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

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

The following discussion and analysis of financial condition and results of operations is dated June 26, 2013.

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

COMPANY OVERVIEW AND RECENT DEVELOPMENTS

We are a leading provider of test and service assurance solutions for network operators and equipment manufacturers in the global telecommunications industry. We offer core-to-edge solutions that assess the performance and reliability of converged, IP (Internet Protocol) fixed and mobile networks. Our test and service assurance solutions specifically target high-growth market opportunities related to increasing bandwidth and improving quality of experience on next-generation IP networks: 4G/LTE (long-term evolution), wireless backhaul, 40G/100G network upgrades and fiber-to-the-home (FTTH)/fiber-to-the-curb (FTTC)/fiber-to-the-node (FTTN) deployments. Customers on a global basis rely on our test and service assurance solutions to enable their fixed and mobile networks to perform optimally during their complete lifecycles: research, development, manufacturing, installation, maintenance and monitoring.

We reported sales of $58.9 million in the third quarter of fiscal 2013, which represents a decrease of 1.1% compared to the same period last year. We reported bookings of $61.8 million in the third quarter of fiscal 2013, for a book-to-bill ratio of 1.05, compared to $57.5 million for the same period last year.

Net loss amounted to $862,000, or $0.01 per share, in the third quarter of fiscal 2013, compared to $3.7 million, or $0.06 per share for the same period last year. Net loss for the third quarter of fiscal 2013 included $1.5 million in after-tax amortization of intangible assets, $415,000 in stock-based compensation costs and a foreign exchange gain of $314,000. Loss from operations amounted to $343,000, or 0.6% of sales in the third quarter of fiscal 2013, compared to $4.4 million, or 7.3% of sales for the same period last year.

Adjusted EBITDA (net loss before interest, income taxes, depreciation of property, plant and equipment, amortization of intangible assets, stock-based compensation costs and foreign exchange gain) reached $3.1 million, or 5.3% of sales in the third quarter of fiscal 2013, compared to minus $472,000, or 0.8% of sales for the same period last year. See further in this document for a complete reconciliation of adjusted EBITDA to IFRS net earnings (loss).

Sales and results for the third quarter of fiscal 2013 were lower than the third-quarter guidance that we issued on March 27, 2013. On June 4, 2013, we issued a press release to announce preliminary third-quarter sales and results below our guidance. This press release is available at www.sedar.com and at www.EXFO.com.

On November 7, 2012, we announced that our Board of Directors approved the renewal of our share repurchase program, by way of a normal course issuer bid on the open market of up to 10% of the issued and outstanding subordinate voting shares, representing 2,072,721 subordinate voting shares at the prevailing market price. We use cash, short-term investments or future cash flows from operations to fund the repurchase of shares. The normal course issuer bid started on November 12, 2012, and will end on November 11, 2013, or on an earlier date if we repurchase the maximum number of shares permitted under the bid. The program does not require that we repurchase any specific number of shares, and it may be modified, suspended or terminated at any time and without prior notice. All shares repurchased under the bid are cancelled.

We launched two new products in the third quarter of fiscal 2013, including a tunable laser source for network equipment manufacturers in the design and testing of ultra-high-capacity optical networks. We also introduced an optical switch based on an all-optical, cross-connect technology that provides a unique combination of low insertion loss, fast switching and high reliability that engineers require in lab and manufacturing environments. Altogether, we have released 13 new products or major enhancements since the beginning of the fiscal year.

RESULTS OF OPERATIONS

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

	Three months ended May 31, 2013	Three months ended May 31, 2012	**Nine months ended May 31, 2013**	Nine months ended May 31, 2012
Sales	**$ 58,865**	$ 59,505	**$ 181,262**	$ 192,810
Cost of sales [1]	**22,574**	23,549	**69,895**	70,535
Selling and administrative	**22,002**	23,625	**67,366**	71,919
Net research and development	**11,573**	13,173	**35,135**	37,963
Depreciation of property, plant and equipment	**1,473**	1,520	**4,582**	4,634
Amortization of intangible assets	**1,586**	1,993	**5,470**	5,888
Changes in the fair value of cash contingent consideration	**–**	–	**–**	(311)
Earnings (loss) from operations	**(343)**	(4,355)	**(1,186)**	2,182
Interest income	**68**	85	**76**	68
Foreign exchange gain	**314**	1,090	**2,770**	1,283
Earnings (loss) before income taxes	**39**	(3,180)	**1,660**	3,533
Income taxes	**901**	540	**4,121**	3,412
Net earnings (loss) for the period	**$ (862)**	$ (3,720)	**$ (2,461)**	$ 121
Basic and diluted net earnings (loss) per share	**$ (0.01)**	$ (0.06)	**$ (0.04)**	$ 0.00
Other selected information:				
Gross margin [2]	**$ 36,291**	$ 35,956	**$ 111,367**	$ 122,275
Research and development:				
Gross research and development [3]	**$ 13,782**	$ 15,575	**$ 41,806**	$ 45,188
Net research and development [3]	**$ 11,573**	$ 13,173	**$ 35,135**	$ 37,963
Adjusted EBITDA [2]	**$ 3,131**	$ (472)	**$ 10,286**	$ 13,826

(1) The cost of sales is exclusive of depreciation and amortization, shown separately.
(2) Refer to page 13 for non-IFRS measures.
(3) Includes $89 in restructuring charges for the nine months ended May 31, 2013 (nil for all other periods).

	Three months ended May 31, 2013	Three months ended May 31, 2012	Nine months ended May 31, 2013	Nine months ended May 31, 2012
Sales	**100.0 %**	100.0 %	**100.0 %**	100.0 %
Cost of sales [1]	**38.3**	39.6	**38.6**	36.6
Selling and administrative	**37.4**	39.7	**37.2**	37.3
Net research and development	**19.7**	22.1	**19.4**	19.7
Depreciation of property, plant and equipment	**2.5**	2.6	**2.5**	2.4
Amortization of intangible assets	**2.7**	3.3	**3.0**	3.1
Changes in fair value of cash contingent consideration	**–**	–	**–**	(0.2)
Earnings (loss) from operations	**(0.6)**	(7.3)	**(0.7)**	1.1
Interest income	**0.1**	0.1	**0.1**	–
Foreign exchange gain	**0.5**	1.8	**1.5**	0.7
Earnings (loss) before income taxes	**–**	(5.4)	**0.9**	1.8
Income taxes	**1.5**	0.9	**2.3**	1.7
Net earnings (loss) for the period	**(1.5) %**	(6.3) %	**(1.4) %**	0.1 %

Other selected information:

Gross margin [2]	**61.7 %**	60.4 %	**61.4 %**	63.4 %
Research and development:				
Gross research and development	**23.4 %**	26.2 %	**23.1 %**	23.4 %
Net research and development	**19.7 %**	22.1 %	**19.4 %**	19.7 %
Adjusted EBITDA [2]	**5.3 %**	(0.8) %	**5.7 %**	7.2 %

(1) The cost of sales is exclusive of depreciation and amortization, shown separately.
(2) Refer to page 13 for non-IFRS measures.

SALES AND BOOKINGS

For the three months ended May 31, 2013, our sales slightly decreased by 1.1% to $58.9 million, compared to $59.5 million for the same period last year; however, our bookings increased by 7.4% to $61.8 million, compared to $57.5 million for the same period last year, for a book-to-bill ratio of 1.05.

For the nine months ended May 31, 2013, our sales decreased by 6.0% to $181.3 million, compared to $192.8 million for the same period last year. For the first nine months of fiscal 2013, our book-to-bill ratio amounted to 0.99.

Over the last quarters, market conditions in the telecommunications industry have been tenuous due to macro-economic uncertainty, the European debt crisis and its ripple effects on other economies, the tightening of capital spending among network operators as well as delays in customers' orders. These market conditions have affected our sales and bookings since the third quarter of fiscal 2012. Although we witnessed some improvements in the United States in the third quarter of fiscal 2013, global market conditions continue to be difficult.

In the United States, we believe that capital spending budgets were released a little later than usually in fiscal 2013 because some network operators are moving ahead with large-scale, multi-billion dollar deployments that require additional scrutiny and planning; consequently, certain investment decisions were pushed back beyond the first quarter of the 2013 calendar year. Although we believe our bookings benefited to some extent from budget releases in the last portion of the third quarter of fiscal 2013, these late releases have affected our sales and bookings for the first nine months of fiscal 2013 compared to the same period last year.

Finally, in fiscal 2013, calendar year-end budget spending from network operators was even more limited than last year, which reduced our sales and bookings for the nine months ended May 31, 2013, compared to the same period last year.

Geographic distribution

In the third quarter of fiscal 2013, sales to the Americas, Europe, Middle-East and Africa (EMEA) and Asia-Pacific (APAC) accounted for 55%, 28% and 17% of sales respectively, compared to 51%, 29% and 20% for the same period last year respectively. In the first nine months of fiscal 2013, sales to the Americas, EMEA and APAC accounted for 53%, 28% and 19% of sales respectively, compared to 52%, 29% and 19% for the same period last year respectively.

Customer concentration

We sell our products to a broad range of customers, including network service providers, network equipment manufacturers, wireless operators and cable TV operators. In the third quarters of fiscal 2012 and 2013, no customer accounted for more than 10% of our sales, and our top three customers accounted for 14.5% and 15.7% of our sales respectively. In the first nine months of fiscal 2012 and 2013, no customer accounted for more than 10% of our sales, and our top three customers accounted for 11.2% and 13.6% of our sales respectively.

GROSS MARGIN (non-IFRS measure – refer to page 13 of this document)

Gross margin reached 61.7% of sales for the three months ended May 31, 2013, compared to 60.4% for the same period last year.

Gross margin amounted to 61.4% of sales for the first nine months ended May 31, 2013, compared to 63.4% for the same period last year.

In the third quarter of fiscal 2013, a more favorable product mix resulted in an increase in our gross margin compared to the same period last year.

In addition, during the third quarter of fiscal 2013, a larger portion of our sales came from products manufactured in our facilities in China compared to the same period last year; those products have a lower cost of goods than those manufactured in our facilities in Canada, thus further improving our gross margin year-over-year.

However, in the third quarter of fiscal 2012, our warranty expenses were lower compared to the same period this year; this resulted in a positive impact on our gross margin in the third quarter of fiscal 2012.

In addition, increased pricing pressure in the third quarter of fiscal 2013, compared to the same period last year, had to some extent a negative impact on our gross margin year-over-year.

The decrease in our gross margin in the first nine months of fiscal 2013, compared to the same period last year, can be explained by the following factors.

In the first nine months of fiscal 2013, our gross margin was negatively affected by the shift in product mix in favor of our physical-layer solutions, compared to the same period last year. In fact, sales of these products, which typically deliver lower margins than our protocol-layer solutions, represented a larger portion of our sales in the first nine months of fiscal 2013, compared to the same period last year. Namely, in the first nine months of fiscal 2013, we shipped large orders of our copper-access test solutions (included in our physical-layer solutions); that product line typically delivers lower margins.

In addition, a lower sales volume in the first nine months of fiscal 2013 compared to the same period last year resulted in a lower absorption of our fixed manufacturing costs, which resulted in a lower gross margin year-over-year.

Furthermore, in the first nine months of fiscal 2012, our warranty expenses were lower compared to the same period this year; this resulted in a positive impact on our gross margin in the first nine months of fiscal 2012.

Finally, increased pricing pressure in the first nine months of fiscal 2013, compared to the same period last year, had to some extent a negative impact on our gross margin year-over-year.

However, during the first nine months of fiscal 2013, a larger portion of our sales came from products manufactured in our facilities in China compared to the same period last year, thus offsetting in part the year-over-year decrease in our gross margin.

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

SELLING AND ADMINISTRATIVE EXPENSES

For the three months ended May 31, 2013, selling and administrative expenses were $22.0 million, or 37.4% of sales, compared to $23.6 million, or 39.7% of sales for the same period last year.

For the nine months ended May 31, 2013, selling and administrative expenses were $67.4 million, or 37.2% of sales, compared to $71.9 million, or 37.3% of sales for the same period last year.

In the third quarter and the first nine months of fiscal 2013, our selling and administrative expenses, especially salaries and benefits as well as travel expenses, decreased year-over-year due in part to the impact of our restructuring plan implemented in the fourth quarter of fiscal 2012.

In addition, in the third quarter and first nine months of fiscal 2013, commission expenses to our sales channels were lower compared to the same periods last year, due to a lower sales volume and a shift in mix of products and territories year-over-year.

Finally, in the third quarter of fiscal 2013, the year-over-year increase in the average value of the US dollar compared to the Canadian dollar and the euro had a positive impact on our selling and administrative expenses, as a portion of these expenses are incurred in these currencies and we report our results in US dollars.

For fiscal 2013, we expect our selling and administrative expenses to decrease as a percentage of sales and range between 36% and 37% of sales. However, any increase in the strength of the Canadian dollar and the euro versus the US dollar would cause our selling and administrative expenses to increase, as a significant portion of these expenses are incurred in these currencies and we report our results in US dollars.

RESEARCH AND DEVELOPMENT EXPENSES

Gross research and development expenses

For the three months ended May 31, 2013, gross research and development expenses totaled $13.8 million, or 23.4% of sales, compared to $15.6 million, or 26.2% of sales for the same period last year.

For the nine months ended May 31, 2013, gross research and development expenses totaled $41.8 million, or 23.1% of sales, compared to $45.2 million, or 23.4% of sales for the same period last year.

In the third quarter and the first nine months of fiscal 2013, our gross research and development expenses decreased year-over-year, especially salaries and benefits, due in part to the impact of our restructuring plan implemented in the fourth quarter of fiscal 2012.

In addition, in the third quarter and the first nine months of fiscal 2013, a shift in the mix and timing of research and development projects resulted in decreased gross research and development expenses compared to the same periods last year, mainly from consultants, subcontracting and material expenses.

Finally, in the third quarter of fiscal 2013, the year-over-year increase in the average value of the US dollar compared to the Canadian dollar, the euro and the Indian rupee had a positive impact on our gross research and development expenses, as most of these expenses are incurred in these currencies and we report our results in US dollars.

However, in the first nine months of in fiscal 2013, our gross research and development expenses included $89,000 in restructuring charges (nil in 2012).

Tax credits and grants

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

For the three months ended May 31, 2013, tax credits and grants for research and development activities were $2.2 million, or 16.0% of gross research and development expenses, compared to $2.4 million, or 15.4% of gross research and development expenses for the same period last year.

For the nine months ended May 31, 2013, tax credits and grants for research and development activities were $6.7 million, or 16.0% of gross research and development expenses, compared to $7.2 million, or 16.0% of gross research and development expenses for the same period last year.

In the third quarter and the first nine months of fiscal 2013, tax credits and grants decreased compared to the same periods last year mainly due to the decrease in our gross research and development expenses and mix of projects year-over-year.

For fiscal 2013, we expect our net research and development expenses to decrease as a percentage of sales to about 19% of sales. However, any increase in the strength of the Canadian dollar, the euro and the Indian rupee versus the US dollar in the upcoming quarters would cause our net research and development expenses to increase, as most of these expenses are incurred in these currencies and we report our results in US dollars.

AMORTIZATION OF INTANGIBLE ASSETS

For the three months ended May 31, 2013, amortization of intangible assets totaled $1.6 million, compared to $2.0 million for the same period last year. For the nine months ended May 31, 2013, amortization of intangible assets totaled $5.5 million, compared to $5.9 million for the same period last year.

The decrease in amortization expenses in the third quarter and the first nine months of fiscal 2013 compared to the same periods last year comes from the fact that core technologies related to the acquisition of Brix Networks Inc. became fully amortized during the third quarter of 2013.

FOREIGN EXCHANGE GAIN

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

For the three months ended May 31, 2013, we recorded a foreign exchange gain of $314,000 compared to $1.1 million for the same period last year.

For the nine months ended May 31, 2013, we recorded a foreign exchange gain of $2.8 million compared to $1.3 million for the same period last year.

During the third quarter of fiscal 2013, the period-end value of the Canadian dollar slightly decreased versus the US dollar, compared to the previous quarter, which resulted in a foreign exchange gain of $314,000 during that period. The period-end value of the Canadian dollar decreased 0.5% to CA$1.0368 = US$1.00 in the third quarter of fiscal 2013, compared to CA$1.0314 = US$1.00 at the end of the previous quarter.

During the same period last year, the period-end value of the Canadian dollar significantly decreased versus the US dollar, compared to the previous quarter, which resulted in a significant foreign exchange gain of $1.1 million during that period. The period-end value of the Canadian dollar decreased 4.4% to CA$1.0349 = US$1.00 in the third quarter of fiscal 2012, compared to CA$0.9895 = US$1.00 at the end of the previous quarter.

During the first nine months of fiscal 2013, the period-end value of the Canadian dollar significantly decreased versus the US dollar and the euro, compared to the previous year end, which resulted in a foreign exchange gain of $2.8 million during that period. Namely, the period-end value of the Canadian dollar decreased 4.9% to CA$1.0368 = US$1.00 in the first nine months of fiscal 2013, compared to CA$0.9863 = US$1.00 at the end of the previous year.

During the same period last year, the period-end value of the Canadian dollar also significantly decreased versus the US dollar, compared to August 31, 2011, which resulted in a significant foreign exchange gain during that period; in fact, the period-end value of the Canadian dollar decreased 5.5% to CA$1.0349 = US$1.00 in the first nine months of fiscal 2012, compared to CA$0.9784 = US$1.00 as at August 31, 2011. However, this gain was offset in part by a foreign exchange loss created by the increase of the period-end value of the Canadian dollar versus the euro, compared to the previous quarter. Overall, we reported a foreign exchange gain of $1.3 million during that period.

Foreign exchange rate fluctuations also flow through the P&L line items as a significant portion of cost of sales and our operating items are denominated in Canadian dollars, euros and Indian rupees, and we report our results in US dollars. Consequently, the increase in the average value of the US dollar in the third quarter of fiscal 2013, compared to these currencies year-over-year, resulted in a positive impact on our financial results. In fact, the average value of the US dollar in the third quarter of fiscal 2013 increased 2.2%, 0.6% and 2.6% respectively year-over-year, compared to the Canadian dollar, the euro and the Indian rupee.

INCOME TAXES

For the three months ended May 31, 2013, our income tax expenses totaled $901,000, compared to $540,000 for the same period last year.

For the nine months ended May 31, 2013, our income tax expenses amounted to $4.1 million, compared to $3.4 million for the same period last year.

For the three months ended May 31, 2013, we reported income tax expenses of $901,000 on a loss before income taxes of $39,000. For the nine months ended May 31, 2013, we reported income tax expenses of $4.1 million on earnings before income taxes of $1.7 million. This situation mainly resulted from the fact that we did not recognize deferred income tax assets for some of our subsidiaries at loss and we had some non-deductible loss and expenses, such as stock-based compensation costs. However, a significant portion of our foreign exchange gain was created by the translation of financial statements of our foreign operations, and was therefore non-taxable. Otherwise, the actual tax rate would have been closer to the combined Canadian and provincial statutory tax rate of 27% for these periods.

For the three months ended May 31, 2012, we reported income tax expenses of $540,000 on a loss before income taxes of $3.2 million. For the nine months ended May 31, 2012, we reported income tax expenses of $3.4 million on earnings before income taxes of $3.5 million. This situation mainly resulted from the fact that we did not recognize deferred income taxes for some of our subsidiaries at loss and we had some non-deductible loss and expenses, such as stock-based compensation costs. However, a significant portion of our foreign exchange gain was created by the translation of financial statements of our foreign operations, and was therefore non-taxable. Finally, during the first nine months of fiscal 2012, we recognized previously unrecognized deferred income tax assets of one of our subsidiaries, which resulted in a one-time income tax recovery of $557,000, which reduced our income tax expense for that period. Otherwise, the actual tax rate would have been closer to the combined Canadian and provincial statutory tax rate of 28% for these periods.

Please refer to note 6 to our condensed interim consolidated financial statements for a full reconciliation of our income tax provision.

LIQUIDITY AND CAPITAL RESOURCES

Cash requirements and capital resources

As at May 31, 2013, cash and short-term investments totaled $54.8 million, while our working capital was at $109.1 million. Our cash and short-term investments decreased $1.6 million in the third quarter of fiscal 2013, compared to the previous quarter. During the third quarter of fiscal 2013, we made cash payments of $1.5 million and $1.2 million respectively for the purchase of capital assets and the redemption of share capital pursuant to our share repurchase program. In addition, we recorded an unrealized foreign exchange loss on our cash and short-term investments of $0.2 million. This unrealized foreign exchange loss resulted from the translation, in US dollars, of our Canadian-dollar-denominated cash and short-term investments and was included in the accumulated other comprehensive income in the balance sheet. However, operating activities generated $1.3 million in cash, which offset in part the decrease in cash and short-term investment compared to the previous quarter.

Our short-term investments consist of a banker acceptance issued by a high-credit quality corporation; therefore, we consider the risk of non-performance of this financial instrument to be limited. This debt instrument is not expected to be affected by a significant liquidity risk. For the purpose of managing our cash position, we have established a cash management policy, which we follow and monitor on a regular basis. Our cash and short-term investments will be used for working capital and other general corporate purposes, any other potential acquisition, as well as our share repurchase program. As at May 31, 2013, cash balances included an amount of $33.7 million that bears interest at a rate of 1.45%.

We believe that our cash balances and short-term investments will be sufficient to meet our liquidity and capital requirements for the foreseeable future, including the effect of our normal course issuer bid. In addition to these assets, we have unused available lines of credit totaling $15.6 million for working capital and other general corporate purposes, and unused lines of credit of $23.3 million for foreign currency exposure related to forward exchange contracts. However, possible operating losses, additional restructuring costs and/or possible investments in or acquisitions of complementary businesses, products or technologies may require additional financing. There can be no assurance that additional debt or equity financing will be available when required or, if available, that it can be secured on satisfactory terms.

Sources and uses of cash

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

Operating activities

Cash flows provided by operating activities were $1.3 million for the three months ended May 31, 2013, compared to $2.8 million for the same period last year.

Cash flows used by operating activities were $1.4 million for the nine months ended May 31, 2013, compared to cash flows provided of $23.0 million for the same period last year.

Cash flows provided by operating activities in the third quarter of fiscal 2013 were attributable to the net earnings after items not affecting cash of $4.5 million offset in part by the negative net change in non-cash operating items of $3.2 million; this was mainly due to the negative effect on cash of the increase of $4.6 million in our accounts receivable due to the timing of sales during the quarter as well as the negative effect on cash of the increase of $804,000 in our prepaid expenses due to the timing of payments during the quarter. These negative effects on cash were offset in part by the positive effect on cash of the decrease of $985,000 in our income taxes and tax credits as, during the quarter, we cashed tax credits earned in previous periods as well as the positive effect on cash of the increase of $1.6 million in our accounts payable, accrued liabilities and provisions due to timing of purchases and payments during the quarter.

Cash flows used by operating activities in the first nine months of fiscal 2013 were attributable to the net earnings after items not affecting cash of $10.3 million more than offset by the negative net change in non-cash operating items of $11.7 million; this was mainly due to the negative effect on cash of the increase of $10.7 million in our accounts receivable due to the timing of sales during the period, the negative effect on cash of the increase of $2.2 million in our income tax and tax credits recoverable due to tax credits earned during the period not yet recovered as well as the negative effect on cash of the increase of $859,000 in our prepaid expenses due to timing of payments during the period. These negative effects on cash were offset in part by the positive effect on cash of the decrease of $791,000 in our inventories due to an improved inventory turn during the period as well as the positive effect on cash of the increase of $1.5 million in our accounts payable, accrued liabilities and provisions due to timing of purchases and payments during the period.

Investing activities

Cash flows used by investing activities were $1.5 million for the three months ended May 31, 2013, compared to $9.9 million for the same period last year.

Cash flows used by investing activities were $2.9 million for the nine months ended May 31, 2013, compared to cash flows provided of $18.9 million for the same period last year.

In the third quarter of fiscal 2013, we paid $1.5 million for the purchase of capital assets.

In the first nine months of fiscal 2013, we paid $5.9 million for the purchase of capital assets but we disposed (net of acquisitions) of $3.0 million worth of short-term investments.

Financing activities

Cash flows used by financing activities were $1.2 million for the three months ended May 31, 2013, compared to cash flows provided of $43,000 for the same period last year.

Cash flows used by financing activities were $2.5 million for the nine months ended May 31, 2013, compared to $1.6 million for the same period last year.

In the third quarter of fiscal 2013, we redeemed share capital for a cash consideration of $1.2 million.

In the first nine months of fiscal 2013, we repaid $293,000 of our long-term debt and redeemed share capital for a cash consideration of $2.3 million. However, we received $87,000 from the exercise of stock options.

FORWARD EXCHANGE CONTRACTS

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

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

As at May 31, 2013, we held forward exchange contracts to sell US dollars at various forward rates, which are summarized as follows:

Expiry dates	Contractual amounts	Weighted average contractual forward rates
June 2013 to August 2013	$ 5,700,000	1.0317
September 2013 to August 2014	18,600,000	1.0243
September 2014 to February 2015	6,600,000	1.0401
Total	$ 30,900,000	1.0290

The carrying amount of forward exchange contracts is equal to fair value, which is based on the amount at which they could be settled based on estimated current market rates. The fair value of forward exchange contracts amounted to net gains of $932,000 as at August 31, 2012 and net losses of $416,000 as at May 31, 2013. The quarter-end exchange rate was CA$1.0368 = US$1.00 as at May 31, 2013.

SHARE CAPITAL

Share capital

As at June 26, 2013, EXFO had 31,643,000 multiple voting shares outstanding, entitling to 10 votes each and 28,575,739 subordinate voting shares outstanding. The multiple voting shares and the subordinate voting shares are unlimited as to number and without par value.

OFF-BALANCE SHEET ARRANGEMENTS

As at May 31, 2013, our off-balance sheet arrangements consisted of letters of guarantee amounting to $5.0 million; these letters of guarantee expire at various dates through fiscal 2017. From this amount, we had $0.6 million worth of letters of guarantee for our own selling and purchasing requirements, which were for the most part reserved from one of our lines of credit. The remainder, in the amount of $4.4 million, was used to secure our line of credit in CNY (Chinese currency) of $4.0 million plus any accrued interest. This line of credit was unused as at May 31, 2013.

SPECIAL PURPOSES ENTITIES

As at May 31, 2013, we did not have interests in any special purposes entities.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

For a description of the critical accounting policies and estimates used in the preparation of our consolidated financial statements, refer to our Annual Report on Form 20-F for the year ended August 31, 2012 filed with the U.S. Securities and Exchange Commission and the Canadian securities commissions.

NEW IFRS PRONOUNCEMENTS AND AMENDMENTS

Refer to note 2 to our condensed interim consolidated financial statements for the three months and nine months ended May 31, 2013 and to our consolidated financial statements for the year ended August 31, 2012 for the effect of certain recent accounting pronouncements on our consolidated financial statements.

RISK FACTORS

There have been no material changes from the risk factors disclosed in our Annual Report in Form 20-F for the year ended August 31, 2012.

NON-IFRS MEASURES

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

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

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

** Adjusted EBITDA represents net earnings (loss) before interest, income taxes, depreciation of property, plant and equipment, amortization of intangible assets, restructuring charges, changes in the fair value of the cash contingent consideration, stock-based compensation costs and foreign exchange gain.

The following table summarizes the reconciliation of adjusted EBITDA to IFRS net earnings (loss), in thousands of US dollars:

Adjusted EBITDA

	Three months ended May 31, 2013	**Three months ended May 31, 2012**	**Nine months ended May 31, 2013**	**Nine months ended May 31, 2012**
IFRS net earnings (loss) for the period	**$ (862)**	$ (3,720)	**$ (2,461)**	$ 121
Add (deduct):				
Depreciation of property, plant and equipment	**1,473**	1,520	**4,582**	4,634
Amortization of intangible assets	**1,586**	1,993	**5,470**	5,888
Interest income	**(68)**	(85)	**(76)**	(68)
Income taxes	**901**	540	**4,121**	3,412
Restructuring charges	**–**	–	**89**	–
Changes in fair value of cash contingent consideration	**–**	–	**–**	(311)
Stock-based compensation costs	**415**	370	**1,331**	1,433
Foreign exchange gain	**(314)**	(1,090)	**(2,770)**	(1,283)
Adjusted EBITDA for the period	**$ 3,131**	$ (472)	**$ 10,286**	$ 13,826
Adjusted EBITDA in percentage of sales	**5.3%**	(0.8)%	**5.7%**	7.2%

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

	Quarters ended			
	May 31, 2013	**February 28, 2013**	**November 30, 2012**	**August 31, 2012**
Sales	$ 58,865	$ 62,576	$ 59,821	$ 57,156
Cost of sales [1]	$ 22,574	$ 23,664	$ 23,657	$ 21,257
Earnings (loss) from operations	$ (343)	$ 452	$ (1,295)	$ (1,678)
Net earnings (loss)	$ (862)	$ 39	$ (1,638)	$ (3,714)
Basic and diluted net earnings (loss) per share	$ (0.01)	$ 0.00	$ (0.03)	$ (0.06)

	Quarters ended			
	May 31, 2012	**February 29, 2012**	**November 30, 2011**	**August 31, 2011**
Sales	$ 59,505	$ 66,917	$ 66,388	$ 64,414
Cost of sales [1]	$ 23,549	$ 23,616	$ 23,370	$ 23,447
Earnings (loss) from operations	$ (4,355)	$ 4,109	$ 2,428	$ 5,878
Net earnings (loss)	$ (3,720)	$ 954	$ 2,887	$ 4,597
Basic and diluted net earnings (loss) per share	$ (0.06)	$ 0.02	$ 0.05	$ 0.08

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