

National Optics Institute

Consolidated Financial Statements
March 31, 2011

May 25, 2011

Independent Auditor's Report

**To the Members
of National Optics Institute**

We have audited the accompanying consolidated financial statements of National Optics Institute, which comprise the consolidated balance sheet as at March 31, 2011 and the consolidated statements of operations, changes in net assets and cash flows for the year then ended, and the related notes, which comprise a summary of significant accounting policies.

Management's responsibility for the consolidated financial statements

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

Auditor's responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of National Optics Institute as at March 31, 2011 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP¹

¹ Chartered accountant auditor permit No. 19478

National Optics Institute

Consolidated Balance Sheet

As at March 31, 2011

| | 2011 \$ | 2010 \$ |
|--|-------------------|-------------------|
| Asset | | |
| Current assets | | |
| Cash | 42,282 | 35,079 |
| Accounts receivable | 3,704,025 | 3,856,642 |
| Financial support receivable related to Internal Research Program (note 3a) | 1,200,000 | 746,470 |
| Capital assets – current portion (note 3b, i) | 3,018,255 | 9,050,985 |
| Inventories (note 4) | 1,449,606 | 791,098 |
| Research contracts in progress | 613,050 | 1,390,042 |
| Prepaid expenses | 871,509 | 697,229 |
| | <u>10,898,727</u> | <u>16,567,545</u> |
| Security investments (note 5) | 823,800 | 7,886,411 |
| Investments in private companies | 696,103 | 1,006,103 |
| Employee future benefits (note 10) | 842,800 | - |
| Financial support receivable related to capital assets (note 3b, i) | 3,454,377 | 4,266,677 |
| Capital assets (notes 6 and 8) | <u>31,764,946</u> | <u>32,890,490</u> |
| | <u>48,480,753</u> | <u>62,617,226</u> |
| Liabilities | | |
| Current liabilities | | |
| Excess of outstanding cheques over bank balances | 620,242 | 255,707 |
| Bank loans (note 7) | 2,705,974 | 1,617,813 |
| Accounts payable and accrued liabilities | 5,429,480 | 6,151,722 |
| Deferred financial support related to the Internal Research Program – current portion (note 3a) | 814,942 | 7,766,925 |
| Deferred revenues and advances on contracts | 2,080,314 | 1,120,221 |
| Current portion of long-term debt (note 8) | <u>3,130,436</u> | <u>9,461,847</u> |
| | 14,781,388 | 26,374,235 |
| Long-term debt (note 8) | 2,473,818 | 3,136,490 |
| Employee future benefits (note 10) | - | 835,953 |
| Deferred financial support related to Capital assets (note 3b, ii) | 23,089,544 | 24,151,598 |
| Business and Regional Growth/Innovation program (note 3c) | <u>361,712</u> | <u>441,501</u> |
| | <u>40,706,462</u> | <u>54,939,777</u> |
| Net assets | | |
| Unrestricted | 7,774,291 | 7,554,271 |
| Accumulated unrealized gains on available-for-sale investments | - | 123,178 |
| | <u>7,774,291</u> | <u>7,677,449</u> |
| | <u>48,480,753</u> | <u>62,617,226</u> |
| Commitments (note 12) | | |
| Subsequent event (note 14) | | |

Approved by the Board of Directors



Director

(3)


Director

National Optics Institute
Consolidated Statement of Changes in Net Assets
For the year ended March 31, 2011

| Unrestricted | 2011 | 2010 |
|---|-------------------------|-------------------------|
| | \$ | \$ |
| Balance – Beginning of year | 7,554,271 | 7,200,549 |
| Excess of revenues over expenses for the year | <u>220,020</u> | <u>353,722</u> |
| Balance – End of year | <u><u>7,774,291</u></u> | <u><u>7,554,271</u></u> |

| Accumulated unrealized gains on available-for-sale investments | 2011 | 2010 |
|---|------------------|-----------------------|
| | \$ | \$ |
| Balance – Beginning of year | 123,178 | 53,900 |
| Changes in gains on investments made during the year | - | 69,278 |
| Reclassification of realized gains for the year to operations | <u>(123,178)</u> | <u>-</u> |
| Balance – End of year | <u><u>-</u></u> | <u><u>123,178</u></u> |

National Optics Institute
Consolidated Statement of Operations
For the year ended March 31, 2011

| | 2011 | 2010 |
|---|-------------|-------------|
| | \$ | \$ |
| Revenues | | |
| Financial support related to | | |
| Internal Research Program (note 3a) | 19,952,000 | 18,000,000 |
| Capital assets (note 3b, ii) | 3,230,918 | 3,159,852 |
| Financing costs (note 3b, iii) | 445,681 | 509,777 |
| Business and Regional Growth/Innovation program (note 3c) | 79,789 | 152,179 |
| Sales and contracts | 11,373,080 | 12,832,690 |
| Royalties | 560,365 | 303,935 |
| Technology transfer agreements and other agreements | 154,352 | 1,571,450 |
| Rent and other revenues | 301,069 | 740,462 |
| Members' contributions | 56,100 | 64,100 |
| | <hr/> | <hr/> |
| | 36,153,354 | 37,334,445 |
| Expenses | | |
| Salaries and fringe benefits | 18,345,928 | 18,629,310 |
| Cost of goods and services pertaining to project completion | 5,198,946 | 6,353,581 |
| Other operating expenses | 7,243,908 | 7,320,372 |
| Gain on forward exchange contracts and security investments | (89,761) | (49,349) |
| Foreign exchange loss | 31,045 | 65,733 |
| Other-than-temporary decline in value on investments in private companies | 338,000 | - |
| Interest on long-term debt | 508,857 | 594,554 |
| Interest and bank charges | 46,585 | 31,755 |
| Depreciation of capital assets | 4,309,826 | 4,034,767 |
| | <hr/> | <hr/> |
| | 35,933,334 | 36,980,723 |
| Excess of revenues over expenses for the year | <hr/> | <hr/> |
| | 220,020 | 353,722 |

National Optics Institute
Consolidated Statement of Cash Flows
For the year ended March 31, 2011

| | 2011 \$ | 2010 \$ |
|--|--------------------|--------------------|
| Cash flows from operating activities | | |
| Excess of revenues over expenses for the year | 220,020 | 353,722 |
| Items not affecting cash | | |
| Depreciation of capital assets | 4,309,826 | 4,034,767 |
| Financial support related to the Internal Research Program (note 3a) | (7,000,000) | (5,000,000) |
| Financial support related to capital assets (note 3b and c) | (3,310,707) | (3,207,262) |
| Capitalized interest on financial support repayable | 34,014 | 31,800 |
| Unrealized gain on foreign exchange contracts | (10,508) | (31,534) |
| Other-than-temporary decline in value on investments in private companies | 338,000 | - |
| Loss (gain) on disposal of security investments | (67,937) | 23,919 |
| Gain on disposal of investments in private companies | (100,000) | (560,280) |
| Sales and contracts in consideration of an investment in a private company | (28,000) | (8,903) |
| | <u>(5,615,292)</u> | <u>(4,363,771)</u> |
| Net change in non-cash working capital items (note 9a) | <u>(1,810,945)</u> | <u>1,864,968</u> |
| | <u>(7,426,237)</u> | <u>(2,498,803)</u> |
| Cash flows from financing activities | | |
| Variation in bank loans | 1,088,161 | (2,477,825) |
| Investment income recognized as deferred financial support, net of interest receivable | 130,759 | 405,674 |
| Long-term debt contracted | 2,421,000 | 2,609,130 |
| Repayment of long-term debt (note 9b) | (398,112) | (342,062) |
| | <u>3,241,808</u> | <u>194,917</u> |
| Cash flows from investing activities | | |
| Acquisition of security investments | (3,255,511) | (7,510,236) |
| Disposal of security investments | 10,260,417 | 12,801,291 |
| Acquisition of capital assets (note 9b) | (3,277,809) | (4,417,245) |
| Proceeds on disposal of investments in private companies | 100,000 | 560,280 |
| | <u>3,827,097</u> | <u>1,434,090</u> |
| Decrease in cash | <u>(357,332)</u> | <u>(869,796)</u> |
| Cash (excess of outstanding cheques over bank balances) – Beginning of year | <u>(220,628)</u> | <u>649,168</u> |
| Excess of outstanding cheques over bank balances – End of year * | <u>(577,960)</u> | <u>(220,628)</u> |
| Supplementary Information (note 9) | | |
| * Excess of outstanding cheques over bank balances at the end of year includes the following amounts disclosed in the balance sheet: | | |
| Cash | 42,282 | 35,079 |
| Excess of outstanding cheques over bank balances | (620,242) | (255,707) |
| | <u>(577,960)</u> | <u>(220,628)</u> |

National Optics Institute

Notes to Consolidated Financial Statements

March 31, 2011

1 Statutes and nature of activities

The National Optics Institute (INO) was incorporated on December 13, 1985 under Part II of the Canada Corporations Act. Its mandate is to provide the Canadian optics industry with research and development support and the technical assistance necessary to sustain its growth and to play a leading role in the development and application of optics in Canada.

2 Summary of significant accounting policies

Presentation and consolidation

The consolidated financial statements have been prepared in conformity with Canadian generally accepted accounting principles and include the accounts of INO and its wholly-owned subsidiary, INO Photonics Corporation.

Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts of assets and liabilities reported in the financial statements. Those estimates and assumptions also affect the disclosure of contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the year. Management deems that these estimates are adequate; however actual results could differ from those estimates.

Inventories

Inventories are valued at the lower of cost or market value. Cost is determined using the first in, first out method for raw materials. The cost of goods in process and finished goods includes raw materials, and a fair share of labour as well as fixed and variable general manufacturing expenses. The market value of goods in process and finished goods corresponds to the net realizable value. Net realizable value corresponds to the estimated selling price of inventories less estimated costs for completion and estimated costs required to realize the sale. Raw materials held for inventory production purposes are not depreciated below cost if the finished goods in which they will be integrated are expected to be sold at cost or beyond cost. Otherwise, market value corresponds to the replacement cost.

National Optics Institute
 Notes to Consolidated Financial Statements
 March 31, 2011

Capital assets

Capital assets are recorded at cost. They are depreciated using the straight-line method over the following periods:

| | Periods |
|---|-------------------|
| Buildings | 20 and 40 years |
| Lease improvements | 5 years |
| Research equipment | 3, 5 and 10 years |
| Production equipment | 10 years |
| Office and laboratory furniture and equipment | 5 and 8 years |
| Vehicles | 5 years |

Financial instruments

As allowed under the CICA Handbook, INO has elected to apply CICA Handbook Section 3861, "Financial Instruments – Disclosure and Presentation" instead of CICA Handbook Section 3862, "Financial Instruments – Disclosures" and 3863, "Financial Instruments – Presentation".

Financial assets and liabilities are initially recorded at fair value and their subsequent measurement depends on their classification as described below. Their classification depends on the purpose of the financial instruments when they are purchased or issued, their characteristics and how INO designates them:

| | |
|---|-----------------------|
| Cash and excess of outstanding cheques over bank balances | Held for trading |
| Accounts receivable and financial support receivable | Loans and receivables |
| Security investments | Available for sale |
| Investments in private companies | Available for sale |
| Bank loans, accounts payable and accrued liabilities and long-term debt | Other liabilities |

Held for trading

These financial assets are initially recorded at fair value. Subsequently, these assets continue to be recorded at fair value in the balance sheet. Variation of fair value is recognized in the statement of operations for the year.

Available for sale

- Not listed on a market

These financial assets, which include investments in private companies, are recorded at cost. Realized gains and losses as well as interest calculated using the effective interest rate are recognized in revenues under "Technology transfer agreements and other agreements".

National Optics Institute

Notes to Consolidated Financial Statements

March 31, 2011

- Listed on a market

These financial assets, which include security investments, are recorded at fair value. Unrealized gains and losses are included in net assets as "Accumulated unrealized gains or losses on available-for-sale investments" until they are realized, at which time the accumulated gains or losses are transferred to "Deferred financial support related to the Internal Research Program" or recorded in the statement of operations. Interest income from term deposits is also recorded under "Deferred financial support related to the Internal Research Program".

These financial assets are subject to an impairment test, and if there is an indication of impairment and the decline is deemed other than temporary, a loss is recorded in the statement of operations for the year. Once an impairment loss is charged to operations, it cannot be reversed. When reviewing securities, INO takes into account a number of facts specific to each investment, in addition to a set of factors that could indicate an other-than-temporary decline in fair value, such as a significant or extended decline in fair value, major financial difficulties for the issuer, increasing risk of bankruptcy or restructuring by the issuer and more specifically for investments in private companies. INO also accounts for any difficulties the issuer may encounter with marketing the technologies transferred.

Loans and receivables

Loans and receivables are recognized at amortized cost using the effective interest method.

Other liabilities

Other liabilities are recognized at amortized cost using the effective interest method and include all financial liabilities other than derivative instruments.

Transaction costs

Transaction costs related to financial assets available for sale, loans and receivables and other liabilities are recorded as a reduction of the carrying amount of the asset or liability, and are then recognized over the expected life of the instrument using the effective interest method.

Derivative financial instruments

Derivative financial instruments that are held for trading or speculation or that do not meet hedge accounting conditions are recorded on the balance sheet and measured at fair value. Changes in fair value are recorded in the statement of operations for the year. INO's derivative financial instruments are mainly forward exchange contracts.

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Notes to Consolidated Financial Statements

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Intellectual property

INO incurs costs to obtain and maintain patents for the technology it develops. Due to the uncertainty surrounding the marketing of the patented technology, these costs are expensed when incurred.

Revenue recognition

(a) Financial support

INO follows the deferral method of accounting for financial support related to the Internal Research Program or related to capital assets and others. Financial support related to the Internal Research Program is accounted for as "Deferred financial support" and in the statement of operations upon recognition of the expenses. Financial support related to the program to purchase research equipment is accounted for as "Deferred financial support" and is amortized and transferred to revenues on the same basis as the depreciation of the corresponding capital assets.

(b) Prototype and product sales

INO recognizes prototype and product sales when persuasive evidence of an arrangement exists, delivery has occurred, the price to the buyer is fixed or determinable and collection is reasonably assured.

(c) Research contracts

Research contracts revenue is recognized based on the percentage-of-completion method. Accordingly, revenue is recognized pro rata based on the degree of completion of the work. INO uses the efforts expended method whereby the degree of completion is calculated on the basis of costs incurred as of the balance sheet date compared with the total estimated costs. The value of work in progress is determined by taking into account the billable costs incurred and the payments received. Losses are accounted for as soon as they can be determined.

(d) Royalties and technology transfer agreements

Agreements to grant licences to companies generally provide for the payment of royalties on future sales of products developed on the basis of licensed technologies and INO's completion of additional scientific research for some of these companies. The revenues generated are recognized in the statement of operations in the year in which they are earned.

(e) Rental revenues

Rental revenues from leases with provisions for increases are accounted for using the straight-line method over the term of the lease. The difference between the recognized revenues and the amounts receivable under the leases is presented in the balance sheet as "Rent assets or liabilities". As such, no amounts have been accounted for as at March 31, 2011 and 2010.

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Notes to Consolidated Financial Statements

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Foreign currencies

Foreign currency transactions

Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at the exchange rate in effect at year-end. Revenues and expenses are translated into Canadian dollars at the exchange rate in effect on the dates they occur. Translation gains or losses are charged to operations.

Foreign subsidiary

The financial statements of the integrated foreign subsidiary are revalued in Canadian dollars according to the temporal method. Accordingly, the monetary assets and liabilities are revalued at the exchange rate in effect at the balance sheet date whereas the non-monetary assets and liabilities are revalued at historical exchange rates. Revenues and expenses are revalued at the average annual exchange rate. Translation gains and losses resulting from this revaluation are charged to operations.

Employee benefit plans

INO accounts for its obligations under employee benefit plans, net of plan assets. Consequently, INO has adopted the following policies:

- The cost of pension benefits earned by employees is actuarially determined using the projected benefit method prorated on years of service and management's best estimate of expected plan investment performance, salary escalation and retirement ages of employees.
- For the purpose of calculating the expected return on plan assets, those assets are valued at fair value.
- The excess of the net actuarial gain (net actuarial loss) over 10% of the accrued benefit obligation or over 10% of the fair value of plan assets, if the latter is greater, is amortized over the average remaining service period of active employees. The average remaining service period of the active employees covered by the pension plan is 19 years in 2011.

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Notes to Consolidated Financial Statements
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3 Financial support

(a) Financial support – Internal Research Program

The financial support that INO receives for the Internal Research Program is as follows:

| | Total support (2006 to 2011) \$ | Support balance available as at March 31, 2011 \$ | Revenues | |
|--|---|---|------------|------------|
| | | | 2011 \$ | 2010 \$ |
| Government of Canada | | | | |
| Industry Canada | 15,000,000 | - | 7,000,000 | 5,000,000 |
| Canada Economic Development | 30,000,000 | - | 6,000,000 | 6,000,000 |
| | 45,000,000 | - | 13,000,000 | 11,000,000 |
| Government of Québec | 34,952,000 | - | 6,952,000 | 7,000,000 |
| Financial support – Internal Research Program | 79,952,000 | - | 19,952,000 | 18,000,000 |

Government of Canada

The Government of Canada, through Canada Economic Development's Regional Strategic Initiatives program, granted maximum financial support of \$18,000,000, which ended on March 31, 2009. In July 2009, a new contribution of \$12,000,000 was granted through Canada Economic Development's Business and Regional Growth program for the two-year period ending on March 31, 2011. As at March 31, 2011, an amount of \$1,200,000 was still receivable on the last \$6,000,000 tranche.

In addition, a financial support agreement was entered into on February 19, 2008 with the Government of Canada (Industry Canada) that grants INO additional financial support of \$15,000,000, paid in full in April 2008. As at March 31, 2011, INO has committed the funds received in eligible expenses as defined in the agreement. Revenues from investments generated by these grants will be used for eligible expenses during the next year (note 5).

National Optics Institute
Notes to Consolidated Financial Statements
March 31, 2011

Deferred financial support related to the Internal Research Program:

| | 2011 \$ | 2010 \$ |
|--|---------------------|--------------------|
| Financial support received in April 2008 | 15,000,000 | 15,000,000 |
| Revenues from investments | 814,942 | 766,925 |
| Amount reported during fiscal years 2008 to 2011 | <u>(15,000,000)</u> | <u>(8,000,000)</u> |
| | 814,942 | 7,766,925 |
| Less: Current portion | <u>814,942</u> | <u>7,766,925</u> |
| | <u>-</u> | <u>-</u> |

The deferred financial support related to the Internal Research Program, which totals \$814,942 as at March 31, 2011 (\$7,766,925 as at March 31, 2010), is invested in securities (note 5).

Government of Québec

The Government of Québec granted financial support of \$34,952,000 over five years, ending on March 31, 2011. The annual financial support was received in full as at March 31, 2011.

(b) Research Equipment Purchase Program – Government of Québec

During 2006-2007, the Government of Québec granted financial support of \$12,800,000 over five years. This financial support was granted at a rate of 90% of costs claimed in the first year and decreased by 5% per year, to reach 70% of the costs claimed in 2010-2011.

(i) Financial support receivable related to capital assets

The financial support receivable pertains to the following items:

| | 2011 \$ | 2010 \$ |
|--|------------------|------------------|
| Term loan of an original amount of \$8,000,000 * | - | 6,334,025 |
| Research equipment purchase program | | |
| Term loan of an original amount of \$2,774,732 * | - | 943,085 |
| Term loan of an original amount of \$2,754,500 * | 949,325 | 1,867,118 |
| Term loan of an original amount of \$2,609,130 * | 1,334,371 | 2,190,453 |
| Term loan of an original amount of \$2,421,000 * | 2,421,000 | - |
| Purchase of research equipment ** | 1,760,247 | 1,976,297 |
| Related temporary financing costs | <u>7,689</u> | <u>6,684</u> |
| | 6,472,632 | 13,317,662 |
| Less: Current portion | <u>3,018,255</u> | <u>9,050,985</u> |
| | <u>3,454,377</u> | <u>4,266,677</u> |

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- * These loans were contracted for capital assets and payments on these loans are made directly by the Government of Québec to the lending financial institution. As a result, financial support receivable is recorded for an amount equal to the capital of the corresponding debt.
- ** As provided in the financial support agreement, research equipment purchased under this program will be financed through a long-term debt repayable in equal semi-annual instalments over a period not exceeding five years. These payments will be made directly by the Government of Québec. As at March 31, 2011, INO has an authorized term loan of a maximum amount of \$2,240,000 for the purpose of financing this equipment.

(ii) Deferred financial support related to capital assets

| | 2011 \$ | 2010 \$ |
|--|--------------------|--------------------|
| Balance – Beginning of year | 24,151,598 | 24,593,099 |
| Financial support during the year to acquire capital assets | 2,168,864 | 2,718,351 |
| Transfer of revenues for the year to offset the corresponding depreciation | <u>(3,230,918)</u> | <u>(3,159,852)</u> |
| Balance – End of year | <u>23,089,544</u> | <u>24,151,598</u> |

(iii) Support related to financing costs

INO receives financial support for the interest charges related to certain long-term debts mentioned in note 9. The financial support received for this purpose amounts to \$445,681 (\$509,777 in 2010) and was included in revenues.

(c) Business and Regional Growth/Innovation program

In 2009, INO obtained financial support through the Business and Regional Growth/Innovation program of Canada Economic Development for the purpose of improving its ability to market the technology and technological know-how produced by its Internal Research Program.

Financial support amounting to \$779,551 has been fully received as repayment for 50% of costs incurred for an amount of \$1,559,101, of which \$992,858 have been used to acquire capital assets.

An amount of \$79,789 (\$47,410 in 2010) has been charged to operations for the year as an offset to the depreciation of the corresponding capital assets.

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The deferred financial support related to capital assets is broken down as follows:

| | 2011 | 2010 |
|--|----------------|----------------|
| | \$ | \$ |
| Balance – Beginning of year | 441,501 | 280,766 |
| Financial support for the year to acquire capital assets | - | 208,145 |
| Transfer of revenues for the year to offset the corresponding depreciation | (79,789) | (47,410) |
| | <hr/> | <hr/> |
| Balance – End of year | <u>361,712</u> | <u>441,501</u> |

4 Inventories

| | 2011 | 2010 |
|------------------|------------------|----------------|
| | \$ | \$ |
| Raw materials | 859,242 | 192,790 |
| Work in progress | 520,265 | 307,968 |
| Finished goods | 70,099 | 290,340 |
| | <hr/> | <hr/> |
| | <u>1,449,606</u> | <u>791,098</u> |

The cost of goods sold included in the statement of operations amounts to \$9,393,895 for the year ended March 31, 2011 (\$10,190,598 in 2010).

5 Security investments

Security investments comprise fixed income securities bearing interest at annual effective rates and maturing as follows:

| | Maturity | Rate | 2011 | 2010 |
|-----------------|-----------------|--------------|----------------|------------------|
| | | % | \$ | \$ |
| Term deposits | 2011 and 2012 | 0.55 to 1.41 | 823,800 | 1,631,360 |
| Corporate bonds | - | - | - | 6,255,051 |
| | | | <hr/> | <hr/> |
| | | | <u>823,800</u> | <u>7,886,411</u> |

National Optics Institute
Notes to Consolidated Financial Statements
March 31, 2011

6 Capital assets

| | | | <u>2011</u> | <u>2010</u> |
|---|-------------------|-----------------------------------|-------------------|-------------------|
| | Cost \$ | Accumulated depreciation \$ | Net amount \$ | Net amount \$ |
| Land | 1,262,550 | - | 1,262,550 | 1,262,550 |
| Buildings | 33,861,386 | 12,113,139 | 21,748,247 | 22,606,653 |
| Lease improvements | 73,984 | 29,593 | 44,391 | 59,187 |
| Research equipment | 54,979,934 | 47,360,134 | 7,619,800 | 7,635,640 |
| Production equipment | 374,264 | 352,466 | 21,798 | 59,700 |
| Office and laboratory furniture and equipment | 4,910,771 | 3,863,449 | 1,047,322 | 1,234,823 |
| Vehicles | 55,494 | 34,656 | 20,838 | 31,937 |
| | <u>95,518,383</u> | <u>63,753,437</u> | <u>31,764,946</u> | <u>32,890,490</u> |

7 Bank loans

INO has an authorized line of credit of CAN\$3,500,000 (including a limit of US\$250,000 for a standby line of credit) which bears interest at prime rate and is renewable annually. It also has a standby line of credit of US\$250,000 for foreign exchange contracts. Under the terms of the agreement, INO is subject to a restrictive covenant as to maintaining a minimum financial ratio, which has been met as at March 31, 2011. As at March 31, 2011, this facility was used for an amount of \$1,417,224.

INO also has a temporary line of credit of \$2,240,000 which bears interest at prime rate less 0.15%, obtained as part of the program to finance the purchase of equipment with the Government of Québec. Under the terms of the credit agreement, the balance of the temporary line of credit will have to be repaid on September 30, 2011. As at March 31, 2011, an amount of \$1,288,750 was used under this credit facility.

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Notes to Consolidated Financial Statements

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8 Long-term debt

| | 2011 \$ | 2010 \$ |
|--|------------|------------|
| Term loans | | |
| Original amount of \$650,000, 5.27%, secured by immovable hypothecs, repayable in equal and consecutive monthly instalments of \$6,980 including interest, maturing in 2017 | 430,078 | 489,468 |
| Original amount of \$2,754,500, 3.3695%, secured by a \$2,754,500 hypothec-assignment of the grant contract with the Government of Québec, repayable in equal semi-annual and consecutive instalments of \$486,508, including interest and a final instalment of \$486,854 in October 2011 * | 949,325 | 1,867,118 |
| Original amount of \$2,609,130, 3.081% secured by a \$2,609,130 hypothec-assignment of the grant contract with the Government of Québec, payable in equal semi-annual and consecutive instalments of \$458,544 including interest beginning in March 2010 and a final instalment of \$458,800 in September 2012 * | 1,334,371 | 2,190,453 |
| Original amount of \$2,421,000, 2.679% secured by a \$2,421,000 hypothec-assignment of the grant contract with the Government of Québec, payable in equal semi-annual and consecutive instalments of \$422,627 including interest beginning in April 2011, maturing in September 2013 * | 2,421,000 | - |
| Financial support repayable to Canada Economic Development as part of the Agrophotonic Program, for a notional amount of \$699,929, non-interest-bearing (effective rate of 6.96%), repayable in annual instalments from August 1, 2010 to August 1, 2015. Instalments will be equal to 10% of the revenue generated from marketing the developed products under this program. The unpaid balance will be payable on August 1, 2016, if applicable. The undiscounted balance is \$646,878 as at March 31, 2011 | 469,480 | 488,517 |
| Reimbursed during the year | - | 7,562,781 |
| | 5,604,254 | 12,598,337 |
| Less: Current portion | 3,130,436 | 9,461,847 |
| | 2,473,818 | 3,136,490 |

* Repayments are made by the Government of Québec directly to the financial institution (note 3b).

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Principal instalments required in each of the next five years are as follows:

| | \$ |
|------|-----------|
| 2012 | 3,130,436 |
| 2013 | 1,335,376 |
| 2014 | 486,579 |
| 2015 | 73,293 |
| 2016 | 77,251 |

9 Supplementary information to the statement of cash flows

(a) Net change in non-cash operating working capital items

| | 2011 \$ | 2010 \$ |
|---|--------------------|------------------|
| Accounts receivable | 72,339 | 161,733 |
| Financial support receivable | (490,621) | 516,155 |
| Inventories | (658,508) | 281,973 |
| Research contracts in progress | 776,992 | (333,993) |
| Prepaid expenses | (174,280) | 133,597 |
| Accounts payable and accrued liabilities | (618,207) | 1,750,588 |
| Deferred revenues and advances on contracts | 960,093 | 395,065 |
| Employee future benefits | (1,678,753) | (1,040,150) |
| | <u>(1,810,945)</u> | <u>1,864,968</u> |

(b) Operations not affecting cash

| | 2011 \$ | 2010 \$ |
|---|------------|------------|
| Acquisition of capital assets included in accounts payable and accrued liabilities | 185,162 | 278,689 |
| Acquisition of an investment in a private company applied against deferred revenues | - | 259,200 |
| Increase in deferred contributions applied against financial support receivable | 2,168,864 | 2,926,496 |
| Capital repayment of long-term debt by the Government of Québec | 9,050,985 | 2,542,891 |

(c) Interest paid

| | |
|--------|--------|
| 53,761 | 56,836 |
|--------|--------|

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10 Employee future benefits

INO offers employee future benefit plans, including a defined benefit plan guaranteeing the payment of pension benefits to some of its employees.

(a) Defined benefit pension plan

The most recent actuarial valuation of the pension plan was performed on December 31, 2009 and included projections to December 31, 2010. Information related to the defined benefit pension plan is as follows:

| | 2011 \$ | 2010 \$ |
|------------------------------------|--------------|--------------|
| Accrued benefit obligations | | |
| Accrued benefit obligations | (24,984,900) | (17,833,900) |
| Fair value of plan assets | 23,028,300 | 19,464,600 |
| | <hr/> | <hr/> |
| Funded status | (1,956,600) | 1,630,700 |
| Net actuarial gain (loss) | 4,278,400 | (914,900) |
| Unamortized past service costs | (1,364,400) | (1,444,600) |
| | <hr/> | <hr/> |
| Accrued benefit asset (liability) | 957,400 | (728,800) |
| | <hr/> | <hr/> |

Plan asset allocations are as follows:

| | <hr/> % of plan assets <hr/> | |
|-----------------|-------------------------------------|-----------|
| | 2011 % | 2010 % |
| Canadian stocks | 23 | 23 |
| Foreign stocks | 37 | 34 |
| Current assets | 10 | 9 |
| Bonds | 30 | 34 |
| | <hr/> | <hr/> |
| | 100 | 100 |
| | <hr/> | <hr/> |

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The significant actuarial assumptions adopted by INO are as follows:

| | 2011 | 2010 |
|--------------------------------|-------------|-------------|
| | % | % |
| Accrued benefit obligations | | |
| Discount rate | 5.85 | 6.50 |
| Rate of compensation increase | 3.00 | 2.50 |
| Cost of benefits | | |
| Discount rate | 6.50 | 7.50 |
| Expected return on plan assets | 6.25 | 6.00 |

Effective April 1, 2007, INO decided to no longer accept new members to its defined benefit pension plan, while maintaining the plan conditions for members who joined the plan before this date.

Under the laws governing defined benefit pension plans, INO will have to make special contributions to address the plan's technical and solvency deficits.

Special contributions will be made to the plan in consideration of the recommendations provided in the last actuarial valuation of the plan as at December 31, 2009. Instalments will be made as follows over the forthcoming years:

| | \$ |
|------|------------------|
| 2012 | 629,640 |
| 2013 | 629,640 |
| 2014 | 629,640 |
| 2015 | 472,230 |
| | <u>2,361,150</u> |

During the year, INO's contributions were \$2,106,500 (\$1,521,100 in 2010) including special contributions of \$1,077,480 (\$823,080 in 2010).

Changes in accrued benefit asset (liability) are as follows:

| | 2011 | 2010 |
|-----------------------------|------------------|--------------------|
| | \$ | \$ |
| Balance – Beginning of year | (728,800) | 1,772,000 |
| Expenses for the year | (420,300) | 477,900 |
| INO's contributions | <u>2,106,500</u> | <u>(1,521,100)</u> |
| Balance – End of year | <u>957,400</u> | <u>728,800</u> |

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(b) Defined contribution plan

On April 1, 2007, INO implemented a defined contribution pension plan for employees hired after March 31, 2007. During the year, the contributions paid by INO totalled \$214,427 (\$131,606 in 2010).

(c) Other employee future benefits

As at March 31, 2011, the obligations under the other employee future benefits are \$114,600 (\$107,153 in 2010). The increase in the provision relating to these obligations resulted in an increase of \$7,447 (\$3,050 in 2010) in salaries and fringe benefit expenses for the year.

As at March 31, the employee future benefit asset (liability) is as follows:

| | 2011 \$ | 2010 \$ |
|--------------------------------|----------------|------------------|
| Defined benefit pension plan | 957,400 | (728,800) |
| Other employee future benefits | (114,600) | (107,153) |
| | <u>842,800</u> | <u>(835,953)</u> |

11 Financial instruments and risk management

Because of its financial assets and liabilities, INO is exposed to the following risks associated with the use of financial instruments: currency risk, interest rate risk and credit risk. The following analysis can be used to evaluate the risks:

(a) Currency risk

A significant portion of "Purchases of goods and services" as well as "Sales and contracts" are made in foreign currencies, mainly in US dollars and euros. INO's excess of revenues over expenses is therefore exposed to foreign currency fluctuations.

As at March 31, 2011, INO has outstanding contracts under which it has committed to selling €231,833 euros at rates ranging from 1.3541 to 1.3627 between August 31, 2011 and March 15, 2012. The purpose of these contracts is to hedge sales denominated in euros, but INO did not designate them as part of hedging relationships. Thus, the negative fair value of these contracts, as at March 31, 2011, of \$3,090 (\$13,598 in 2010) has been recognized in the statement of operations under foreign exchange loss and is included in accounts payable and accrued liabilities in the balance sheet.

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The balance sheet includes the following significant amounts in Canadian dollars for financial assets and liabilities whose cash flows are denominated in the following currencies:

| | 2011 | 2010 |
|---------------------|---------|---------|
| | \$ | \$ |
| In US dollars | | |
| Cash | 277,734 | 115,157 |
| Accounts receivable | 946,854 | 862,294 |
| Accounts payable | 266,004 | 407,209 |

(b) Interest rate risk

The interest rate risk refers to the effect of interest rate changes on the fair value of INO's financial assets and liabilities.

In addition, INO deems its exposition to interest rate risk on its long-term debts to be minimal since most of its interest is paid by the Government of Québec.

(c) Credit risk

INO's main financial assets, which are subject to credit risk, include cash and accounts receivable. The carrying amount of the financial assets recorded on the balance sheet represents the maximum credit risk as at the balance sheet date.

INO's credit risk is attributed mainly to its accounts receivable. The amounts are presented on the balance sheet, net of the allowance for doubtful accounts.

The allowance for doubtful accounts is the result of an estimate by INO's management based on previous experience and its assessment of the current economic climate. In order to reduce credit risk, management has adopted credit policies that include a regular review of credit limits. INO has no client that represents more than 10% of its total accounts receivable as at March 31, 2011 (in 2010, two major clients represented approximately 30% of its total accounts receivable). The allowance for doubtful accounts amounts to \$200,000 as at March 31, 2011 and 2010.

The credit risk associated with cash and term deposits is limited since these are held by known financial institutions.

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(d) Fair value

The fair value of accounts receivable, current portion of financial support receivable related to the Internal Research Program, bank loans, as well as accounts payable and accrued liabilities approximates their carrying amount due to their short-term maturity.

The fair value of the long-term debt bearing interest at a floating rate approximates its carrying amount because the financing cost will fluctuate based on the market and the related financing conditions could currently be obtained by INO.

The fair value of long-term debts bearing interest at fixed rates and secured by the Government of Québec has not been calculated since a corresponding amount of financial support receivable has been accounted for.

Finally, the fair value of the long-term debt with a carrying amount of \$430,078 (\$489,468 in 2010) approximates \$396,000 as at March 31, 2011 (\$437,000 in 2010).

12 Commitments

(a) Long-term commitments

Payments required over the next four years are as follows:

| | Operating leases \$ | Natural gas \$ | Maintenance contract \$ | Total \$ |
|------|------------------------------------|---------------------------|--|---------------------|
| 2012 | 41,412 | 212,000 | 155,772 | 409,184 |
| 2013 | 30,606 | 18,000 | 155,772 | 204,378 |
| 2014 | 24,641 | - | - | 24,641 |
| 2015 | 6,160 | - | - | 6,160 |

(b) Market development or fee agreements

Under these agreements, INO is committed to paying \$273,934 in 2012 as market development expenses or fees to companies or individuals.

13 Capital management

Funding for INO's activities is provided by several government financial support programs. These programs impose certain requirements on the way the funds are used. During the year, these requirements were met by INO.

14 Subsequent event

In April 2011, the government of Canada announced it will grant INO a \$45 million non-refundable contribution over a period of five years. This contribution, granted through Canada Economic Development's Business and Regional Growth program, will enable INO to carry on its activities regarding the marketing of innovation and technology transfers.