

EXFO Inc.
Condensed Unaudited Interim Consolidated Balance Sheets

(in thousands of US dollars)

	As at November 30, 2016	As at August 31, 2016
Assets		
Current assets		
Cash	\$ 35,061	\$ 43,208
Short-term investments	4,281	4,087
Accounts receivable		
Trade	43,476	42,993
Other	3,321	2,474
Income taxes and tax credits recoverable	4,047	4,208
Inventories	33,880	33,004
Prepaid expenses	2,781	3,099
	126,847	133,073
Tax credits recoverable	33,800	34,594
Property, plant and equipment	35,530	35,978
Intangible assets (note 3)	10,855	3,391
Goodwill	21,418	21,928
Deferred income tax assets	7,901	8,240
Other assets	372	589
	\$ 236,723	\$ 237,793
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	\$ 34,779	\$ 37,174
Provisions	308	299
Income taxes payable	567	971
Deferred revenue	8,910	9,486
	44,564	47,930
Deferred revenue	5,681	5,530
Deferred income tax liabilities	2,546	2,857
Other liabilities	29	75
	52,820	56,392
Shareholders' equity		
Share capital (note 5)	89,352	85,516
Contributed surplus	18,018	18,150
Retained earnings	129,612	126,309
Accumulated other comprehensive loss	(53,079)	(48,574)
	183,903	181,401
	\$ 236,723	\$ 237,793

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

EXFO Inc.
Condensed Unaudited Interim Consolidated Statements of Earnings

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

	Three months ended November 30,	
	2016	2015
Sales	\$ 61,785	\$ 55,232
Cost of sales ⁽¹⁾ (note 6)	22,813	20,137
Selling and administrative (note 6)	21,595	20,252
Net research and development (note 6)	11,314	9,933
Depreciation of property, plant and equipment (note 6)	903	975
Amortization of intangible assets (note 6)	427	300
Interest (income) expense	(20)	63
Foreign exchange gain	(512)	(310)
Earnings before income taxes	5,265	3,882
Income taxes (note 7)	1,962	2,116
Net earnings for the period	\$ 3,303	\$ 1,766
Basic and diluted net earnings per share	\$ 0.06	\$ 0.03
Basic weighted average number of shares outstanding (000's)	53,884	53,814
Diluted weighted average number of shares outstanding (000's) (note 8)	55,001	54,535

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

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

EXFO Inc.

Condensed Unaudited Interim Consolidated Statements of Comprehensive Loss

(in thousands of US dollars)

	Three months ended November 30,	
	2016	2015
Net earnings for the period	\$ 3,303	\$ 1,766
Other comprehensive income (loss), net of income taxes		
Items that will not be reclassified subsequently to net earnings		
Foreign currency translation adjustment	(4,217)	(2,509)
Items that may be reclassified subsequently to net earnings		
Unrealized gains/losses on forward exchange contracts	(561)	(270)
Reclassification of realized gains/losses on forward exchange contracts in net earnings	181	878
Deferred income tax effect of gains/losses on forward exchange contracts	92	(148)
Other comprehensive loss	(4,505)	(2,049)
Comprehensive loss for the period	<u>\$ (1,202)</u>	<u>\$ (283)</u>

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

EXFO Inc.

Condensed Unaudited Interim Consolidated Statements of Changes in Shareholders' Equity

(in thousands of US dollars)

	Three months ended November 30, 2015				
	Share capital	Contributed surplus	Retained earnings	Accumulated other comprehensive loss	Total shareholders' equity
Balance as at September 1, 2015	\$ 86,045	\$ 17,778	\$ 117,409	\$ (52,005)	\$ 169,227
Redemption of share capital (note 5)	(1)	–	–	–	(1)
Reclassification of stock-based compensation costs (note 5)	723	(723)	–	–	–
Stock-based compensation costs	–	341	–	–	341
Net earnings for the period	–	–	1,766	–	1,766
Other comprehensive income (loss)					
Foreign currency translation adjustment	–	–	–	(2,509)	(2,509)
Changes in unrealized losses on forward exchange contracts, net of deferred income taxes of \$148	–	–	–	460	460
Total comprehensive loss for the period					(283)
Balance as at November 30, 2015	<u>\$ 86,767</u>	<u>\$ 17,396</u>	<u>\$ 119,175</u>	<u>\$ (54,054)</u>	<u>\$ 169,284</u>
	Three months ended November 30, 2016				
	Share capital	Contributed surplus	Retained earnings	Accumulated other comprehensive loss	Total shareholders' equity
Balance as at September 1, 2016	\$ 85,516	\$ 18,150	\$ 126,309	\$ (48,574)	\$ 181,401
Issuance of share capital (notes 3 and 5)	3,490	–	–	–	3,490
Reclassification of stock-based compensation costs (note 5)	346	(346)	–	–	–
Stock-based compensation costs	–	214	–	–	214
Net earnings for the period	–	–	3,303	–	3,303
Other comprehensive loss					
Foreign currency translation adjustment	–	–	–	(4,217)	(4,217)
Changes in unrealized gains/losses on forward exchange contracts, net of deferred income taxes of \$92	–	–	–	(288)	(288)
Total comprehensive loss for the period					(1,202)
Balance as at November 30, 2016	<u>\$ 89,352</u>	<u>\$ 18,018</u>	<u>\$ 129,612</u>	<u>\$ (53,079)</u>	<u>\$ 183,903</u>

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

EXFO Inc.
Condensed Unaudited Interim Consolidated Statements of Cash Flows

(in thousands of US dollars)

	Three months ended November 30,	
	2016	2015
Cash flows from operating activities		
Net earnings for the period	\$ 3,303	\$ 1,766
Add (deduct) items not affecting cash		
Stock-based compensation costs	258	376
Depreciation and amortization	1,330	1,275
Deferred revenue	(75)	1,511
Deferred income taxes	147	573
Changes in foreign exchange gain/loss	(538)	(344)
	4,425	5,157
Changes in non-cash operating items		
Accounts receivable	(2,558)	(2,024)
Income taxes and tax credits	(344)	(278)
Inventories	(1,248)	(3,226)
Prepaid expenses	258	54
Other assets	13	193
Accounts payable, accrued liabilities and provisions	(1,425)	3,375
Other liabilities	-	(28)
	(879)	3,223
Cash flows from investing activities		
Additions to short-term investments	(296)	(21)
Additions to capital assets	(1,237)	(1,309)
Business combination (note 3)	(5,000)	-
	(6,533)	(1,330)
Cash flows from financing activities		
Bank loan	-	315
Redemption of share capital	-	(1)
	-	314
Effect of foreign exchange rate changes on cash	(735)	(197)
Change in cash	(8,147)	2,010
Cash – Beginning of the period	43,208	25,864
Cash – End of the period	\$ 35,061	\$ 27,874
Supplementary information		
Income taxes paid	\$ 958	\$ 608

As at November 30, 2015 and 2016, additions to capital assets amounted to \$1,309 and \$1,179 respectively, and unpaid purchases of capital assets amounted to \$377 and \$441 respectively.

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

EXFO Inc.

Notes to Condensed Unaudited Interim Consolidated Financial Statements

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

1 Nature of Activities and Incorporation

EXFO Inc. and its subsidiaries (together “EXFO” or the “the company”) design, manufacture and market test, service assurance and network visibility solutions for fixed and mobile network operators, web-scale service providers as well as equipment manufacturers in the global telecommunications industry.

EXFO is a company incorporated under the Canada Business Corporations Act and domiciled in Canada. The address of its headquarters is 400 Godin Avenue, Quebec, Province of Quebec, Canada, G1M 2K2.

These condensed interim consolidated financial statements were authorized for issue by the Board of Directors on January 10, 2017.

2 Basis of Presentation

These condensed interim consolidated financial statements have been prepared in accordance with the *International Financial Reporting Standards* (IFRS), as issued by the *International Accounting Standards Board* (IASB) applicable to the preparation of interim financial statements, including IAS 34, “*Interim Financial Reporting*”, and using the same accounting policies and methods used in the preparation of the company’s most recent annual consolidated financial statements. Consequently, these condensed interim consolidated financial statements should be read in conjunction with the company’s most recent annual consolidated financial statements, which have been prepared in accordance with IFRS as issued by the IASB.

New IFRS Pronouncements Not Yet Adopted

Financial instruments

The final version of IFRS 9, “*Financial Instruments*”, was issued in July 2014 and will replace IAS 39, “*Financial Instruments: Recognition and Measurement*”. IFRS 9 uses a single approach to determine whether a financial asset is measured at amortized cost or fair value, replacing the multiple rules in IAS 39. The approach in IFRS 9 is based on how an entity manages its financial instruments in the context of its business model and the contractual cash flow characteristics of the financial assets. Most of the requirements in IAS 39 for classification and measurement of financial liabilities were carried forward unchanged to IFRS 9. The new standard also requires a single impairment method to be used, replacing the multiple impairment methods in IAS 39. Requirements relating to hedge accounting representing a new hedge accounting model have also been added to IFRS 9. The new standard is effective for annual periods beginning on or after January 1, 2018, and must be applied retrospectively. The company will adopt this new standard on September 1, 2018. The company is currently assessing the impact that the new standard will have on its consolidated financial statements.

Revenue from contracts with customers

IFRS 15, “*Revenue from Contracts with Customers*”, was issued in May 2014. The objective of this new standard is to provide a single, comprehensive revenue recognition model for all contracts with customers to improve comparability. This new standard contains principles that an entity will apply to determine the measurement of revenue and timing of when it is recognized. The underlying principle is that an entity will recognize revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. This new standard is effective for annual periods beginning on or after January 1, 2018. Early adoption is permitted. The company is currently assessing the impact that the new standard will have on its consolidated financial statements and whether or not early adopt the new standard.

EXFO Inc.

Notes to Condensed Unaudited Interim Consolidated Financial Statements

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

Leases

IFRS 16, "Leases", was issued in January 2016. IFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract, i.e., the customer (lessee) and the supplier (lessor). IFRS 16 will supersede IAS 17, "Leases", and related Interpretations. This new standard is effective for annual periods beginning on or after January 1, 2019, with earlier adoption permitted if IFRS 15, "Revenue from Contracts with Customers", is also applied. The company has not yet assessed the impact that the new standard will have on its consolidated financial statements.

3 Business Combination

On October 31, 2016, the company acquired substantially all of the assets of Absolute Analysis Inc. (Absolute), a privately held company located in United States, supplying solutions for radio frequency testing of fiber-based radio access networks. The acquisition-date fair value of the total consideration transferred amounted to \$8,490,000, and consisted of \$5,000,000 in cash and the issuance of 793,070 subordinate voting shares, valued at \$3,490,000.

This acquisition was accounted by applying the acquisition method as required by IFRS 3, "Business Combinations", and the requirements of IFRS 10, "Consolidated Financial Statements"; consequently, the fair value of the total consideration transferred was allocated to the assets acquired based on management's preliminary estimate of their fair value as of the acquisition date. The results of operations of the acquired business have been included in the consolidated financial statements of the company since October 31, 2016, being the date of acquisition.

The fair value of the total consideration transferred was allocated based on a preliminary estimate of fair value of acquired net assets at the date of acquisition as follows:

Assets acquired	
Core technology	\$ 8,254
Other assets	236
Net identifiable assets acquired and fair value of the total consideration transferred	<u>\$ 8,490</u>

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

The allocation of the fair value of the total consideration transferred is preliminary because the acquisition was closed during the quarter and because certain information required to complete the final allocation remains outstanding. The company expects to complete the final allocation for this acquisition in the second quarter of fiscal 2017. Assets and liabilities likely to change upon completing a more detailed valuation and the finalization of the allocation are intangible assets, goodwill and deferred income taxes.

EXFO Inc.

Notes to Condensed Unaudited Interim Consolidated Financial Statements

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

4 Financial Instruments

Fair Value of Financial Instruments

The company classifies its derivative and non-derivative financial assets and liabilities measured at fair value using the fair value hierarchy as follows:

Level 1: Quoted prices (unadjusted) in active market for identical assets or liabilities

Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset and liability, either directly or indirectly

Level 3: Unobservable inputs for the asset or liability

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

The fair value of forward exchange contracts represents the amount at which they could be settled based on estimated current market rates.

The fair value of derivative and non-derivative financial assets and liabilities measured at fair value by level of fair value hierarchy, is as follows:

	As at November 30, 2016		As at August 31, 2016	
	Level 1	Level 2	Level 1	Level 2
Financial assets				
Short-term investments	\$ 4,281	\$ –	\$ 4,087	\$ –
Forward exchange contracts	\$ –	\$ 461	\$ –	\$ 980
Financial Liabilities				
Forward exchange contracts	\$ –	\$ 903	\$ –	\$ 1,120

Derivative Financial Instruments

The functional currency of the company is the Canadian dollar. The company is exposed to currency risk as a result of its export sales of products manufactured in Canada, China and Finland, the majority of which are denominated in US dollars and euros. This risk is partially hedged by forward exchange contracts and certain cost of sales and operating expenses (US dollars and euros). In addition, the company is exposed to currency risk as a result of its research and development activities in India (Indian rupees). This risk is partially hedged by forward exchange contracts. The company's forward exchange contracts, which are designated as cash flow hedging instruments, qualify for hedge accounting.

EXFO Inc.

Notes to Condensed Unaudited Interim Consolidated Financial Statements

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

As at November 30, 2016, the company held contracts to sell US dollars for Canadian dollars and Indian rupees at various forward rates, which are summarized as follows:

US dollars – Canadian dollars

Expiry dates	Contractual amounts	Weighted average contractual forward rates
December 2016 to August 2017	\$ 17,900	1.2995
September 2017 to August 2018	12,700	1.3376
September 2018 to December 2018	2,500	1.3585
Total	\$ 33,100	1.3185

US dollars – Indian rupees

Expiry dates	Contractual amounts	Weighted average contractual forward rates
December 2016 to August 2017	\$ 3,000	71.06
September 2017 to January 2018	2,000	70.76
Total	\$ 5,000	70.94

The carrying amount of forward exchange contracts is equal to fair value, which is based on the amount at which they could be settled based on estimated current market rates. The fair value of forward exchange contracts amounted to net losses of \$140,000 as at August 31, 2016, and \$442,000 as at November 30, 2016.

As at November 30, 2016, forward exchange contracts in the amount of \$313,000 are presented as current assets in other accounts receivable; forward exchange contracts in the amount of \$148,000 are presented as long-term assets in other long-term assets; and forward exchange contracts in the amount of \$903,000 are presented as current liabilities in accounts payable and accrued liabilities in the balance sheet. Forward exchange contracts of \$196,000 included in accounts payable and accrued liabilities, for which related hedged sales are recognized, are recorded in the consolidated statement of earnings; otherwise, other forward exchange contracts are not yet recorded in the consolidated statement of earnings and are recorded in other comprehensive income.

Based on the portfolio of forward exchange contracts as at November 30, 2016, the company estimates that the portion of the net unrealized losses on these contracts as of that date, which will be realized and reclassified from accumulated other comprehensive income to net earnings over the next 12 months, amounts to \$392,000.

During the three months ended November 30, 2015 and 2016, the company recognized within its sales foreign exchange losses on forward exchange contracts of \$874,000 and \$240,000 respectively.

EXFO Inc.

Notes to Condensed Unaudited Interim Consolidated Financial Statements

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

5 Share Capital

The following tables summarize changes in share capital for the three months ended November 30, 2015 and 2016.

	Three months ended November 30, 2015				
	Multiple voting shares		Subordinate voting shares		Total amount
	Number	Amount	Number	Amount	
Balance as at September 1, 2015	31,643,000	\$ 1	22,092,034	\$ 86,044	\$ 86,045
Redemption of restricted share units	-	-	155,784	-	-
Redemption of deferred share units	-	-	653	-	-
Redemption of share capital	-	-	(200)	(1)	(1)
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	-	-	-	723	723
Balance as at November 30, 2015	<u>31,643,000</u>	<u>\$ 1</u>	<u>22,248,271</u>	<u>\$ 86,766</u>	<u>\$ 86,767</u>

	Three months ended November 30, 2016				
	Multiple voting shares		Subordinate voting shares		Total amount
	Number	Amount	Number	Amount	
Balance as at September 1, 2016	31,643,000	\$ 1	21,917,942	\$ 85,515	\$ 85,516
Issuance of share capital (note 3)	-	-	793,070	3,490	3,490
Redemption of restricted share units	-	-	88,371	-	-
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	-	-	-	346	346
Balance as at November 30, 2016	<u>31,643,000</u>	<u>\$ 1</u>	<u>22,799,383</u>	<u>\$ 89,351</u>	<u>\$ 89,352</u>

6 Statements of Earnings

Net research and development expenses comprise the following:

	Three months ended November 30,	
	2016	2015
Gross research and development expenses	\$ 12,640	\$ 11,279
Research and development tax credits and grants	(1,326)	(1,346)
Net research and development expenses for the period	<u>\$ 11,314</u>	<u>\$ 9,933</u>

EXFO Inc.

Notes to Condensed Unaudited Interim Consolidated Financial Statements

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

Inventory write-down is as follows:

	Three months ended November 30,	
	2016	2015
Inventory write-down for the period	\$ 1,129	\$ 847

Depreciation and amortization expenses by functional area are as follows:

	Three months ended November 30,	
	2016	2015
Cost of sales		
Depreciation of property, plant and equipment	\$ 359	\$ 323
Amortization of intangible assets	296	177
	<u>655</u>	<u>500</u>
Selling and administrative expenses		
Depreciation of property, plant and equipment	118	146
Amortization of intangible assets	19	18
	<u>137</u>	<u>164</u>
Net research and development expenses		
Depreciation of property, plant and equipment	426	506
Amortization of intangible assets	112	105
	<u>538</u>	<u>611</u>
	<u>\$ 1,330</u>	<u>\$ 1,275</u>
Depreciation of property, plant and equipment	\$ 903	\$ 975
Amortization of intangible assets	427	300
	<u>\$ 1,330</u>	<u>\$ 1,275</u>

Employee compensation comprises the following:

	Three months ended November 30,	
	2016	2015
Salaries and benefits	\$ 28,778	\$ 26,964
Stock-based compensation costs	258	376
Total employee compensation for the period	<u>\$ 29,036</u>	<u>\$ 27,340</u>

EXFO Inc.

Notes to Condensed Unaudited Interim Consolidated Financial Statements

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

Stock-based compensation costs by functional area are as follows:

	Three months ended November 30,	
	2016	2015
Cost of sales	\$ 27	\$ 31
Selling and administrative expenses	179	266
Net research and development expenses	52	79
Total stock-based compensation for the period	<u>\$ 258</u>	<u>\$ 376</u>

7 Income Taxes

For the three months ended November 30, 2015 and 2016, the reconciliation of the income tax provision calculated using the combined Canadian federal and provincial statutory income tax rate with the income tax provision in the financial statements is as follows:

	Three months ended November 30,	
	2016	2015
Income tax provision at combined Canadian federal and provincial statutory tax rate (27%)	\$ 1,422	\$ 1,048
Increase (decrease) due to:		
Foreign income taxed at different rates	(172)	(158)
Non-deductible loss	194	204
Non-deductible expenses	173	170
Change in tax rates	(89)	-
Foreign exchange effect of translation of foreign subsidiaries	(122)	(150)
Utilization of previously unrecognized deferred income tax assets	(156)	-
Unrecognized deferred income tax assets on temporary deductible differences and unused tax losses	850	1,012
Other	(138)	(10)
Income tax provision for the period	<u>\$ 1,962</u>	<u>\$ 2,116</u>

The income tax provision consists of the following:

	Three months ended November 30,	
	2016	2015
Current	\$ 1,815	\$ 1,543
Deferred	147	573
	<u>\$ 1,962</u>	<u>\$ 2,116</u>

EXFO Inc.

Notes to Condensed Unaudited Interim Consolidated Financial Statements

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

8 Earnings per Share

The following table summarizes the reconciliation of the basic weighted average number of shares outstanding and the diluted weighted average number of shares outstanding:

	Three months ended November 30,	
	2016	2015
Basic weighted average number of shares outstanding (000's)	53,884	53,814
Plus dilutive effect of (000's):		
Restricted share units	958	607
Deferred share units	159	114
Diluted weighted average number of shares outstanding (000's)	55,001	54,535
Stock awards excluded from the calculation of diluted weighted average number of shares because their exercise price was greater than the average market price of the common shares (000's)	-	57