Management's Discussion and Analysis of Financial Condition and Results of Operations (revised – January 9, 2017)

This amended management's discussion and analysis of the financial condition and results of operations ("MD&A") of EXFO Inc. should be read in conjunction with our revised consolidated financial statements and the notes thereto for the year ended August 31, 2016. Details of the revision are disclosed in Note 1, *Revision of Consolidated Financial Statements*, to our consolidated financial statements. This MD&A has been amended to reflect the impact of this revision.

During the first quarter of fiscal 2017, we identified errors in our previously issued consolidated financial statements relating to the overstatement of a single trade receivable account as further explained in our August 31, 2016 consolidated financial statements under Note 1, *Revision of Consolidated Financial Statements*. We evaluated the aggregate effects of the errors to our previously issued consolidated financial statements in accordance with IAS 8 - *Accounting Policies, Accounting Estimates and Errors ("IAS 8")*, as well as and in consideration of the guidance in SEC Staff Accounting Bulletins No. 99 and No. 108. Based upon quantitative and qualitative factors, we have determined that the errors were not material to our previously issued consolidated financial statements and disclosures in our Annual Report on Form 20-F for the year ended August 31, 2016. However, the cumulative effect of the errors may be significant to our financial results for the year ending August 31, 2017. Accordingly, we have revised our previously issued consolidated financial statements.

In conjunction with the errors described above, we have identified a material weakness in our internal control over financial reporting as of August 31, 2016, resulting in the improper aging of our trade account receivable ledger which led to an incorrect assessment of bad debt expense against a single trade receivable account. Specifically, we did not maintain sufficient controls over the trade accounts receivable ledger, which included failure to maintain appropriate segregation of duties and lack of supervisory review and monitoring of journal entries recorded to the trade accounts receivable ledger.

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 analytics solutions 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 January 9, 2017.

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

COMPANY OVERVIEW

We are a leading provider of next-generation test, service assurance and analytics solutions for fixed and mobile communications service providers (CSPs), web-scale operators as well as network equipment manufacturers in the global telecommunications industry. Our intelligent solutions with contextually relevant analytics are designed to improve end-user quality of experience, enhance network performance and drive operational efficiencies throughout the network and service delivery lifecycles. 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.

Our success has been largely predicated on our core expertise in developing test equipment for wireline networks. These solutions are available as handheld test instruments, portable platforms with related modules, and as rack-mounted chassis with related modules. Our PC-centric, open-ended platforms, combined with cloud-based software applications, can be transformed into a fully connected test environment that allows CSPs to automate complex, labor-intensive tasks like fiber-to-the-antenna (FTTA), DAS and small cell deployments. Leveraging platform connectivity, CSPs can also keep track of their entire test fleet, manage software updates and schedule calibration procedures. All test data be stored in a central database and used as a point of reference against future measurements. Consequently, this enhanced test environment enables customers to increase productivity and reduce operating expenses.

Over the years, we expanded our product portfolio into service assurance for next-generation IP (Internet protocol) networks and into test equipment for 2G, 3G and 4G/LTE wireless networks. Our service assurance solution, called the Brix System, is a probe-based hardware and software offering that delivers end-to-end, quality of service and quality of experience visibility as well as real-time, service monitoring and verification of next-generation IP networks. We have enriched our service assurance offering with infrastructure performance management tools and analytics software solutions via technology acquisitions. Built around a distributed architecture, the Brix System enables the successful launch and ongoing profitable operation of IP-based voice, video and data applications and services across wireline and wireless networks.

Our 2G, 3G and 4G/LTE test portfolio mainly consists of network simulators and protocol analyzers. Our network simulators simulate real-world, large-scale network traffic and end-user behavior in a laboratory environment in order to predict network behavior, uncover faults and optimize networks before wireless networks and services are deployed. Our protocol analyzers analyze mobile network elements in order to validate functionality according to wireless technology specifications, determine whether or not these elements interoperate with each other effectively when combined to form a network, and assess how well the live network performs.

The competitive advantages of our products include a high degree of innovation, modularity (especially wireline products) and ease of use. Ultimately, our products enable network equipment manufacturers, CSPs and web-scale operators to design, deploy, troubleshoot and monitor wireline and wireless networks and, in the process, help them reduce the cost of operating their networks.

We have a staff of approximately 1600 people in 25 countries, supporting more than 2000 customers in approximately 100 countries around the world. We operate three main manufacturing sites, which are located in Quebec City, Canada, in Shenzhen, China and in Oulu, Finland. We also have five main research and development expertise centers in Boston, Toronto, Montreal, Quebec City and Oulu, supported by a software development center in India.

We launched 15 new products or major enhancements in fiscal 2016. Key new product introductions included TestFlow, a unique cloud-based, field test automation solution simplifying and accelerating complex, labor-intensive deployment activities for home-broadband and wireless radio access networks (RAN); LTB-8 platform, a multi-module test and software-sharing automation suite accelerating high-speed optical testing in lab and manufacturing environments; a whole new family of optical time domain reflectometers (OTDRs), raising industry standards for technical specifications and time savings in characterizing optical networks; iSAM, an intelligent service activation software bringing speed and simplicity to testing Ethernet services; MaxTester-940 Fiber Certifier OLTS (optical loss test set) for data center and enterprise markets; and the telecom industry's first G.fast handheld test set for the roll out of ultra-broadband services on copper links.

Our sales increased 4.7% to $232.6 million in fiscal 2016 compared to $222.1 million in 2015, despite a headwind from a stronger US dollar versus other currencies. In fiscal 2016, in constant currency, our sales would have increased 6.0% year-over-year. Bookings increased 7.7% to $240.3 million in fiscal 2016 compared to $223.1 million in 2015, for a book-to-bill ratio of 1.03. In constant currency, bookings would have increased 9.0% year-over-year.

Net earnings amounted to $8.9 million, or $0.16 per diluted share in fiscal 2016, compared to $4.9 million, or $0.08 per diluted share, in fiscal 2015. Net earnings in fiscal 2016 included $1.1 million in after-tax amortization of intangible assets, $1.4 million in stock-based compensation costs, and a foreign exchange gain of $0.2 million. Net earnings in fiscal 2015 included $2.7 million in after-tax amortization of intangible assets, $1.3 million in after-tax restructuring charges, $1.3 million in stock-based compensation costs, after-tax unusual charge of $0.4 million, and a foreign exchange gain of $7.2 million.

Adjusted EBITDA (net earnings before interest, income taxes, depreciation and amortization, restructuring charges, stock-based compensation costs, unusual charge and foreign exchange gain) amounted to $22.0 million, or 9.5% of sales, in fiscal 2016, compared to $13.8 million, or 6.2% of sales, in 2015. See page 20 of this document for a complete reconciliation of adjusted EBITDA and 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% of the issued and outstanding subordinate voting shares, representing 0.9 million subordinate voting shares 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. In fiscal 2016, we redeemed for cancellation 0.5 million subordinate voting shares for a cash consideration of $1.6 million.

On October 31, 2016, we acquired substantially all the assets of Absolute Analysis Inc., a privately held company located in United States, supplying solutions for radio frequency testing of fiber-based radio access networks. This acquisition was settled for a total consideration of approximately $8.5 million, excluding acquisition-related costs. The consideration paid consisted of $5 million in cash and the issuance of 793,070 subordinate voting shares, valued at $3.5 million.

Sales

We sell our products to a diversified customer base in approximately 100 countries through our direct sales force and channel partners, such as sales representatives and distributors. Most of our sales are denominated in US dollars, euros and Canadian dollars.

In fiscal 2014, 2015 and 2016, no customer accounted for more than 10% of our sales, with our top customer representing 6.1%, 7.1% and 7.1% of our sales respectively.

We believe that we have a vast array of products, a diversified customer base, and a good spread across geographical areas, which provides us with reasonable protection against the concentration of sales and credit risk.

Cost of Sales

The cost of sales includes raw materials, salaries and related expenses for direct and indirect manufacturing personnel, as well as overhead costs. Excess, obsolete and scrapped materials are also included in the cost of sales. However, the cost of sales is presented exclusive of depreciation and amortization, which are shown separately in the statements of earnings.

Operating Expenses

We classify our operating expenses into three main categories: selling and administrative expenses, research and development expenses, as well as depreciation and amortization expenses.

Selling and administrative expenses consist primarily of salaries and related expenses for personnel, sales commissions, travel expenses, marketing programs, professional services, information systems, human resources and other corporate expenses. Selling and administrative expenses excludes, however, the unusual charge relating to the adjustment to bad debt expense arising from the revision described in Note 1 to the consolidated financial statements.

Gross research and development expenses consist primarily of salaries and related expenses for engineers and other technical personnel, material component costs as well as fees paid to third-party consultants. We are eligible to receive research and development tax credits and grants on research and development activities carried out in Canada and Finland. All related research and development tax credits and grants are recorded as a reduction of gross research and development expenses.

RESULTS OF OPERATIONS

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

Consolidated statements of earnings data [1]:	**2016**	2015	2014	**2016**	2015	2014
Sales	**$ 232,583**	$ 222,089	$ 230,806	**100.0 %**	100.0 %	100.0 %
Cost of sales [2]	**87,066**	85,039	86,836	**37.4**	38.3	37.6
Selling and administrative [3]	**82,169**	82,200	86,429	**35.3**	37.0	37.4
Net research and development	**42,687**	44,003	44,846	**18.4**	19.8	19.4
Depreciation of property, plant and equipment	**3,814**	4,835	4,995	**1.6**	2.2	2.2
Amortization of intangible assets	**1,172**	2,883	4,398	**0.5**	1.3	1.9
Interest and other income	**(828)**	(155)	(326)	**(0.4)**	(0.1)	(0.1)
Foreign exchange gain	**(161)**	(7,212)	(1,634)	**–**	(3.2)	(0.7)
Unusual charge [3]	**–**	603	720	**–**	0.3	0.3
Earnings before income taxes	**16,664**	9,893	4,542	**7.2**	4.4	2.0
Income taxes	**7,764**	5,036	4,286	**3.4**	2.2	1.9
Net earnings for the year	**$ 8,900**	$ 4,857	$ 256	**3.8 %**	2.2 %	0.1 %
Basic net earnings per share	**$ 0.17**	$ 0.09	$ 0.00			
Diluted net earnings per share	**$ 0.16**	$ 0.08	$ 0.00			
Other selected information:						
Gross margin before depreciation and amortization [4]	**$ 145,517**	$ 137,050	$ 143,970	**62.6 %**	61.7 %	62.4 %
Research and development data:						
Gross research and development	**$ 47,875**	$ 50,148	$ 52,423	**20.6 %**	22.6 %	22.7 %
Net research and development	**$ 42,687**	$ 44,003	$ 44,846	**18.4 %**	19.8 %	19.4 %
Restructuring charges included in:						
Cost of sales	**$ –**	$ 290	$ –	**– %**	0.1 %	– %
Selling and administrative expenses	**$ –**	$ 586	$ –	**– %**	0.3 %	– %
Net research and development expenses	**$ –**	$ 761	$ –	**– %**	0.3 %	– %
Adjusted EBITDA [4]	**$ 22,039**	$ 13,779	$ 14,391	**9.5 %**	6.2 %	6.2 %
Consolidated balance sheets data [1]:						
Total assets	**$ 237,793**	$ 217,478	$ 276,948			

(1) Consolidated statements of earnings and balance sheets data has been derived from our consolidated financial statements prepared according with IFRS, as issued by the IASB, except for non-IFRS measures [4].

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

(3) Selling and administrative is exclusive of unusual charge, shown separately, which represents bad debt expenses arising from the revision (see Note 1 to the consolidated financial statements).

(4) Refer to page 20 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

	Years ended August 31,		
	2016	2015	2014
Physical-layer product line	$ 151,910	$ 144,060	$ 132,097
Protocol-layer product line	83,324	80,591	99,618
	235,234	224,651	231,715
Foreign exchange losses on forward exchange contracts	(2,651)	(2,562)	(909)
Total sales	$ 232,583	$ 222,089	$ 230,806

Bookings

	Years ended August 31,		
	2016	2015	2014
Physical-layer product line	$ 155,320	$ 144,673	$ 137,166
Protocol-layer product line	87,631	80,948	104,148
	242,951	225,621	241,314
Foreign exchange losses on forward exchange contracts	(2,651)	(2,562)	(909)
Total bookings	$ 240,300	$ 223,059	$ 240,405

Fiscal 2016 vs. 2015

In fiscal 2016, our sales increased 4.7% to $232.6 million, compared to $222.1 million in 2015, while our bookings increased 7.7% year-over-year to $240.3 million in 2016 from $223.1 million in 2015, for a book-to-bill ratio of 1.03 (1.00 in 2015).

In fiscal 2016, despite year-over-year sales increase, we suffered from a continued headwind from a stronger US dollar compared to 2015. 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, in fiscal 2016, our total sales would have increased by approximately 6% and our total bookings would have increased by approximately 9% year-over-year in constant currencies.

In fiscal 2016, despite the negative currency impact, both product lines delivered year-over-year increases in sales, with respective increases of 5.4% and 3.4 % for our Physical and Protocol-layer product lines.

In fiscal 2016, the year-over-year sales increase in our Physical-layer product line (optical and copper testing) is mainly due to our leadership position in portable optical testing and a 100G investment cycle among communications service providers (CSPs), especially in the United States. This 100G investment cycle also benefited to our transport and datacom product line (a sub-group within our Protocol-layer product line), especially in the United States. In addition, in fiscal 2016, sales of our newly launched analytics software solution EXFO Xtract (which is also a sub-group of our Protocol-layer product line) contributed to the year-over-year sales increase.

Overall, the year-over-year increase in sales in fiscal 2016 comes from the Americas, namely in the United States and from the Asia-Pacific (APAC) region, namely in China. Both United States and China delivered robust year-over-year sales increase. On the other hand, sales to EMEA slightly decreased year-over-year, due to negative currency impact. Otherwise, this region would have reported slight sales increase year-over-year, despite uncertain market conditions in many European countries. United Kingdom however, delivered strong sales increase in 2016, after a steady decline in sales over the last couple of years.

In 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 fiscal 2016, we received orders in the Americas for our EXFO Xtract solution, which resulted in increased bookings for our protocol-layer product line year-over-year.

Overall, in fiscal 2016, we reported robust year-over-year bookings increases in every geographic area.

As we gradually evolve from a supplier of dedicated test instruments to a supplier of end-to-end solutions, our quarterly sales and bookings are becoming increasingly subject to quarterly fluctuations, as we are managing more complex, multimillion dollar deals that have prolonged sales and revenue recognition cycles related to our Protocol-layer products.

Fiscal 2015 vs. 2014

In fiscal 2015, our sales decreased 3.8% to $222.1 million, compared to $230.8 million in 2014, while our bookings decreased 7.2% year-over-year to $223.1 million in 2015 from $240.4 million in 2014, for a book-to-bill ratio of 1.00 (1.04 in 2014).

In fiscal 2015, however, we faced a significant headwind from a stronger US dollar, compared to 2014. Excluding this negative currency impact, our sales would have been flat year-over-year.

In fiscal 2015, we increased sales of our Physical-layer product line by 9.1% based on our leadership position in portable optical testing and the growing need for fiber in wireless access areas. Sales or our Protocol-layer product line, meanwhile, decreased 19.1% year-over-over, especially in the areas of 10G or less, portable transport testing and in wireless protocol analysis, due to delays in the launched of some important products (in the first half of the fiscal year), longer than usual market acceptance of newly launched products and difficult market conditions in EMEA. On a constant currency basis, sales growth of our Physical-layer product line would be higher and the decline of our Protocol-layer product line lower to reflect stable sales year-over-year for the combined product lines.

In constant currency, our sales to the Americas and APAC slightly increased year-over-year. In fiscal 2015, we benefited from some improvements in the Americas, following a challenging year in 2014 due to order delays and lower spending levels, especially among key customers. In fiscal 2015, we would have reported year-over-year increase in sales of our Physical-layer product line in the Americas and APAC, offset in part by a decrease in sales of our Protocol-layer product line in these areas.

In constant currency, sales to EMEA slightly decreased year-over-year as Europe, overall, remained a challenging market due to weaker currencies and economic uncertainties. That slight year-over-year decline in sales in the EMEA region comes from our Protocol-layer product line.

In fiscal 2015, our bookings were also negatively affected by a stronger US dollar, compared to the Canadian dollar and euro. In fiscal 2015, the year-over-year decrease in total bookings comes from our Protocol-layer product line; this more than offset the increase in bookings for our Physical-layer product line in the Americas and Asia-Pacific.

In addition, in fiscal 2015, our sales and bookings for our Protocol-layer product line were negatively affected by the management of more complex, multimillion dollar deals that have prolonged sales and revenue recognition cycles.

Finally, in fiscal 2015, we faced increased competition and pricing pressure, compared to 2014, which negatively affected our sales and bookings year-over-year.

Sales by geographic region

The following table summarizes sales by geographic region:

	Years ended August 31,		
	2016	**2015**	**2014**
Americas	55 %	54 %	53 %
EMEA	25	26	28
APAC	20	20	19
	100 %	100 %	100 %

GROSS MARGIN BEFORE DEPRECIATION AND AMORTIZATION
(non-IFRS measure – refer to page 20 of this document)

Gross margin before depreciation and amortization (gross margin) amounted to 62.6%, 61.7% and 62.4% of sales in fiscal 2016, 2015 and 2014 respectively.

Fiscal 2016 vs. 2015

In 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 products, as well as the recognition of orders for our EXFO Xtract software analytics solution, had a positive impact on our gross margin in fiscal 2016, compared to 2015; this was offset in part by an unfavorable product mix within our physical-layer product line year-over-year.

In addition, in fiscal 2016, we recorded lower inventory write-off compared to 2015, which contributed to increase our gross margin by 0.2% year-over-year.

Furthermore, in fiscal 2015, we recorded $0.3 million in restructuring charges in the cost of sales (nil in 2016), which negatively affected our gross margin for that year (0.1%).

Finally, in 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.

Fiscal 2015 vs. 2014

In fiscal 2015, our gross margin was unfavorably affected by product mix compared to 2014 as our Physical-layer product line represented a larger portion of our sales year-over-year and this product line delivers lower margins than our Protocol-layer product line.

In addition, the decrease in our gross margin year-over-year comes from foreign exchange losses on our forward exchange contracts, which reduced our sales and negatively affected our gross margin by 0.3% compared to 2014.

Furthermore, in fiscal 2015, we faced increased competition and pricing pressure for some product lines, compared to 2014, which negatively affected our gross margin year-over-year.

Finally, in fiscal 2015, we recorded $0.3 million in restructuring charges in the cost of sales (nil in 2014), which negatively affected our gross margin for that year (0.1%).

However, in fiscal 2015, we reported lower inventory write-down compared to the same period last year, which increased our gross margin by 0.2% year-over-year.

In addition, in fiscal 2015, 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 (excluding unusual charge, which represents bad debt expenses arising from the revision (see Note 1 to the consolidated financial statements))

Selling and administrative expenses amounted to $82.2 million, $82.2 million and $86.4 million for fiscal 2016, 2015 and 2014 respectively. As a percentage of sales, selling and administrative expenses amounted to 35.3%, 37.0% and 37.4% for fiscal 2016, 2015 and 2014 respectively.

Fiscal 2016 vs. 2015

In fiscal 2016, our selling and administrative expenses were positively affected by the significant 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 2015 restructuring plan. In addition, our 2015 restructuring plan resulted in severance expenses of $0.6 million (or 0.3% of sales) recorded in the fourth quarter of 2015 (nil in 2016); these elements offset inflation, salary increases and increased commission expenses on increased sales.

As percentage of sales, our selling and administrative expenses decreased in fiscal 2016 compared to 2015 as these expenses were flat year-over-year and our sales increased.

Fiscal 2015 vs. 2014

In fiscal 2015, selling and administrative expenses included $0.6 million or 0.3% of sales, in restructuring charges compared to nil in 2014.

Otherwise, in fiscal 2015, 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 these latter two currencies and we report our results in US dollars, and to tight control on expenses, which more than offset inflation and salary increases.

RESEARCH AND DEVELOPMENT EXPENSES

Gross research and development expenses

Gross research and development expenses totaled $47.9 million, $50.1 million and $52.4 million for fiscal 2016, 2015 and 2014 respectively. As a percentage of sales, gross research and development expenses amounted to 20.6%, 22.6% and 22.7% for fiscal 2016, 2015 and 2014 respectively, while net research and development expenses accounted for 18.4%, 19.8% and 19.4% of sales for these respective years.

Fiscal 2016 vs. 2015

In fiscal 2016, the year-over-year significant 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. In addition, the 2015 restructuring plan positively affected our gross research and development expenses in 2016. Finally, our 2015 restructuring plan resulted in severance expenses of $0.8 million (or 0.3% of sales) in 2015 versus nil in 2016. However, these positive effects 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 2015.

As percentage of sales, our gross research and development decreased in fiscal 2016 compared to 2015 as these expenses decreased year-over-year and our sales increased.

Fiscal 2015 vs. 2014

In fiscal 2015, 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 these latter two currencies and we report our results in US dollars.

In fiscal 2015, excluding the positive currency impact year-over-year, inflation, salary increases, as well as a shift in the mix and timing of research and development projects slightly increased our gross research and development expenses, compared to 2014.

In addition, in fiscal 2015, our gross research and development expenses included $0.8 million, or 0.3% of sales, in restructuring charges, compared to nil in 2014.

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

Tax credits and grants for research and development activities were $5.2 million, $6.1 million and $7.6 million for fiscal 2016, 2015 and 2014 respectively. As a percentage of gross research and development expenses, tax credits and grants reached 10.8%, 12.3% and 14.5% for fiscal 2016, 2015 and 2014 respectively.

Fiscal 2016 vs. 2015

The decrease in our tax credits and grants in fiscal 2016, compared to 2015, results from the decrease in our gross research and development expenses, the shift in mix of eligible projects, namely in Finland, as well as 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.

In fiscal 2016, the decrease in tax credits and grants as a percentage of gross research and development expenses, compared to 2015, mainly comes from the shift in mix of eligible projects.

Fiscal 2015 vs. 2014

The decrease in our tax credits and grants in fiscal 2015, compared to 2014, results from the decrease in the statutory Canadian federal and provincial research and development tax credit rates, as well as 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.

In fiscal 2015, the decrease in tax credits and grants as a percentage of gross research and development expenses, compared to 2014, mainly comes from the decrease in the statutory Canadian federal and provincial research and development tax credit rates.

DEPRECIATION OF PROPERTY, PLANT AND EQUIPMENT

Depreciation of property, plant and equipment totaled $3.8 million, $4.8 million and $5.0 million for fiscal 2016, 2015 and 2014 respectively.

Fiscal 2016 vs. 2015

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

AMORTIZATION OF INTANGIBLE ASSETS

In conjunction with the business combinations we completed over the past several years, we recorded intangible assets, primarily consisting of core technology, customer relationships and brand name. In addition, intangible assets include software. These intangible assets resulted in amortization expenses of $1.2 million, $2.9 million and $4.4 million for fiscal 2016, 2015 and 2014 respectively.

Fiscal 2016 vs. 2015

The decrease in our amortization expenses in fiscal 2016, compared to 2015, 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.

Fiscal 2015 vs. 2014

The decrease in amortization expenses in fiscal 2015, compared to 2014, is mainly due the core technology related to the acquisition of NetHawk Oyj, as well as the increase in the average value of the US dollar 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

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.

We reported a foreign exchange gain of $0.2 million in fiscal 2016, compared to $7.2 million in 2015 and $1.6 million in 2014.

Fiscal 2016

In 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 $0.2 million during that period. The period-end value of the Canadian dollar slightly increased 0.3% versus the US dollar to CAD$1.3116 = US$1.00 in fiscal 2016, compared to CAD$1.3157 = US$1.00 at the end of the previous year. In fiscal 2016 the average value of the Canadian dollar versus the US dollar was CA$1.3278 = US$1.00.

Fiscal 2015

In fiscal 2015, 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 significant foreign exchange gain of $7.2 million during the year. The period-end value of the Canadian dollar decreased 17.5% to CA$1.3157 = US$1.00 in fiscal 2015, compared to CA$1.0858 = US$1.00 at the end of the previous year, and decreased 3.0% to CA$1.4755 = €1.00 in fiscal 2015, compared to CA$1.4319 = €1.00 at the end of the previous year. In fiscal 2015, the average value of the Canadian dollar versus the US dollar was CA$1.2093 = US$1.00.

Fiscal 2014

In fiscal 2014, the period-end value of the Canadian dollar decreased versus the US dollar and the euro, compared to the previous year end, which resulted in a foreign exchange gain of $1.6 million during the year. The period-end value of the Canadian dollar decreased 3.0% compared to CA$1.0858 = US$1.00 in fiscal 2014, compared to CA$1.0530 = US$1.00 at the end of the previous year, and decreased 2.7% compared to CA$1.4319 = €1.00 in fiscal 2014, compared to CA$1.3936 = €1.00 at the end of the previous year. In fiscal 2014, the average value of the Canadian dollar versus the US dollar was CA$1.0782 = US$1.00.

Foreign exchange rate fluctuations also flow through the P&L line items as a portion of our sales 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.

Fiscal 2016 vs. 2015

In fiscal 2016, the increase in the average value of the US dollar compared to the Canadian dollar, the euro and the Indian rupee year-over-year, resulted in a positive impact on our financial results. The average value of the US dollar increased 8.9%, 4.6% and 6.3% respectively year-over-year, compared to the Canadian dollar, the euro and the Indian rupee.

Fiscal 2015 vs. 2014

In fiscal 2015, the increase in the average value of the US dollar compared to the Canadian dollar and the euro year-over-year had a positive impact on our financial results. The average value of the US dollar in fiscal 2015 increased 10.8% and 14.5%, respectively, compared to the Canadian dollar and the euro.

UNUSUAL CHARGE

Unusual charge for fiscal 2015 and 2014 relates to bad debt expenses associated with a single trade receivable account. See “Note 1, Revision of Consolidated Financial Statements” to our consolidated financial statements for the year ended August 31, 2016.

INCOME TAXES

In fiscal 2016, we reported income tax expenses of $7.8 million on earnings before income taxes of $16.7 million, compared to income tax expenses of $5.0 million on earnings before income taxes of $9.9 million in 2015 and income tax expenses of $4.3 million on earnings before income taxes of $4.5 million in 2014.

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. However, a significant portion of our foreign exchange gain was created by the translation of financial statements of our foreign subsidiaries from their local currency to the functional currency, and was therefore non-taxable. Otherwise, our effective tax rate would have been closer to the combined Canadian and provincial statutory tax rate of 27% for these years.

Please refer to note 18 to our consolidated financial statements for a full reconciliation of our income tax provision.

LIQUIDITY AND CAPITAL RESOURCES

Cash Requirements and Capital Resources

As at August 31, 2016, cash and short-term investments totaled $47.3 million, while our working capital was at $85.1 million. Our cash and short-term investments increased $19.9 million in fiscal 2016, compared to 2015. In fiscal 2016, we generated $24.4 million in cash flows from operating activities and we recorded an unrealized foreign exchange gain on our cash and short-term investment of $1.6 million. This unrealized foreign exchange gain 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. Otherwise, in fiscal 2016, we made cash payments of $4.4 million and $1.6 million respectively for the purchase of capital assets and the redemption of share capital.

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 August 31, 2016, cash balances included an amount of $23.3 million that bears interest at an annual rate of 1.2%.

We believe that our cash balances and short-term investments of $47.3 million will be sufficient to meet our liquidity and capital requirements for the foreseeable future, including the effect of our share repurchase program. In addition to these assets, we have unused available lines of credit totaling $14.9 million for working capital and other general corporate purposes, and unused lines of credit of $21.6 million for foreign currency exposure related to forward exchange contracts. However, possible operating losses, restructuring charges 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.

As at August 31, 2016, our commitments under operating leases amount to $3.3 million in 2017, $1.8 million in 2018, $0.8 million in 2019, $0.7 million in 2020 and $1.7 million in 2021 and after, for total commitments of $8.3 million.

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 $24.4 million in fiscal 2016, compared to $6.5 million in 2015 and $19.8 million in 2014.

Fiscal 2016 vs. 2015

Cash flows provided by operating activities in fiscal 2016 were attributable to the net earnings after items not affecting cash of $20.7 million, and the positive net change in non-cash operating items of $3.6 million. This was mainly due to the positive effect on cash of the decrease of $2.7 million in our accounts receivable due to the timing of receipts and sales during the year, the $0.9 million decrease in our income tax and tax credits recoverable due to tax credits earned in previous periods recovered during the year, and the $4.9 million increase in our accounts payable, accrued liabilities and provisions due to the timing of purchases and payments during the year. These positive effects on cash were offset in part by the negative effect on cash of the $4.7 million increase in our inventories to meet future demand, and the negative effect on cash of the increase of $0.3 million in our prepaid expenses due to timing of payments during the year.

Fiscal 2015 vs. 2014

Cash flows provided by operating activities in fiscal 2015 were attributable to the net earnings after items not affecting cash of $11.4 million, offset in part by the negative net change in non-cash operating items of $4.9 million; this was mainly due to the negative effect on cash of the increase of $10.8 million in our accounts receivable due to the timing of receipts and sales during the year, the negative effect on cash of the increase of $2.1 million in our income tax and tax credits recoverable due to tax credits earned during the year not yet recovered, and the negative effect on cash of the increase of $1.0 million in our prepaid expenses due to timing of payments during the year. These negative effects on cash were offset in part by the positive effect on cash of the decrease of $0.8 million in our inventories due to improved inventory turns during the year and the increase of $8.1 million in our accounts payable, accrued liabilities and provisions due to timing of purchases and payments during the year.

Investing activities

Cash flows used by investing activities amounted to $7.0 million in fiscal 2016, compared to $2.3 million in 2015 and $8.9 million in 2014.

Fiscal 2016

In fiscal 2016, we paid $4.4 million for the purchase of capital assets and we acquired (net of disposal) $2.6 million worth of short-term investments.

Fiscal 2015

In fiscal 2015, we paid $5.9 million for the purchase of capital assets but we disposed (net of acquisitions) of $3.6 million worth of short-term investments.

Fiscal 2014

In fiscal 2014, we acquired (net of disposal) $1.0 million worth of short-term investments and we paid $7.9 million for the purchase of capital assets, including the assets of ByteSphere and Aito.

Financing activities

Cash flows used by financing activities amounted to $1.6 million in fiscal 2016, compared to $25.5 million in 2015 and $1.0 million in 2014.

Fiscal 2016

In fiscal 2016, we redeemed share capital under our share repurchase program for a cash consideration of $1.6 million.

Fiscal 2015

In fiscal 2015, we redeemed share capital under our share repurchase programs (namely our substantial issuer bid) for a cash consideration of $25.5 million.

Fiscal 2014

In fiscal 2014, we redeemed share capital under our share repurchase program for a cash consideration of $0.9 million and repaid $0.3 million of our long-term debt. However, we received $0.2 million from the exercise of stock options.

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 August 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
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	$ 34,000,000	1.3002

US dollars – Indian rupees

Expiry dates	Contractual amounts	Weighted average contractual forward rate
September 2016 to August 2017	$ 3,800,000	70.92

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 and $0.1 million as at August 31, 2015 and 2016 respectively. The US dollar – Canadian dollar year-end exchange rate was CA$1.3116 = US$1.00 as at August 31, 2016.

SHARE CAPITAL

As at November 14, 2016, EXFO had 31,643,000 multiple voting shares outstanding, entitling to 10 votes each and 22,799,383 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 August 31, 2016, our off-balance sheet arrangements consisted of letters of guarantee amounting to $0.4 million 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 August 31, 2016, we did not have interests in any structured entities.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in accordance with IFRS requires us to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses and the disclosures of contingent assets and liabilities at the date of the financial statements. On an ongoing basis, we evaluate these estimates and assumptions, including those related to the fair value of financial instruments, the allowance for doubtful accounts receivable, the amount of tax credits recoverable, the provision for excess and obsolete inventories, the estimated useful lives of capital assets, the valuation of long-lived assets, the impairment of goodwill, the recoverable amount of deferred income tax assets, the amount of certain accrued liabilities, provisions and deferred revenue as well as stock-based compensation costs. We base our estimates and assumptions on historical experience and on other factors that we believe to be reasonable under the circumstances.

Critical Judgments in Applying Accounting Policies

(a) Determination of functional currency

We operate in multiple countries and generate revenue and incur expenses in several currencies, namely the Canadian dollar, the US dollar, the euro, the British pound, the Indian rupee and the CNY (Chinese currency). The determination of the functional currency of EXFO and its subsidiaries may require significant judgment. In determining the functional currency of EXFO and its subsidiaries, we take into account primary, secondary and tertiary indicators. When indicators are mixed and the functional currency is not obvious, we use our judgment to determine the functional currency.

(b) Determination of cash generating units and allocation of goodwill

For the purpose of impairment testing, goodwill must be allocated to each cash-generating unit (CGU) or group of CGUs that are expected to benefit from the synergies of the business combination. Initial allocation and possible reallocation of goodwill to a CGU or a group of CGUs requires judgment.

Critical Estimates and Assumptions

(a) Inventories

We state our inventories at the lower of cost, determined on an average cost basis and net realizable value, and we provide reserves for excess and obsolete inventories. We determine our reserves for excess and obsolete inventories based on the quantities on hand at the reporting dates compared to foreseeable needs, taking into account changes in demand, technology or market. It is possible that additional inventory reserves may occur if future sales are less than our forecasts or if there is a significant shift in product mix compared to our forecasts, which could adversely affect our results.

(b) Income taxes

We are subject to income tax laws and regulations in several jurisdictions. Under these laws and regulations, uncertainties exist with respect to the interpretation of complex tax regulations and the amount and timing of future taxable income. We maintain provisions for uncertain tax positions that we believe appropriately reflect our risk based on our interpretation of laws and regulations. In addition, we make reasonable estimates and assumptions to determine the amount of deferred tax assets that can be recognized in our consolidated financial statements, based upon the likely timing and level of anticipated future taxable income together with tax planning strategies. The ultimate realization of our deferred income tax assets is dependent upon the generation of sufficient future taxable income during the periods in which those assets are expected to be realized.

As at August 31, 2016, we had deferred income tax assets in the balance sheet in the amount of $4.6 million for operating losses in the United States. In order to recover these deferred income tax assets, we need to generate approximately $13.5 million in pre-tax earnings in the United States, and in order to do so over the estimated recovery period of four years, we must generate pre-tax earnings compound annual growth rate (CAGR) of 2%, which we believe is probable. Our losses in the United States can be carried forward over a twenty-year period.

(c) Tax credits recoverable

Tax credits are recorded provided that there is reasonable assurance that we have complied and will comply with all the conditions related to the tax credits and that the tax credits will be received. The ultimate recovery of our non-refundable tax credits is dependent upon the generation of sufficient future taxable income during the tax credits carry-forward periods. We have made reasonable estimates and assumptions to determine the amount of non-refundable tax credits that can be recognized in our consolidated financial statements, based upon the likely timing and level of anticipated future taxable income together with tax planning strategies.

As at August 31, 2016, our non-refundable research and development tax credits recognized in the balance sheet amounted to $37.2 million. In order to recover these non-refundable research and development tax credits, we need to generate approximately $240 million (CA$315 million) in pre-tax earnings at the Canadian federal level and approximately $12 million at the Canadian provincial level. In order to generate $240 million in pre-tax earnings at the Canadian Federal level over the estimated recovery period of 12 years, we must generate a pre-tax earnings CAGR of 2%, which we believe is probable. Our non-refundable research and development tax credits can be carried forward over a twenty-year period.

(d) Impairment of non-financial assets

Impairment exists when the carrying value of an asset or group of assets (cash generating unit (CGU)) exceeds its recoverable amount, which is the higher of its fair value less costs of disposal and its value in use. The fair value less costs of disposal calculation for our CGUs is based on a market approach that relies on input from implicit valuation multiples and recent transactions for comparable assets or businesses, within the same industry. We apply judgment in making adjustments for factors such as size, risk profile or profitability and also consider EXFO's value derived from its market capitalization considering a control premium based on comparable situations. Depending on the market evidence available, we, from time to time, may further supplement this market approach with discounted cash flows.

In the fourth quarter of fiscal 2016, we performed our annual goodwill impairment test for our two CGUs, EXFO and Brix.

For the purposes of the impairment test, goodwill has been allocated to the lowest level within the company at which it is monitored by management to make business decisions, which are the following two CGUs:

EXFO CGU	$ 8,663,000
Brix CGU	13,265,000
Total	$ 21,928,000

In performing the goodwill impairment review of both CGUs, we determined the recoverable amount of goodwill based on fair value less costs of disposal. In estimating the recoverable amount of the EXFO CGU, we used a market approach, which is based on sales multiples within the range of 0.7 to 3.7 times sales, for comparable businesses with similar operations within the same industry over the past year. We applied judgment in making certain adjustments for factors such as size, risk profile or profitability of the comparable businesses, when compared to the EXFO CGU. To calculate the recoverable amount of the Brix CGU, we also applied a similar market approach, based on sales multiples for comparable businesses, which also ranged from 0.7 to 3.7 times sales. Furthermore, as the sales and operations of the EXFO CGU constitutes the significant majority of our sales and operations, we also compared the carrying amount of the EXFO CGU to EXFO's overall market capitalization, after adjustment for a control premium and the adjustment to deduct the recoverable amount of the Brix CGU. Based on this calculation, we calculated a recoverable amount which resulted in an implied sales multiple that was within the 0.7 to 3.7 times range, as used in the market approach described above.

As at August 31, 2016, the recoverable amount for both CGUs exceeded their carrying value. The recoverable amount of EXFO CGU and Brix CGU would equal their carrying value using sales multiples of 0.6 and 0.7 time sales respectively.

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. We will adopt this new standard on September 1, 2018. We are currently assessing the impact that the new standard will have on our 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. We are currently assessing the impact that the new standard will have on our consolidated financial statements and whether or not early adopt the new standard.

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. We have not yet assessed the impact that the new standard will have on our consolidated financial statements.

RISKS AND UNCERTAINTIES

Over the past several years, we have managed our business in a difficult environment; gradually evolved from a supplier of dedicated test instruments to a supplier of end-to-end solutions, focused on research and development programs for new and innovative solutions aimed at expected growth pockets in our sector; continued the development of our domestic and international markets; and made strategic acquisitions. However, we operate in a highly competitive and complex sector that is in constant evolution and, as a result, we encounter various risks and uncertainties that must be given appropriate consideration in our strategic management plans and policies.

Our business is subject to the effects of general global and regional economic conditions, particularly conditions in the telecommunications test, service assurance and analytics markets. In the past, our operating results have been adversely affected as a result of unfavorable economic conditions and reduced or delayed capital spending in the Americas, Europe, Middle East and Africa as well as Asia-Pacific regions. Global and regional economic conditions continue to be volatile and uncertain as reflected by Britain's decision to exit the European Union. If global and/or regional economic and market conditions, or economic conditions in key markets, remain uncertain or deteriorate, we may experience material adverse impacts on our business. Unfavorable and/or uncertain economic and market conditions may result in lower capital spending or delayed spending by our customers on network test, service assurance and analytics solutions and, therefore, demand for our products could decline and adversely impact our revenue.

Our functional currency is the Canadian dollar. 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, while a significant portion of our cost of sales and operating expenses are denominated in Canadian dollars and currencies such as euros, British pounds, Rupees (India) and CNY (China). As a result, even though we manage our exposure to currency risk to some extent with forward exchange contracts (by selling US dollars for Canadian dollars and US dollars for Indian Rupees) and certain cost of sales and operating expenses denominated in currencies other than the Canadian dollar, namely the US dollars and euros, we are exposed to fluctuations in the exchange rates between the Canadian dollar on one hand and the US dollar, euro and other currencies on the other. Any increase in the value of the Canadian dollar relative to the US dollar and other currencies, or any unfavorable variance between the value of the Canadian dollar and the contractual rates of our US dollar - Canadian dollar forward exchange contracts, could result in foreign exchange losses and have a material adverse effect on our operating results. Foreign exchange rate fluctuations also flow through the statement of earnings line items as a significant portion of cost of sales and our operating expenses are denominated in Canadian dollars, euros and Indian rupees, and we report our results in US dollars. Any decrease in the value of the US dollar relative to the Canadian dollar and other currencies, could have a material adverse effect on our operating results.

Risks and uncertainties related to the telecommunications test, service assurance and analytics industry involve the rapid and timely development of new products that may have short lifecycles and require extensive research and development; the difficulty of adequately predicting market size, trends and customer needs; the ability to quickly adapt our cost structure to changing market conditions in order to achieve profitability; and the challenge of retaining highly skilled employees.

Given our strategic goals for growth and competitive positioning in our industry, we are continuously expanding into international markets, such as the operation of our manufacturing facilities in China and our software development center in India as well as operating other subsidiaries in many countries. This exposes us to certain risks and uncertainties, namely changes in local laws and regulations, multiple technological standards, protective legislation, inter-company transfer price audits, pricing pressure, cultural differences and the management of operations in different countries.

The economic environment of our industry could also result in some of our customers experiencing difficulties, which, consequently, could have a negative effect on our results, especially in terms of future sales and recoverability of accounts receivable. However, the sectorial and geographic diversity of our customer base provides us with a reasonable level of protection in this area. Finally, other financial instruments, which potentially subject us to credit risks, consist mainly of cash, short-term investments and forward exchange contracts. Our short-term investments consist of debt instruments issued by high-credit quality corporations. Our cash and forward exchange contracts are held with or issued by high-credit quality financial institutions; therefore, we consider the risk of non-performance on these instruments to be limited.

We depend on a single supplier or a limited number of suppliers for some of the parts used to manufacture our products for which alternative sources may not be readily available. In addition, all our orders are placed through individual purchase orders and, therefore, our suppliers may experience difficulties, suffer from natural disasters, delays or stop supplying parts to us at any time. The reliance on a single source or limited number of suppliers could result in increased costs, delivery problems and reduced control over product pricing and quality. Any interruption or delay in the supply of any of these parts could significantly harm our ability to meet scheduled product deliveries to our customers and cause us to lose sales. Furthermore, the process of qualifying a new manufacturer for complex parts designed to our specifications, such as our optical, electronic or mechanical parts, is lengthy and would consume a substantial amount of time for our technical personnel and management. If we were required to change a supplier in a short period of time, our business would be disrupted. In addition, we may be unsuccessful in identifying a new supplier capable of meeting and willing to meet our needs on terms that we would find acceptable.

While strategic acquisitions, like those we have made in the past and possibly others in the future, are essential to our long-term growth, they also expose us to certain risks and uncertainties related to the rapid and effective integration of these businesses, their products, technologies and personnel as well as key personnel retention. Finally, integration of new acquisitions will require the dedication of management resources, which may detract their attention from our day-to-day business and operations.

For a more complete understanding of risk factors that may affect us, please refer to the risk factors set forth in our Annual Report, on Form 20-F/A published with securities commissions at www.EXFO.com, or at www.sedar.com in Canada or www.sec.gov/edgar.shtml in the U.S.

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 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.

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, restructuring charges, stock-based compensation costs, unusual charge, and foreign exchange gain.

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

Adjusted EBITDA

	Years ended August 31,		
	2016	**2015**	**2014**
IFRS net earnings for the year	$ 8,900	$ 4,857	$ 256
Add (deduct):			
Depreciation of property, plant and equipment	3,814	4,835	4,995
Amortization of intangible assets	1,172	2,883	4,398
Interest and other income	(828)	(155)	(326)
Income taxes	7,764	5,036	4,286
Restructuring charges	–	1,637	–
Unusual charge [(1)]	–	603	720
Stock-based compensation costs	1,378	1,295	1,696
Foreign exchange gain	(161)	(7,212)	(1,634)
Adjusted EBITDA for the year	$ 22,039	$ 13,779	$ 14,391
Adjusted EBITDA in percentage of total sales	9.5%	6.2%	6.2%

(1) Management has amended the calculation of adjusted EBITDA to include an adjustment for the unusual charge associated with bad debt expense, as described in Note 1, *Revision to Consolidated Financial Statements*, on the basis that the charge is not considered typical for our historical or future operating performance.

QUARTERLY SUMMARY FINANCIAL INFORMATION [(1)]

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

	1st quarter	**2nd quarter**	**3rd quarter**	**4th quarter**	**Year ended August 31,**
2016					
Sales	$ 55,232	$ 53,597	$ 60,896	$ 62,858	$ 232,583
Cost of sales [(2)]	$ 20,137	$ 18,904	$ 23,880	$ 24,145	$ 87,066
Net earnings	$ 1,766	$ 3,963	$ 919	$ 2,252	$ 8,900
Basic net earnings per share [(3)]	$ 0.03	$ 0.07	$ 0.02	$ 0.04	$ 0.17
Diluted net earnings per share	$ 0.03	$ 0.07	$ 0.02	$ 0.04	$ 0.16

	1st quarter	**2nd quarter**	**3rd quarter**	**4th quarter**	**Year ended August 31,**
2015					
Sales	$ 56,724	$ 50,990	$ 57,781	$ 56,594	$ 222,089
Cost of sales [(2)]	$ 21,237	$ 19,546	$ 22,281	$ 21,975	$ 85,039
Net earnings	$ 1,481	$ 931	$ 563	$ 1,882	$ 4,857
Basic net earnings per share [(3)]	$ 0.02	$ 0.02	$ 0.01	$ 0.03	$ 0.09
Diluted net earnings per share	$ 0.02	$ 0.02	$ 0.01	$ 0.03	$ 0.08

(1) Quarterly financial information has been derived from our unaudited interim condensed financial statements, which are prepared in accordance with the IFRS, as issued by the IASB applicable to the preparation of interim financial statements, including IAS 34, "*Interim Financial Reporting*". The presentation currency is the US dollars, which differs from the functional currency of the company (Canadian dollar).

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

(3) Per share data is calculated independently for each quarter presented. Therefore, the sum of this quarterly information does not equal the corresponding annual information.

Quarterly Sales Analysis

Overall in fiscal 2016, our sales increased 4.7% to $232.6 million comparted to $222.1 million in 2015. Refer to section ''Sales and bookings'' elsewhere in this document for explanations about the year-over-year annual increase in sales. On a quarterly basis, our sales fluctuate from quarter to quarter due to timing and magnitude of orders.

Fourth-Quarter Results

Gross margin

In the fourth quarter of fiscal 2016, our gross margin reached 61.6%, compared to 61.2% for the same period last year.

In the fourth quarter of fiscal 2016, our gross margin was favorably affected by a richer product mix within our protocol-layer product line. Namely, the year-over-year sales increase for our transport and datacom products had a positive impact on our gross margin in the fourth quarter 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 fourth quarter of fiscal 2015, we had recorded $0.3 million in restructuring charges in the cost of sales (nil in 2016), which had negatively affected our gross margin for that quarter in 2015 (0.5%).

However, in the fourth quarter of fiscal 2016, we recorded higher inventory write-off compared to the same period last year, which contributed to reduce our gross margin by 1.0% year-over-year.

Net earnings

Net earnings amounted to $2.3 million, or $0.04 per diluted share, in the fourth quarter of fiscal 2016, compared to $1.9 million, or $0.03 per share, for the same period last year.

First, in the fourth quarter of fiscal 2016, higher gross margin in dollars (on higher sales) compared to the same period last year increased our net earnings $4.1 million year-over-year.

However, in the fourth quarter of fiscal 2016, our operating expenses (selling, administrative, net R&D, depreciation and amortization expenses) were $1.2 million higher compared to the same period last year, which included restructuring charges of $1.3 million; excluding restructuring charges, operating expenses would have increased $2.5 million year-over-year. General inflation and salary increases as well as higher commissions to our sales channels on higher sales explain the year-over-year increase in operating expenses in the fourth quarter of fiscal 2016; this was offset in part by the positive effect of the increase of the average value of the US dollar compared to the Canadian dollar and the euro.

In addition, in the fourth quarter of fiscal 2016, we recorded a foreign exchange loss of $0.3 million compared to a gain of $2.4 million for the same period last year due to the fluctuation of the period-end foreign exchange rates; this resulted in a $2.7 million decrease in our net earnings year-over-year.

Finally, in the fourth quarter of fiscal 2016, we recorded an income tax expense of $2.2 million compared to $1.6 million for the same period last year, which decrease our net earnings year-over-year.