we operate in a highly competitive field 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 policies.

The main risks and uncertainties related to the communications test and measurement industry involve the rapid development of new products that have short life cycles and require extensive research and development; the difficulty of predicting market size and trends; the difficulty retaining highly skilled employees; and the ability to quickly adapt our cost structure to changing market conditions in order to achieve profitability.

In addition, given our strategic goals for growth and competitive positioning in our industry, we are expanding into international markets. This exposes us to certain risks and uncertainties related to changes in local laws and regulations, multiple technological standards, protective legislation and pricing pressure.

Furthermore, while the strategic acquisitions we have completed 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 as well as their products, technologies and personnel.

We are also exposed to currency risks through the export of our products manufactured in Canada, substantially all of which are denominated in US dollars. These risks are partially hedged by operating expenses denominated in US dollars, the purchase of raw materials in US dollars and forward exchange contracts.

The economic slowdown in our industry could also result in some of our customers experiencing difficulties and, consequently, this 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. 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 of these instruments to be remote.

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.

QUARTERLY SUMMARY FINANCIAL INFORMATION (UNAUDITED)
(in thousands of US dollars, except per share data)

	1ST QUARTER	2ND QUARTER	3RD QUARTER	4TH QUARTER	YE A
2003					
Sales	$ 17,748	$ 14,753	$ 15,103	$ 14,326	$
Cost of sales (1)	$ 8,031	$ 7,939	$ 10,460	$ 9,767	$
Gross margin	$ 9,717	$ 6,814	$ 4,643	$ 4,559	$
Loss from operations	$ (3,562)	$ (6,085)	$ (14,419)	$ (11,013)	$
Net loss	$ (2,158)	$ (4,246)	$ (38,427)	$ (10,119)	$
Pro forma net loss (2)	$ (1,354)	$ (3,426)	$ (4,067)	$ (2,663)	$
Basic and diluted net loss per share (2)	$ (0.03)	$ (0.07)	$ (0.61)	$ (0.16)	$
Basic and diluted pro forma net loss per share (2)	$ (0.02)	$ (0.05)	$ (0.06)	$ (0.04)	$
2002					
Sales	$ 20,138	$ 14,601	$ 16,348	$ 17,243	$
Cost of sales (1)	$ 13,008	$ 13,172	$ 17,429	$ 8,757	$
Gross margin (loss)	$ 7,130	$ 1,429	$ (1,081)	$ 8,486	$
Loss from operations	$ (10,893)	$ (16,612)	$ (43,396)	$ (3,882)	$
Net loss	$ (19,055)	$ (22,675)	$ (263,826)	$ (2,968)	$
Pro forma net loss (2)	$ (1,937)	$ (4,099)	$ (3,930)	$ (1,183)	$
Basic and diluted net loss per share (2)	$ (0.33)	$ (0.37)	$ (4.29)	$ (0.05)	$
Basic and diluted pro forma net loss per share (2)	$ (0.03)	$ (0.07)	$ (0.06)	$ (0.02)	$
2001					
Sales	$ 28,519	$ 36,293	$ 45,781	$ 35,420	$
Cost of sales (1)	$ 10,525	$ 13,004	$ 17,743	$ 14,935	$
Gross margin	$ 17,994	$ 23,289	$ 28,038	$ 20,485	$
Earnings (loss) from					

operations	$ 6,791	$ 6,912	$ 4,335	$ (3,531)	$
Net earnings (loss)	$ 7,505	$ 24	$ (8,630)	$ (14,193)	$
Pro forma net earnings (2)	$ 7,638	$ 7,511	$ 6,204	$ 3,219	$
Basic and diluted net earnings (loss) per share (2)	$ 0.16	$ --	$ (0.15)	$ (0.25)	$
Basic and diluted pro forma net earnings per share (2)	$ 0.16	$ 0.14	$ 0.11	$ 0.06	$

(1) A new presentation was adopted in 2003 with certain expenses reclassified from selling and administrative expenses to cost of sales.

(2) Pro forma net earnings (loss) and per share data are calculated independently for each of the quarters presented. Therefore, the sum of this quarterly information may not equal the corresponding annual information. Pro forma net earnings (loss) represent net earnings (loss) excluding amortization and write-down of goodwill, non-recurring tax recovery, future income tax assets valuation allowance and the after-tax effect of amortization and write-down