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 statements that refer 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, macroeconomic 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; consolidation in the global telecommunications test, service assurance and network visibility markets and increased competition among vendors; capacity to adapt our future product offering to future technological changes; limited visibility with regards to the timing and nature of customer orders; delay in revenue recognition due to longer sales cycles for complex systems involving customers' acceptance; fluctuating exchange rates; 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. This discussion and analysis should be read in conjunction with the consolidated financial statements.

The following discussion and analysis of financial condition and results of operations is dated June 29, 2016.

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

COMPANY OVERVIEW AND RECENT DEVELOPMENTS

We provide communications service providers (CSPs) with test orchestration and performance intelligence solutions to ensure the smooth deployment, maintenance and management of next-generation physical, virtual, fixed and mobile networks. We have also forged strong relationships with network equipment manufacturers (NEMs) to develop deep expertise that migrates from the lab to the field and beyond. Our key differentiation comes from combining intelligent, automated and cloud-based test and monitoring solutions with real-time analytics to deliver unmatched end-to-end visibility and assurance—from a network, services and end-user level.

Our original products were focused on the needs of installers and operators of fiber-optic networks. Customers use these field-portable test solutions for the installation, maintenance and troubleshooting of optical networks. Over the past several years, we have enhanced our competitive position in telecommunications test, service assurance and network visibility markets through acquisitions of transport and datacom, copper/xDSL (digital subscriber lines) and wireless test companies, an IP (internet protocol) service assurance business as well as an analytics software company.

We target high-growth market opportunities related to increasing bandwidth and improving quality of experience on network infrastructures: 4G/LTE (long-term evolution), wireless backhaul, small cells and distributed antenna systems (DAS), 100G network upgrades and fiber-to-the-home (FTTH)/fiber-to-the-curb (FTTC)/fiber-to-the-node (FTTN) deployments.

We launched four key new solutions during the third quarter of 2016, including the LTB-8, a multi-module test platform dedicated to high-speed testing in lab and manufacturing environments; a 100G Power Blazer test module that can be swapped between the LTB-8 and FTB-2 Pro platforms to ease the transition between lab and field testing; and we added two 100G portable testers to our NetBlazer product family in order to address growing turn-up and troubleshooting requirements for metro networks and data center interconnects (DCIs).

Our sales increased 5.4% to $60.9 million in the third quarter of fiscal 2016 compared to $57.8 million for the same period last year. Bookings slightly increased 0.8% to $59.7 million in the third quarter of fiscal 2016, for a book-to-bill ratio of 0.98, from $59.2 million for the same period last year.

Net earnings amounted to $0.9 million, or $0.02 per diluted share, in the third quarter of fiscal 2016, compared to $0.6 million, or $0.01 per diluted share, for the same period last year. Net earnings for the third quarter of fiscal 2016 included $0.3 million in after-tax amortization of intangible assets, $0.4 million in stock-based compensation costs and a foreign exchange loss of $1.0 million. For the same period last year, net earnings included $0.4 million in after-tax amortization of intangible assets, $0.4 million in stock-based compensation costs and a foreign exchange loss of $0.2 million.

Adjusted EBITDA (net earnings before interest, income taxes, depreciation and amortization, stock-based compensation costs and foreign exchange gain or loss) reached $5.3 million, or 8.7% of sales, in the third quarter of fiscal 2016, compared to $4.5 million, or 7.7% of sales for the same period last year. See page 15 in this document for a complete reconciliation of adjusted EBITDA to IFRS net earnings.

On March 29, 2016, 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 approximately 6.6% (0.9 million subordinate voting shares) of the public float of 13.6 million subordinate voting shares (as defined by the Toronto Stock Exchange (TSX)), as of March 21, 2016, at the prevailing market price. We expect to use cash, short-term investments or future cash flows from operations to fund the repurchase of shares. The normal course issuer bid started on April 1, 2016, and will end on March 31, 2017, 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 will be cancelled.

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, 2016	Three months ended May 31, 2015	**Nine months ended May 31, 2016**	Nine months ended May 31, 2015
Sales	**$ 60,896**	$ 57,781	**$ 169,725**	$ 165,495
Cost of sales (1)	**23,880**	22,281	**62,921**	63,064
Selling and administrative	**20,798**	20,489	**60,615**	61,689
Net research and development	**11,303**	10,923	**31,398**	33,087
Depreciation of property, plant and equipment	**958**	1,163	**2,857**	3,664
Amortization of intangible assets	**294**	444	**880**	2,561
Interest and other (income) expense	**(309)**	36	**(716)**	(216)
Foreign exchange (gain) loss	**957**	175	**(454)**	(4,787)
Earnings before income taxes	**3,015**	2,270	**12,224**	6,433
Income taxes	**2,096**	1,707	**5,576**	3,458
Net earnings for the period	**$ 919**	$ 563	**$ 6,648**	$ 2,975
Basic and diluted net earnings per share	**$ 0.02**	$ 0.01	**$ 0.12**	$ 0.05
Other selected information:				
Gross margin before depreciation and amortization (2)	**$ 37,016**	$ 35,500	**$ 106,804**	$ 102,431
Research and development:				
Gross research and development	**$ 12,612**	$ 12,462	**$ 35,363**	$ 37,947
Net research and development	**$ 11,303**	$ 10,923	**$ 31,398**	$ 33,087
Adjusted EBITDA (2)	**$ 5,301**	$ 4,462	**$ 15,867**	$ 8,817

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

(2) Refer to page 15 for non-IFRS measures.

	Three months ended May 31, 2016	Three months ended May 31, 2015	Nine months ended May 31, 2016	Nine months ended May 31, 2015
Sales	**100.0 %**	100.0 %	**100.0 %**	100.0 %
Cost of sales (1)	**39.2**	38.6	**37.1**	38.1
Selling and administrative	**34.2**	35.5	**35.7**	37.3
Net research and development	**18.6**	18.9	**18.5**	20.0
Depreciation of property, plant and equipment	**1.5**	2.0	**1.7**	2.2
Amortization of intangible assets	**0.5**	0.8	**0.5**	1.5
Interest and other (income) expense	**(0.5)**	–	**(0.4)**	(0.1)
Foreign exchange (gain) loss	**1.5**	0.3	**(0.3)**	(2.9)
Earnings before income taxes	**5.0**	3.9	**7.2**	3.9
Income taxes	**3.5**	2.9	**3.3**	2.1
Net earnings for the period	**1.5 %**	1.0 %	**3.9 %**	1.8 %

Other selected information:

Gross margin before depreciation and amortization (2)	**60.8 %**	61.4 %	**62.9 %**	61.9 %
Research and development:				
Gross research and development	**20.7 %**	21.6 %	**20.8 %**	22.9 %
Net research and development	**18.6 %**	18.9 %	**18.5 %**	20.0 %
Adjusted EBITDA (2)	**8.7 %**	7.7 %	**9.3 %**	5.3 %

(1) The cost of sales is exclusive of depreciation and amortization, shown separately.
(2) Refer to page 15 for non-IFRS measures.

RESULTS OF OPERATIONS

SALES AND BOOKINGS

The following tables summarize sales and bookings by product line in thousands of US dollars:

Sales

	Three months ended May 31, 2016	Three months ended May 31, 2015	Nine months ended May 31, 2016	Nine months ended May 31, 2015
Physical-layer product line	**$ 42,074**	$ 38,167	**$ 112,133**	$ 109,074
Protocol-layer product line	**19,260**	20,492	**59,879**	58,191
	61,334	58,659	**172,012**	167,265
Foreign exchange losses on forward exchange contracts	**(438)**	(878)	**(2,287)**	(1,770)
Total sales	**$ 60,896**	$ 57,781	**$ 169,725**	$ 165,495

Bookings

	Three months ended May 31, 2016	Three months ended May 31, 2015	Nine months ended May 31, 2016	Nine months ended May 31, 2015
Physical-layer product line	**$ 41,797**	$ 38,534	**$ 115,549**	$ 109,151
Protocol-layer product line	**18,389**	21,593	**64,662**	60,762
	60,186	60,127	**180,211**	169,913
Foreign exchange losses on forward exchange contracts	**(438)**	(878)	**(2,287)**	(1,770)
Total bookings	**$ 59,748**	$ 59,249	**$ 177,924**	$ 168,143

For the three months ended May 31, 2016, our sales increased 5.4% to $60.9 million, from $57.8 million for the same period last year, while our bookings slightly increased 0.8% to $59.7 million, from $59.2 million for the same period last year, for a book-to-bill ratio of 0.98.

For the nine months ended May 31, 2016, our sales increased 2.6% to $169.7 million, from $165.5 million for the same period last year, while our bookings increased 5.8% to $177.9 million, from $168.1 million for the same period last year, for a book-to-bill ratio of 1.05.

Sales

In the third quarter of fiscal 2016, the year-over-year sales increase in our Physical-layer product line is mainly due to our leadership position in portable optical testing and a 100G investment cycle among communications service providers (CSPs), especially in the Americas. On the other hand, our Protocol-layer product line reported a year-over-year sales decrease since longer-than-expected sales cycles for systems-related solutions postponed some deals after the end of the third quarter. Our transport and datacom product line mitigated this negative impact with year-over-year sales growth as this sub-group within our Protocol-layer product line also benefited from the 100G investment cycle.

On a year-to-date basis, despite strong sales results in the first nine months of fiscal 2016, we faced a significant headwind from a stronger US dollar compared to the same last year. Given that we generate a portion of our revenue in Canadian dollars (Americas) and in euros (Europe, Middle East and Africa [EMEA]) but report our results in US dollars, it had a negative impact on our total sales and bookings year-over-year, as the US dollar increased against these currencies. In fact, for the first nine months of fiscal 2016, our total sales would have increased by approximately 5% and our total bookings would have increased by approximately 8% year-over-year in constant currencies.

In the first nine months of fiscal 2016, both product lines delivered year-over-year increases in sales, despite the negative currency impact. Overall, the year-over-year increase in sales in the first nine months of fiscal 2016 comes from the Americas, as sales to EMEA slightly decreased and sales to the Asia-Pacific (APAC) region were flat.

Bookings

In the third quarter of fiscal 2016, we delivered robust 8.5% year-over-year increases in bookings for our physical-layer product line, especially in the EMEA and APAC regions. These strong results were offset in part by a year-over-year decrease in bookings for our protocol-layer product line, which decreased 14.8% year-over-year, especially in the Americas. As we evolve from a supplier of dedicated test instruments to a supplier of end-to-end solutions, our quarterly sales and bookings are increasingly subject to quarterly fluctuations, because we are managing more complex, multi-million dollar deals that have prolonged sales and revenue recognition cycles related to our protocol-layer products. In the third quarter of fiscal 2016, a longer than expected sales cycle resulted in some deals postponed to after the quarter, mainly in the Americas.

In the first nine months of fiscal 2016, we delivered solid year-over-year increases in bookings for our two product lines, despite the negative currency impact. The year-over-year increase in bookings was manifested through heightened penetration of mobile network operators for their fronthaul and backhaul networks, increased traction with fixed network operators for their 100G long-haul and metro links, and growing business with web-scale operators for their data center interconnects. In addition, in the second quarter of 2016, we received significant orders from two network operators in the Americas for our EXFO Xtract solution, which resulted in increased bookings for our protocol-layer product line year-over-year. Overall, in the first nine months of fiscal 2016, we reported year-over-year increases in bookings in every geographic area, with robust growth in EMEA and APAC, and modest growth in the Americas.

We delivered book-to-bill ratios of 0.98 and 1.05 for the third quarter and the first nine months of fiscal 2016 respectively.

Sales by geographic region

The following table summarizes sales by geographic region:

	Three months ended May 31, 2016	Three months ended May 31, 2015	Nine months ended May 31, 2016	Nine months ended May 31, 2015
Americas	59 %	58 %	55 %	53 %
EMEA	22	23	25	27
APAC	19	19	20	20
	100 %	100 %	100 %	100 %

Customer concentration

We sell our products to a broad range of customers, including fixed and mobile network operators, web-scale service providers as well as equipment manufacturers. In the third quarters of fiscal 2015 and 2016, no customer accounted for more than 10% of our sales, and our top three customers accounted for 15.7% and 14.7% of sales respectively. In the first nine months of fiscal 2015 and 2016, no customer accounted for more than 10% of our sales, and our top three customers accounted for 12.8% and 14.2% of our sales respectively.

GROSS MARGIN BEFORE DEPRECIATION AND AMORTIZATION
(non-IFRS measure — refer to page 15 of this document)

Gross margin before depreciation and amortization (gross margin) decreased to 60.8% of sales for the three months ended May 31, 2016, from 61.4% for the same period last year.

Gross margin increased to 62.9% of sales for the nine months ended May 31, 2016, from 61.9% for the same period last year.

In the third quarter of fiscal 2016, our gross margin was unfavorably affected by our product mix. In fact, the year-over-year increase in sales comes from our physical-layer product line, which delivers lower margins compared to our protocol-layer product line, which has richer software content. In addition, an unfavorable product mix within our physical-layer product line, reduced our gross margin year-over-year.

On the other hand, in the third quarter of fiscal 2016, we recorded lower inventory write-off compared to the same period last year, which contributed to increase our gross margin by 0.9% year-over-year.

In addition, in the third quarter of fiscal 2016, we recorded in our sales foreign exchange losses of $0.4 million on our forward exchange contracts, which were lower compared to $0.9 million for the same period last year; this contributed to increase our gross margin by 0.3% year-over-year.

Finally, in the third quarter of fiscal 2016, a stronger US dollar compared to other currencies reduced our manufacturing costs and had a positive impact on our gross margin year-over-year.

In the first nine months of fiscal 2016, our gross margin was favorably affected by a richer product mix within our protocol-layer product line. Namely, year-over-year sales increases for our transport and datacom (T&D) products, as well as the recognition of a large order with a tier-1 network operator for our EXFO Xtract software analytics solution, had a positive impact on our gross margin during the first nine months of fiscal 2016, compared to the same period last year; this was offset in part by an unfavorable product mix within our physical-layer product line year-over-year.

In addition, in the first nine months of fiscal 2016, we recorded lower inventory write-off compared to the same period last year, which contributed to increase our gross margin by 0.7% year-over-year.

Finally, in the first nine months of fiscal 2016, a stronger US dollar compared to other currencies reduced our manufacturing costs and had a positive impact on our gross margin year-over-year.

SELLING AND ADMINISTRATIVE EXPENSES

For the three months ended May 31, 2016, selling and administrative expenses were $20.8 million, or 34.2% of sales, compared to $20.5 million, or 35.5% of sales for the same period last year.

For the nine months ended May 31, 2016, selling and administrative expenses were $60.6 million, or 35.7% of sales, compared to $61.7 million, or 37.3% of sales for the same period last year.

In the third quarter of fiscal 2016, our selling and administrative expenses increased year-over-year due to higher expenses on higher sales, as well as inflation and salary increases. These elements were offset in part by the positive impact of the increase in the average value of the US dollar compared to the Canadian dollar year-over-year, as a portion of our selling and administrative expenses are incurred in Canadian dollars and we report our results in US dollars.

In the first nine months of fiscal 2016, our selling and administrative expenses decreased due to the increase in the average value of the US dollar compared to the Canadian dollar and the euro year-over-year, as a portion of our selling and administrative expenses are incurred in Canadian dollars and euros, and we report our results in US dollars, and the positive impact of our latest restructuring plan, which more than offset inflation, salary increases, and increased commission expenses on increased sales.

In the third quarter and the first nine months of fiscal 2016, our selling and administrative expenses decreased as a percentage of sales compared to the same periods last year; this is because our sales increased year-over-year and a large portion of these expenses are relatively fixed in the short term.

RESEARCH AND DEVELOPMENT EXPENSES

Gross research and development expenses

For the three months ended May 31, 2016, gross research and development expenses totaled $12.6 million, or 20.7% of sales, compared to $12.5 million, or 21.6% of sales, for the same period last year.

For the nine months ended May 31, 2016, gross research and development expenses totaled $35.4 million, or 20.8% of sales, compared to $37.9 million, or 22.9% of sales, for the same period last year.

In the third quarter of fiscal 2016, our gross research and development expenses increased year-over-year due to a shift in the mix and timing of research and development projects, compared to the same period last year, as well as inflation and salary increases; these elements were offset in part by the positive impact of the increase in the average value of the US dollar compared to the Canadian dollar year-over-year, as a portion of our gross research and development expenses are incurred in Canadian dollars and we report our results in US dollars.

In the first nine months of fiscal 2016, 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 gross research and development expenses as a large portion of these expenses are incurred in Canadian dollars and euros, and we report our results in US dollars. However, these positive impacts year-over-year were offset in part by inflation, salary increases, as well as a shift in the mix and timing of research and development projects, compared to the same period last year.

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 for grants issued by a Finnish technology organization on certain research and development projects conducted in Finland.

For the three months ended May 31, 2016, tax credits and grants for research and development activities were $1.3 million, or 10.4% of gross research and development expenses, compared to $1.5 million, or 12.3% of gross research and development expenses for the same period last year.

For the nine months ended May 31, 2016, tax credits and grants for research and development activities were $4.0 million, or 11.2% of gross research and development expenses, compared to $4.9 million, or 12.8% of gross research and development expenses for the same period last year.

In the third quarter and the first nine months of fiscal 2016, the year-over-year decrease in our tax credits and grants mainly results from the increase in the average value of the US dollar, compared to the Canadian dollar year-over-year, as our tax credits are denominated in Canadian dollars and we report our results in US dollars.

DEPRECIATION OF PROPERTY, PLANT AND EQUIPMENT

For the three months ended May 31, 2016, depreciation of property, plant and equipment amounted to $1.0 million compared to $1.2 million for the same period last year.

For the nine months ended May 31, 2016, depreciation of property, plant and equipment amounted to $2.9 million compared to $3.7 million for the same period last year.

In the third quarter and the first nine months of fiscal 2016, the year-over-year increase in the average value of the US dollar compared to the Canadian dollar had a positive impact on our depreciation expenses as these expenses are incurred in Canadian dollars and we report our results in US dollars.

AMORTIZATION OF INTANGIBLE ASSETS

For the three months ended May 31, 2016, amortization of intangible assets amounted to $0.3 million compared to $0.4 million for the same period last year.

For the nine months ended May 31, 2016, amortization of intangible assets amounted to $0.9 million compared to $2.6 million for the same period last year.

The decrease in our amortization expenses in the third quarter and the first nine months of fiscal 2016, compared to the same period last years, is mainly due to the fact that core technology related to the acquisition of NetHawk Oyj (acquired in fiscal 2010) became fully amortized in the third quarter of fiscal 2015, and that the average value of the US dollar increased compared to the Canadian dollar year-over-year, as our amortization expenses is incurred in this currency and we report our results in US dollars.

FOREIGN EXCHANGE GAIN (LOSS)

Foreign exchange gains and losses are mainly the result of the translation of operating activities denominated in currencies other than our functional currency, which is the Canadian dollar. A portion of our foreign exchange gains or losses result from the translation of cash balances and deferred income taxes denominated in US dollars. We manage our exposure to currency risk in part with forward exchange contracts. In addition, some of our entities' operating activities are denominated in US dollars, euros and British pounds, which further hedges this risk. However, we remain exposed to a currency risk; 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, 2016, we recorded a foreign exchange loss of $1.0 million compared to $0.2 million for the same period last year.

For the nine months ended May 31, 2016, foreign exchange gain amounted to $0.5 million compared to $4.8 million for the same period last year.

During the third quarter of fiscal 2016, the period-end value of the Canadian dollar increased versus the US dollar, compared to the previous quarter, which resulted in a foreign exchange loss of $1.0 million during the quarter. In fact, the period-end value of the Canadian dollar increased 3.2% versus the US dollar to CAD$1.3110 = US$1.00 in the third quarter of fiscal 2016, compared to CAD$1.3531 = US$1.00 at the end of the previous quarter.

During the same period last year, the period-end value of the Canadian dollar slightly increased versus the US dollar, compared to the previous quarter, which resulted in a foreign exchange loss of $0.2 million during that period. The period-end value of the Canadian dollar increased 0.5% versus the US dollar to CAD$1.2437= US$1.00 in the third quarter of fiscal 2015, compared to CAD$1.2503 = US$1.00 at the end of the previous quarter.

During the first nine months of fiscal 2016, we witnessed some volatility in the value of the Canadian dollar as it fluctuated compared to the US dollar, which overall resulted in a foreign exchange gain of $0.5 million during that period. The period-end value of the Canadian dollar slightly increased 0.4% versus the US dollar to CAD$1.3110 = US$1.00 in the first nine months of fiscal 2016, compared to CAD$1.3157 = US$1.00 at the end of the previous year.

During the same period last year, the period-end value of the Canadian dollar significantly decreased versus the US dollar, compared to the previous year end, which resulted in a foreign exchange gain of $4.8 million during that period. The period-end value of the Canadian dollar decreased 12.7% versus the US dollar to CAD$1.2437 = US$1.00 in the first nine months of fiscal 2015, compared to CAD$1.0858 = US$1.00 at the end of the previous year.

Foreign exchange rate fluctuations also flow through the P&L line items as a portion of our sales, which are dominated in Canadian dollars and euros, and 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 compared to the Canadian dollar 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 2016 increased 4.8% year-over-year, compared to the Canadian dollar. In the first nine months of fiscal 2016, the increase in the average value of the US dollar compared to the Canadian dollar and the euro year-over-year, resulted in a positive impact on our financial results. In fact, during the first nine months of fiscal 2016, it increased 11.3% and 6.1% respectively year-over-year, compared to the Canadian dollar and the euro.

INCOME TAXES

For the three months ended May 31, 2016, we reported income tax expenses of $2.1 million on earnings before income taxes of $3.0 million. For the corresponding period last year, we reported income tax expenses of $1.7 million on earnings before income taxes of $2.3 million.

For the nine months ended May 31, 2016, we reported income tax expenses of $5.6 million on earnings before income taxes of $12.2 million. For the corresponding period last year, we reported income tax expenses of $3.5 million on earnings before income taxes of $6.4 million.

These distorted tax rates mainly resulted from the fact that we did not recognize deferred income tax assets for some of our subsidiaries at loss and had some non-deductible losses and expenses, such as stock-based compensation costs. In addition, a significant portion of our foreign exchange gain or loss was created by the translation of financial statements of our foreign subsidiaries into the functional currency, and was therefore non-taxable or non-deductible. Otherwise, our effective tax rate would have been closer to the combined Canadian and provincial statutory tax rate of 27% for both periods.

Please refer to note 7 to our condensed unaudited 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, 2016, cash and short-term investments totaled $46.3 million, while our working capital was at $84.6 million. Our cash and short-term investments increased by $1.9 million in the third quarter of fiscal 2016, compared to the previous quarter, mainly due to cash flows from operating activities of $2.3 million.

Our short-term investments consist of debt instruments issued by high-credit quality corporations; therefore, we consider the risk of non-performance of these financial instruments to be limited. These debt instruments are 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, potential acquisitions as well as our share repurchase program. As at May 31, 2016, cash balances included an amount of $25.0 million that bears interest at an annual rate of 1.2%.

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 $15.2 million for working capital and other general corporate purposes, and unused lines of credit of $20.7 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 $2.3 million for the three months ended May 31, 2016, compared to cash flows used of $1.3 million for the same period last year.

Cash flows provided by operating activities were $20.8 million for the nine months ended May 31, 2016, compared to $6.4 million for the same period last year.

Cash flows provided by operating activities in the third quarter of fiscal 2016 were attributable to the net earnings after items not affecting cash of $5.0 million, offset in part by the negative net change in non-cash operating items of $2.7 million. This was mainly due to the negative effect on cash of the increase of $5.9 million in our accounts receivable due to the sequential increase in sales, as well as the timing of receipts and sales during the quarter, the $0.3 million increase in our income tax and tax credits recoverable due to tax credits earned during the quarter not yet recovered, the $0.8 million increase in our inventories to meet future demand, and the $0.5 million increase in our prepaid expenses due to timing of payments during the quarter. These negative effects on cash were offset in part by the positive effect on cash of the $4.7 million increase in our accounts payable, accrued liabilities and provisions due to the timing of purchases and payments during the quarter.

Cash flows used by operating activities in the third quarter of fiscal 2015 were attributable to the net earnings after items not affecting cash of $3.9 million, which was more than offset by the $5.1 million negative net change in non-cash operating items. This was mainly due to the negative effect on cash of the increase of $6.5 million in our accounts receivable due to the sequential increase in sales as well as the timing of receipts and sales during the quarter, the negative effect on cash of the increase of $0.5 million in our income tax and tax credits recoverable due to tax credits earned during the quarter not yet recovered, and the negative effect on cash of the increase of $0.4 million in our prepaid expenses due to 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 $1.0 million in our inventories due to improved inventory turns and the positive effect on cash of the increase of $1.3 million in our accounts payable, accrued liabilities and provisions due to timing of purchases and payments during the quarter.

Cash flows provided by operating activities in the first nine months of fiscal 2016 were attributable to the net earnings after items not affecting cash of $17.3 million, and the positive net change in non-cash operating items of $3.5 million. This was mainly due to the positive effect on cash of the decrease of $3.4 million in our accounts receivable due to the timing of receipts and sales during the period, the $0.6 million decrease in our income tax and tax credits recoverable due to tax credits earned in previous periods recovered during the period, and the $6.4 million increase in our accounts payable, accrued liabilities and provisions due to the timing of purchases and payments during the period. These positive effects on cash were offset in part by the negative effect on cash of the $6.6 million increase in our inventories to meet future demand, and the negative effect on cash of the increase of $0.4 million in our prepaid expenses due to timing of payments during the period.

Cash flows provided by operating activities in the first nine months of fiscal 2015 were attributable to the net earnings after items not affecting cash of $9.0 million, offset in part by the negative net change in non-cash operating items of $2.7 million. This was mainly due to the positive effect on cash of the increase of $9.0 million in our accounts payable, accrued liabilities and provisions due to timing of purchases and payments during the period. This positive effect on cash was offset in part by the negative effect on cash of the increase of $7.8 million in our accounts receivable due to the timing of receipts and sales during the period, the negative effect on cash of the increase of $2.0 million in our income tax and tax credits recoverable due to tax credits earned during the period not yet recovered, the negative effect on cash of the increase of $1.0 million in our inventories to meet future demand, and the negative effect on cash of the increase of $0.9 million in our prepaid expenses due to timing of payments during the period.

Investing activities

Cash flows used by investing activities were $4.2 million for the three months ended May 31, 2016, compared to $0.2 million for the same period last year.

Cash flows used by investing activities were $6.0 million for the nine months ended May 31, 2016, compared to $0.4 million for the same period last year.

In the third quarter of fiscal 2016, we acquired $3.1 million worth of short-term investment and we paid $1.1 million for the purchase of capital assets.

For the corresponding period last year, we paid $1.8 million for the purchase of capital assets but we disposed (net of acquisitions) of $1.6 million worth of short-term investments.

In the first nine months of fiscal 2016, we acquired (net of disposals) $2.6 million worth or short-term investments, and we paid $3.4 million for the purchase of capital assets.

For the corresponding period last year, we paid $4.6 million for the purchase of capital assets, but we disposed (net of acquisitions) of $4.2 million worth of short-term investments.

Financing activities

Cash flows used by financing activities were $0.2 million for the three months ended May 31, 2016, compared to $0.1 million for the same period last year.

Cash flows provided by financing activities were $0.1 million for the nine months ended May 31, 2016, compared to cash flows used of $25.2 million for the same period last year.

In the third quarter of fiscal 2016, we redeemed share capital under our share repurchase program for a cash consideration of $0.2 million.

In the first nine months of fiscal 2016, our bank loan increased by $0.5 million, but we redeemed share capital under our share repurchase program for a cash consideration of $0.4 million.

For the corresponding period last year, we redeemed share capital under our share repurchase programs (namely our substantial issuer bid) for a cash consideration of $25.2 million.

FORWARD EXCHANGE CONTRACTS

We are exposed to a currency risk as a result of our export sales of products manufactured in Canada, China and Finland, the majority of which are denominated in US dollars and euros. In addition, we are exposed to a currency risk as a result of our research and development activities in India (Indian rupees). These risks are partially hedged by forward exchange contracts. Forward exchange contracts, which are designated as cash flow hedging instruments, qualify for hedge accounting.

As at May 31, 2016, we held forward exchange 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
June 2016 to August 2016	$ 6,300,000	1.2142
September 2016 to August 2017	22,200,000	1.2784
September 2017 to August 2018	9,900,000	1.3367
September 2018 to December 2018	1,900,000	1.3639
Total	$ 40,300,000	1.2867

US dollars – Indian rupees

Expiry dates	Contractual amounts	Weighted average contractual forward rates
June 2016 to August 2016	$ 1,000,000	67.88
September 2016 to May 2017	2,600,000	70.82
	$ 3,600,000	70.00

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 $4.2 million as at August 31, 2015 and $0.6 million as at May 31, 2016, mainly for our US/Canadian dollars forward exchange contracts. The quarter-end exchange rate was CAD$1.3110 = US$1.00 as at May 31, 2016.

SHARE CAPITAL

As at June 29, 2016, EXFO had 31,643,000 multiple voting shares outstanding, each entitled to 10 votes per share, and 22,253,240 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, 2016, our off-balance sheet arrangements consisted of letters of guarantee amounting to $469,000 for our own selling and purchasing requirements, which were reserved from our lines of credit; these letters of guarantee expire at various dates through fiscal 2020.

STRUCTURED ENTITIES

As at May 31, 2016, we did not have interests in any structured entities.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

For a description of the critical accounting policies, judgments in applying accounting policies as well as estimates and assumptions used in the preparation of our consolidated financial statements, refer to our Annual Report on Form 20-F for the year ended August 31, 2015, filed with the U.S. Securities and Exchange Commission and the Canadian securities commissions.

NEW IFRS PRONOUNCEMENTS

Refer to note 2 to our condensed unaudited interim consolidated financial statements for the three and nine months ended May 31, 2016 and to our consolidated financial statements for the year ended August 31, 2015, for the effect of certain recent accounting pronouncements on our consolidated financial statements.

RISKS AND UNCERTAINTIES

For the first nine months of fiscal 2016, there have been no material changes from the risk factors disclosed in our Annual Report on Form 20-F for the year ended August 31, 2015.

NON-IFRS MEASURES

We provide non-IFRS measures (constant currency data, gross margin before depreciation and amortization and adjusted EBITDA) as supplemental information regarding our operational performance. We use these measures for the purpose of evaluating our historical and prospective financial performance, as well as our performance relative to our competitors. These measures also help us plan and forecast future periods as well as 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.

Constant currency data represents data before foreign currency impact. Data for the current period is translated using foreign exchange rates of the corresponding period from the preceding year.

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

Adjusted EBITDA represents net earnings before interest, income taxes, depreciation and amortization, stock-based compensation costs and foreign exchange gain or loss.

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

Adjusted EBITDA (unaudited)

	Three months ended May 31, 2016	Three months ended May 31, 2015	**Nine months ended May 31, 2016**	Nine months ended May 31, 2015
IFRS net earnings for the period	**$ 919**	$ 563	**$ 6,648**	$ 2,975
Add (deduct):				
Depreciation of property, plant and equipment	**958**	1,163	**2,857**	3,664
Amortization of intangible assets	**294**	444	**880**	2,561
Interest and other (income) expense	**(309)**	36	**(716)**	(216)
Income taxes	**2,096**	1,707	**5,576**	3,458
Stock-based compensation costs	**386**	374	**1,076**	1,162
Foreign exchange (gain) loss	**957**	175	**(454)**	(4,787)
Adjusted EBITDA for the period	**$ 5,301**	$ 4,462	**$ 15,867**	$ 8,817
Adjusted EBITDA in percentage of sales	**8.7%**	7.7%	**9.3%**	5.3%

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

	Quarters ended			
	May 31, 2016	**February 29, 2016**	**November 30, 2015**	**August 31, 2015**
Sales	$ 60,896	$ 53,597	$ 55,232	$ 56,594
Cost of sales [(1)]	$ 23,880	$ 18,904	$ 20,137	$ 21,975
Net earnings	$ 919	$ 3,963	$ 1,766	$ 2,323
Basic and diluted net earnings per share	$ 0.02	$ 0.07	$ 0.03	$ 0.04

	Quarters ended			
	May 31, 2015	**February 28, 2015**	**November 30, 2014**	**August 31, 2014**
Sales	$ 57,781	$ 50,990	$ 56,724	$ 59,742
Cost of sales [(1)]	$ 22,281	$ 19,546	$ 21,237	$ 22,109
Net earnings	$ 563	$ 931	$ 1,481	$ 1,204
Basic and diluted net earnings per share	$ 0.01	$ 0.02	$ 0.02	$ 0.02

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