

Independent Auditor's Report

To the Shareholders of EXFO Inc.

We have completed integrated audits of EXFO Inc.'s and its subsidiaries' 2016, 2015 and 2014 consolidated financial statements and their internal control over financial reporting as at August 31, 2016. Our opinions, based on our audits are presented below.

Report on the consolidated financial statements

We have audited the accompanying consolidated financial statements of EXFO Inc. and its subsidiaries (the company), which comprise the consolidated balance sheets as at August 31, 2016 and August 31, 2015 and the consolidated statements of earnings, comprehensive income (loss), changes in shareholders' equity and cash flows for each of the three years in the period ended August 31, 2016, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement. Canadian generally accepted auditing standards also require that we comply with ethical requirements.

An audit involves performing procedures to obtain audit evidence, on a test basis, about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting principles and policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion on the consolidated financial statements.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of EXFO Inc. and its subsidiaries as at August 31, 2016 and August 31, 2015 and their financial performance and their cash flows for each of the three years in the period ended August 31, 2016 in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board.

Revision to Consolidated Financial Statements

Without modifying our opinion on the consolidated financial statements, we draw attention to Note 1 to these consolidated financial statements, which explains that the consolidated financial statements for the year ended August 31, 2016 have been revised from those on which we originally reported on November 28, 2016.

Report on internal control over financial reporting

We have also audited EXFO Inc.'s and its subsidiaries' internal control over financial reporting as at August 31, 2016, based on criteria established in Internal Control – Integrated Framework (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Management's responsibility for internal control over financial reporting

Management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in "Management's Annual Report on Internal Control over Financial Reporting (restated)" appearing under Item 15b) of the Annual Report on Form 20-F/A for the fiscal year ended August 31, 2016.

Auditor's responsibility

Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control, based on the assessed risk, and performing such other procedures as we consider necessary in the circumstances.

We believe that our audit provides a reasonable basis for our audit opinion on the company's internal control over financial reporting.

Definition of internal control over financial reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Inherent limitations

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Opinion

In our opinion, EXFO Inc. and its subsidiaries did not maintain, in all material respects, effective internal control over financial reporting as at August 31, 2016, based on criteria established in Internal Control – Integrated Framework (2013) issued by COSO because a material weakness in internal control over financial reporting existed at that date related to the failure to maintain appropriate controls over the trade accounts receivable ledger, which included the lack of appropriate segregation of duties and supervisory review and monitoring of journal entries recorded in the trade accounts receivable ledger. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis. The material weakness referred to above is described under "Management's Annual Report on Internal Control over Financial Reporting (restated)" appearing under Item 15(b) of the Annual Report on Form 20-F/A for the fiscal year ended August 31, 2016. We considered this material weakness in determining the nature, timing, and extent of audit tests applied in our audit of the August 31, 2016 consolidated financial statements, and our opinion regarding the effectiveness of the EXFO Inc.'s internal control over financial reporting does not affect our opinion on those consolidated financial statements.

Management and we previously concluded that EXFO Inc. and its subsidiaries maintained effective internal control over financial reporting as at August 31, 2016. However, management has subsequently determined that the material weakness described above existed as at August 31, 2016. Accordingly, Management's Report on Internal Control over Financial Reporting has been restated and our present opinion on internal control over financial reporting, as presented herein, is different from that expressed in our previous report.

PricewaterhouseCoopers LLP¹

Montréal, Quebec
January 9, 2017

¹ CPA auditor, CA, public accountancy permit No. A119427

EXFO Inc.

Consolidated Balance Sheets

(in thousands of US dollars)

	As at August 31,	
	2016	2015
Assets		
Current assets		
Cash	\$ 43,208	\$ 25,864
Short-term investments (note 5)	4,087	1,487
Accounts receivable (note 5)		
Trade	42,993	45,985
Other	2,474	2,384
Income taxes and tax credits recoverable (note 18)	4,208	3,855
Inventories (note 6)	33,004	27,951
Prepaid expenses	3,099	2,801
	133,073	110,327
Tax credits recoverable (note 18)	34,594	35,625
Property, plant and equipment (notes 7 and 20)	35,978	35,695
Intangible assets (notes 8 and 20)	3,391	4,096
Goodwill (notes 8 and 20)	21,928	21,860
Deferred income tax assets (note 18)	8,240	9,459
Other assets	589	416
	\$ 237,793	\$ 217,478
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities (note 10)	\$ 37,174	\$ 34,126
Provisions	299	427
Income taxes payable	971	779
Deferred revenue	9,486	7,647
	47,930	42,979
Deferred revenue	5,530	2,957
Deferred income tax liabilities (note 18)	2,857	1,524
Other liabilities	75	791
	56,392	48,251
Commitments (note 11)		
Shareholders' equity		
Share capital (note 12)	85,516	86,045
Contributed surplus	18,150	17,778
Retained earnings	126,309	117,409
Accumulated other comprehensive loss (note 13)	(48,574)	(52,005)
	181,401	169,227
	\$ 237,793	\$ 217,478

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

On behalf of the Board
/s/ Germain Lamonde
 GERMAIN LAMONDE
 Chairman, President and CEO

/s/ Claude Séguin
 CLAUDE SÉGUIN
 Chairman, Audit Committee

EXFO Inc.

Consolidated Statements of Earnings

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

	Years ended August 31,		
	2016	2015	2014
Sales (note 20)	\$ 232,583	\$ 222,089	\$ 230,806
Cost of sales ⁽¹⁾ (note 16)	87,066	85,039	86,836
Selling and administrative ⁽²⁾ (note 16)	82,169	82,200	86,429
Net research and development (note 16)	42,687	44,003	44,846
Depreciation of property, plant and equipment (note 16)	3,814	4,835	4,995
Amortization of intangible assets (note 16)	1,172	2,883	4,398
Interest and other income	(828)	(155)	(326)
Foreign exchange gain	(161)	(7,212)	(1,634)
Unusual charge (note 1)	–	603	720
Earnings before income taxes	16,664	9,893	4,542
Income taxes (note 18)	7,764	5,036	4,286
Net earnings for the year	<u>\$ 8,900</u>	<u>\$ 4,857</u>	<u>\$ 256</u>
Basic net earnings per share	\$ 0.17	\$ 0.09	\$ 0.00
Diluted net earnings per share	\$ 0.16	\$ 0.08	\$ 0.00
Basic weighted average number of shares outstanding (000's)	53,863	56,804	60,329
Diluted weighted average number of shares outstanding (000's) (note 19)	54,669	57,457	61,015

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

(2) Selling and administrative is exclusive of unusual charge, which represents bad debt expenses.

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

EXFO Inc.

Consolidated Statements of Comprehensive Income (Loss)

(in thousands of US dollars)

	Years ended August 31,		
	2016	2015	2014
Net earnings for the year	\$ 8,900	\$ 4,857	\$ 256
Other comprehensive income (loss), net of income taxes			
Items that will not be reclassified subsequently to net earnings			
Foreign currency translation adjustment	707	(39,175)	(7,086)
Items that may be reclassified subsequently to net earnings			
Unrealized gains/losses on forward exchange contracts	862	(5,583)	(618)
Reclassification of realized gains/losses on forward exchange contracts in net earnings	2,797	2,107	959
Deferred income tax effect of gains/losses on forward exchange contracts	(935)	905	(91)
Other comprehensive income (loss)	3,431	(41,746)	(6,836)
Comprehensive income (loss) for the year	\$ 12,331	\$ (36,889)	\$ (6,580)

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

EXFO Inc.

Consolidated Statements of Changes in Shareholders' Equity

(in thousands of US dollars)

	Year ended August 31, 2014				
	Share capital	Contributed surplus	Retained earnings	Accumulated other comprehensive loss	Total shareholders' equity
Balance as at September 1, 2013	\$ 109,837	\$ 17,186	\$ 112,296	\$ (3,423)	\$ 235,896
Exercise of stock options (note 12)	225	–	–	–	225
Redemption of share capital (note 12)	(831)	(106)	–	–	(937)
Reclassification of stock-based compensation costs (note 12)	2,260	(2,260)	–	–	–
Stock-based compensation costs	–	1,683	–	–	1,683
Net earnings for the year	–	–	256	–	256
Other comprehensive income (loss)					
Foreign currency translation adjustment	–	–	–	(7,086)	(7,086)
Changes in unrealized losses on forward exchange contracts, net of deferred income taxes of \$91	–	–	–	250	250
Total comprehensive loss for the year					(6,580)
Balance as at August 31, 2014	<u>\$ 111,491</u>	<u>\$ 16,503</u>	<u>\$ 112,552</u>	<u>\$ (10,259)</u>	<u>\$ 230,287</u>
	Year ended August 31, 2015				
	Share capital	Contributed surplus	Retained earnings	Accumulated other comprehensive loss	Total shareholders' equity
Balance as at September 1, 2014	\$ 111,491	\$ 16,503	\$ 112,552	\$ (10,259)	\$ 230,287
Redemption of share capital (note 12)	(26,827)	1,333	–	–	(25,494)
Reclassification of stock-based compensation costs (note 12)	1,381	(1,381)	–	–	–
Stock-based compensation costs	–	1,323	–	–	1,323
Net earnings for the year	–	–	4,857	–	4,857
Other comprehensive loss					
Foreign currency translation adjustment	–	–	–	(39,175)	(39,175)
Changes in unrealized losses on forward exchange contracts, net of deferred income taxes of \$905	–	–	–	(2,571)	(2,571)
Total comprehensive loss for the year					(36,889)
Balance as at August 31, 2015	<u>\$ 86,045</u>	<u>\$ 17,778</u>	<u>\$ 117,409</u>	<u>\$ (52,005)</u>	<u>\$ 169,227</u>
	Year ended August 31, 2016				
	Share capital	Contributed surplus	Retained earnings	Accumulated other comprehensive loss	Total shareholders' equity
Balance as at September 1, 2015	\$ 86,045	\$ 17,778	\$ 117,409	\$ (52,005)	\$ 169,227
Redemption of share capital (note 12)	(1,768)	217	–	–	(1,551)
Reclassification of stock-based compensation costs (note 12)	1,239	(1,239)	–	–	–
Stock-based compensation costs	–	1,394	–	–	1,394
Net earnings for the year	–	–	8,900	–	8,900
Other comprehensive income (loss)					
Foreign currency translation adjustment	–	–	–	707	707
Changes in unrealized gains/losses on forward exchange contracts, net of deferred income taxes of \$935	–	–	–	2,724	2,724
Total comprehensive income for the year					12,331
Balance as at August 31, 2016	<u>\$ 85,516</u>	<u>\$ 18,150</u>	<u>\$ 126,309</u>	<u>\$ (48,574)</u>	<u>\$ 181,401</u>

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

EXFO Inc.

Consolidated Statements of Cash Flows

(in thousands of US dollars)

	Years ended August 31,		
	2016	2015	2014
Cash flows from operating activities			
Net earnings for the year	\$ 8,900	\$ 4,857	\$ 256
Add (deduct) items not affecting cash			
Stock-based compensation costs	1,378	1,295	1,696
Depreciation and amortization	4,986	7,718	9,393
Unusual charge	–	603	720
Deferred revenue	4,238	396	(804)
Deferred income taxes	1,578	403	698
Changes in foreign exchange gain/loss	(332)	(3,842)	(491)
	<u>20,748</u>	<u>11,430</u>	<u>11,468</u>
Changes in non-cash operating items			
Accounts receivable	2,682	(10,828)	3,578
Income taxes and tax credits	939	(2,062)	1,447
Inventories	(4,713)	820	(734)
Prepaid expenses	(280)	(982)	210
Other assets	170	61	92
Accounts payable and accrued liabilities and provisions	4,882	8,132	3,832
Other liabilities	(65)	(87)	(107)
	<u>24,363</u>	<u>6,484</u>	<u>19,786</u>
Cash flows from investing activities			
Additions to short-term investments	(3,546)	(20,067)	(34,222)
Proceeds from disposal and maturity of short-term investments	873	23,685	33,208
Purchases of capital assets (notes 7 and 8)	(4,356)	(5,933)	(7,931)
	<u>(7,029)</u>	<u>(2,315)</u>	<u>(8,945)</u>
Cash flows from financing activities			
Repayment of long-term debt	–	–	(307)
Exercise of stock options (note 12)	–	–	225
Redemption of share capital (note 12)	(1,551)	(25,494)	(937)
	<u>(1,551)</u>	<u>(25,494)</u>	<u>(1,019)</u>
Effect of foreign exchange rate changes on cash	<u>1,561</u>	<u>(6,932)</u>	<u>(1,087)</u>
Change in cash	17,344	(28,257)	8,735
Cash – Beginning of year	25,864	54,121	45,386
Cash – End of year	<u>\$ 43,208</u>	<u>\$ 25,864</u>	<u>\$ 54,121</u>
Supplementary information			
Income taxes paid	\$ 2,015	\$ 1,491	\$ 1,272

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

EXFO Inc.

Notes to Consolidated Financial Statements

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

1 Nature of Activities and Incorporation

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

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

These consolidated financial statements were authorized for issue by the Board of Directors on January 9, 2017.

Revision of Consolidated Financial Statements

The company has revised its previously issued consolidated financial statements (filed on November 28, 2016) to properly record a bad debt expense associated with a single trade receivable account. During the first quarter of fiscal 2017, the company identified certain errors in the aging of the trade accounts receivable ledger which were traced back to an outstanding trade receivable balance arising from one customer, which dated back to the period from 2012 to 2015. This resulted in an understatement of the prior years’ allowance for doubtful accounts against this trade receivable account and a corresponding adjustment to deferred taxes as a result of the additional expense.

The company evaluated the aggregate effects of the errors to its 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, the company has determined that the errors were not material to the previously issued consolidated financial statements and disclosures in its 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, the company has revised its previously issued consolidated financial statements for the year ended August 31, 2016.

All financial information presented in the accompanying notes to these consolidated financial statements was revised to reflect the correction of these errors.

The following tables present the effect of the aforementioned revisions on the company’s consolidated balance sheets and the consolidated statement of earnings for each period. These revisions are non-cash and therefore do not impact the company’s statement of cash flows for any prior period. The revision also does not impact the consolidated statement of earnings for the year ended August 31, 2016:

	As at August 31, 2016		
	As reported	Adjustment	Revised
<i>Revision to Consolidated Balance Sheet</i>			
Accounts receivable - Trade	\$ 45,076	\$ (2,083)	\$ 42,993
Deferred income tax assets	\$ 7,681	\$ 559	\$ 8,240
Retained earnings	\$ 127,833	\$ (1,524)	\$ 126,309
Total assets	\$ 239,317	\$ (1,524)	\$ 237,793
Shareholders’ equity	\$ 182,925	\$ (1,524)	\$ 181,401

EXFO Inc.

Notes to Consolidated Financial Statements

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

	As at and for the year ended August 31, 2015		
	As reported	Adjustment	Revised
<u>Revision to Consolidated Balance Sheet</u>			
Accounts receivable - Trade	\$ 48,068	\$ (2,083)	\$ 45,985
Deferred income tax assets	\$ 8,900	\$ 559	\$ 9,459
Retained earnings	\$ 118,933	\$ (1,524)	\$ 117,409
Total assets	\$ 219,002	\$ (1,524)	\$ 217,478
Shareholders' equity	\$ 170,751	\$ (1,524)	\$ 169,227

Revision to Consolidated Statement of Earnings and Consolidated Statement of Comprehensive Income (Loss)

Unusual charge (1)	\$ –	\$ 603	\$ 603
Earnings before income taxes	\$ 10,496	\$ (603)	\$ 9,893
Deferred income tax expense	\$ 565	\$ (162)	\$ 403
Net earnings for the year	\$ 5,298	\$ (441)	\$ 4,857
Basic net earnings per share for the year	\$ 0.09	\$ –	\$ 0.09
Diluted net earnings per share for the year	\$ 0.09	\$ (0.01)	\$ 0.08
Comprehensive loss for the year	\$ (36,448)	\$ (441)	\$ (36,889)

- (1) Adjustment to recognize bad debt expense in connection with a past due trade receivable balance, for which, upon correction of the aging, management would have provided an allowance in accordance with the company's credit provision policies.

	As at and for the year ended August 31, 2014		
	As reported	Adjustment	Revised
<u>Revision to Consolidated Balance Sheet</u>			
Retained earnings	\$ 113,635	\$ (1,083)	\$ 112,552

Revision to Consolidated Statement of Earnings and Consolidated Statement of Comprehensive Income (Loss)

Unusual charge (2)	\$ –	\$ 720	\$ 720
Earnings before income taxes	\$ 5,262	\$ (720)	\$ 4,542
Deferred income tax expense	\$ 891	\$ (193)	\$ 698
Net earnings for the year	\$ 783	\$ (527)	\$ 256
Basic and diluted net earnings per share for the year	\$ 0.01	\$ (0.01)	\$ 0.00
Comprehensive loss for the year	\$ (6,053)	\$ (527)	\$ (6,580)

- (2) Adjustment to recognize bad debt expense in connection with a past due trade receivable balance, for which, upon correction of the aging, management would have provided an allowance in accordance with the company's credit provision policies.

EXFO Inc.

Notes to Consolidated Financial Statements

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

	As at August 31, 2013		
	As reported	Adjustment	Revised
<u>Revision to Consolidated Balance Sheet</u>			
Retained earnings (3)	\$ 112,852	\$ (556)	\$ 112,296

(3) Adjustment to opening retained earnings as at September 1, 2013 in connection with a past due trade receivable balance, for which, upon correction of the aging, management would have provided an allowance in accordance with the company's credit provision policies.

2 Basis of Presentation

These consolidated financial statements have been prepared in accordance with the *International Financial Reporting Standards* (IFRS), as issued by the *International Accounting Standards Board* (IASB). The company has consistently applied the same accounting policies through all periods presented.

These IFRS consolidated financial statements have been prepared based on the following accounting policies:

Basis of measurement

These consolidated financial statements have been prepared under the historical cost convention, except for the revaluation of derivative financial instruments and available-for-sale investments.

Consolidation

These consolidated financial statements include the accounts of the company and its domestic and foreign subsidiaries. Intercompany accounts and transactions have been eliminated.

Revenue recognition

Revenue comprises the fair value of the consideration received or receivable for the sales of goods and services in the ordinary course of business.

Sales of goods

Revenue from the sales of goods, which represents the majority of the sales of the company, is recognized when the significant risks and rewards of ownership of the goods have passed to the buyer, usually upon delivery of the goods. Revenue is recorded based on the price specified in the sales arrangements.

Maintenance contracts

Maintenance contracts are usually offered to customers for periods of 12 to 36 months. They generally include the right to unspecified software upgrades and enhancements on a when-and-if-available basis as well as customer service. Revenue from these contracts is recognized ratably over the terms of the maintenance contracts on a straight-line basis.

EXFO Inc.

Notes to Consolidated Financial Statements

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

Extended warranties

Extended warranties are usually offered to customers for periods of 6 to 48 months. Revenue from these extended warranties is recognized ratably over the warranty period on a straight-line basis.

Multiple-component arrangements

When a sales arrangement includes multiple separately identifiable components such as goods, extended warranties, maintenance contracts, installation and training, the revenue recognition criteria are applied to each separately identifiable component. A component is considered separately identifiable if the delivered item has value to the customer on a stand-alone basis and the fair value associated with the component can be measured reliably. The company allocates the selling price of a multiple-component arrangement to each component based on the fair value of each component in relation to the fair value of the arrangement as a whole.

Sales arrangements may include acceptance clauses. When a sales arrangement does include an acceptance provision, acceptance occurs upon the earliest of receipt of a written customer acceptance or expiration of the acceptance period. For these sales arrangements, the sale is recognized when acceptance occurs.

Presentation currency

The functional currency of the company is the Canadian dollar. The company has adopted the US dollar as its presentation currency as it is the most commonly used reporting currency in its industry. The consolidated financial statements are translated into the presentation currency as follows: assets and liabilities are translated at the exchange rate in effect on the date of the balance sheet; revenues and expenses are translated at the monthly average exchange rate. The foreign currency translation adjustment arising from such translation is included in accumulated other comprehensive income in the shareholders' equity.

Foreign currency transactions

Transactions denominated in currencies other than the functional currency are translated into the relevant functional currency as follows: Monetary assets and liabilities are translated at the exchange rate in effect on the date of the balance sheet, and revenues and expenses are translated at the exchange rate in effect on the date of the transaction. Non-monetary assets and liabilities measured at historical cost and denominated in a foreign currency are translated using the exchange rate at the date of the transaction, whereas non-monetary items that are measured at fair value and denominated in a foreign currency are translated using the exchange rates at the date when the fair value was determined. Foreign exchange gains and losses arising from such translation are included in the consolidated statements of earnings.

Financial instruments

The classification of financial instruments depends on the intended purpose when the financial instruments were acquired or issued, as well as on their characteristics and designation by the company.

Classification

Financial assets

Cash	Loans and receivables
Short-term investments	Available for sale
Accounts receivable	Loans and receivables
Other assets	Loans and receivables

EXFO Inc.

Notes to Consolidated Financial Statements

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

Financial liabilities

Accounts payable and accrued liabilities

Other financial liabilities

Available-for-sale financial assets

Available-for-sale financial assets are non-derivative financial assets that are designated as available for sale, or are not classified in any of the other categories. They are initially recognized at fair value plus transaction costs and they are subsequently measured at fair value. After their initial recognition, any changes in their fair value are reflected in other comprehensive income.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. After their initial measurement at fair value plus transaction costs, they are carried at amortized cost, using the effective interest rate method, which generally corresponds to the nominal amount due to their short-term maturity.

Other financial liabilities

Other financial liabilities are non-derivative financial liabilities initially measured at fair value plus transaction costs and they are subsequently carried at amortized cost, using the effective interest rate method, which generally corresponds to the nominal amount due to their short-term maturity.

Derivative financial instruments and hedging activities

Forward exchange contracts are utilized by the company to manage its foreign currency exposure. Forward exchange contracts are entered into by the company to hedge anticipated US-dollar-denominated sales and the related accounts receivable as well as Indian-rupee-denominated operating expenses and the related accounts payable. The company's policy is not to utilize those derivative financial instruments for trading or speculative purposes.

The company's forward exchange contracts, which are designated as cash flow hedging instruments, qualify for hedge accounting.

They are initially recorded at fair value plus transaction costs and they are subsequently measured at fair value. The fair value of forward exchange contracts is determined using quoted prices and forward exchange rates at the balance sheet date, with the resulting value discounted back to present value. After initial recognition, the effective portion of changes in their fair value is reflected in other comprehensive income. Any ineffective portion is recognized immediately in the consolidated statements of earnings. Upon the recognition of related hedged sales and operating expenses, accumulated changes in fair value of forward exchange contracts are respectively reclassified in sales and net research and development expenses in the consolidated statements of earnings.

At the inception of a hedge relationship, the company formally designates and documents the hedge relationship to which the company wishes to apply hedge accounting, the risk management objectives, the hedging instrument, the hedged item and the method used to test effectiveness. The company assesses effectiveness of the hedge relationship at inception and on an ongoing basis using the dollar-offset method.

Fair value hierarchy

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

EXFO Inc.

Notes to Consolidated Financial Statements

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

- Level 1: Quoted prices (unadjusted) in active market for identical assets or liabilities;
- Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset and liability, either directly or indirectly;
- Level 3: Unobservable inputs for the asset or liability.

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

Short-term investments

All investments with original terms to maturity of three months or less and that are not required for the purposes of meeting short-term cash requirements are classified as short-term investments. Short-term investments are classified as available-for-sale financial assets; therefore, they are carried at fair value in the balance sheet, and any changes in their fair value are reflected in other comprehensive income. Upon the disposal or maturity of these assets, accumulated changes in their fair value are reclassified in the consolidated statements of earnings.

Inventories

Inventories are valued on an average cost basis, at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs necessary to make the sale.

The cost of work in progress and finished goods includes material, labor and an allocation of manufacturing overhead.

Property, plant and equipment and depreciation

Property, plant and equipment are recorded at cost, net of accumulated depreciation and accumulated impairment losses. Such cost is reduced by related research and development tax credits.

Depreciation is provided on a straight-line basis over the estimated useful lives of the asset as follows:

	Term
Land improvements	15 years
Buildings	20 to 60 years
Equipment	3 to 15 years
Leasehold improvements	The lesser of useful life and remaining lease term

The assets' residual values and useful lives are reviewed at each financial year-end, and adjusted prospectively, if appropriate.

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Intangible assets, goodwill and amortization

Intangible assets

Intangible assets with finite useful lives primarily include the cost of core technology, customer relationships, brand name and software. The cost of intangible assets acquired in a business combination is the fair value of the assets at the date of acquisition. Following initial recognition, intangible assets are carried at cost less accumulated amortization and accumulated impairment losses. Amortization is provided on a straight-line basis over the estimated useful lives of five years for core technology, customer relationships and brand name, and four and eight years for software. None of the company's intangible assets were developed internally.

The amortization method and the useful lives of intangible assets are reviewed at each financial year-end, and adjusted prospectively, if appropriate.

Goodwill

Goodwill represents the excess of the purchase price of acquired businesses over the estimated fair value of net identifiable assets acquired, and is allocated to each cash-generating unit (CGU) or group of CGUs that are expected to benefit from the related business combination. A group of CGUs represents the lowest level within the company at which the goodwill is monitored for internal management purposes, which is not higher than an operating segment. Goodwill is not amortized but must be tested for impairment on an annual basis or more frequently if events or circumstances indicate that it might be impaired.

Research and development

All costs related to research are expensed as incurred, net of related tax credits and grants. Development costs are expensed as incurred, net of related tax credits and grants, unless they meet the recognition criteria of IAS 38, "Intangible Assets", in which case they are capitalized, net of related tax credits and grants and amortized on a straight-line basis over the estimated benefit period. Research and development expenses are mainly comprised of salaries and related expenses, material costs as well as fees paid to third-party consultants. As at August 31, 2015 and 2016, the company had not capitalized any development costs.

The company elected to account for non-refundable research and development tax credits under IAS 20, "Accounting for Governmental Grants and Disclosures of Governmental Assistance", and as such, these tax credits are presented against gross research and development expenses in the consolidated statements of earnings. Non-refundable research and development tax credits are included in earnings or deducted from the related assets, provided there is reasonable assurance that the company has complied and will comply with the conditions related to the tax credits and that the tax credits will be received.

Impairment of non-financial assets

The company assesses at each reporting date whether there is an indication that the carrying value of property, plant and equipment and finite-life intangible assets may not be recoverable. Non-financial assets that are not amortized (such as goodwill) are subject to an annual impairment test. If any indication exists, or when annual impairment testing is required, the company estimates the asset or asset group's recoverable amount. For the purpose of measuring recoverable amounts, assets are grouped at the lowest levels for which there are separately identifiable cash flows (CGUs). The recoverable amount is the higher of an asset or CGU's fair value less costs of disposal and its value in use. Where the carrying value of an asset or CGU exceeds its recoverable amount, the asset or the CGU is considered impaired and is written down to its recoverable amount. The company performs its annual goodwill impairment test in the fourth quarter of each fiscal year.

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For property, plant and equipment and finite-life intangible assets, the reversal of impairment is limited so that the carrying value of the asset does not exceed its recoverable amount, nor exceed the carrying value that would have been determined, net of depreciation or amortization, had no impairment loss been recognized for the asset in prior periods. Impairment losses on goodwill are not reversed.

Leases

Operating leases are leases for which the company does not assume substantially all the risks and rewards of ownership of the asset. Operating lease rentals are charged to the consolidated statements of earnings on a straight-line basis over the lease term.

As at August 31, 2015 and 2016, all significant leases of the company were classified as operating leases.

Government grants

Grants related to operating expenses are included in earnings when the related expenses are incurred. Grants related to capital expenditures are deducted from the related assets. Grants are included in the consolidated statements of earnings or deducted from the related assets, provided there is reasonable assurance that the company has complied and will comply with all the conditions related to the grants and that the grants will be received.

Warranty

The company offers its customers basic warranties of one to three years, depending on the specific products and terms of the purchase agreement. The company's typical warranties require it to repair or replace defective products during the warranty period at no cost to the customer. Costs related to basic warranties are accrued at the time of shipment, based upon estimates of expected rework and warranty costs to be incurred. Costs associated with separately priced extended warranties are expensed as incurred.

Income taxes

Income taxes comprise current and deferred income taxes.

Current income taxes

Current income tax assets and liabilities for the current and prior years are measured at the amount expected to be recovered or paid to the taxation authorities. Income tax rates used to calculate the amount are those that are enacted or substantively enacted at the balance sheet dates in the tax jurisdictions where the company generates taxable income/loss.

Deferred income taxes

The company provides for deferred income taxes using the liability method. Under this method, deferred income tax assets and liabilities are determined based on deductible or taxable temporary differences between financial statement values and tax values of assets and liabilities as well as the carry-forward of unused tax losses and deductions, using enacted or substantively enacted income tax rates at the balance sheet dates, that are expected to be in effect for the years in which the assets are expected to be recovered or the liabilities to be settled.

Deferred income tax assets are recognized only to the extent that it is probable that future taxable income will be available against which the deductible temporary differences as well as unused tax losses and deductions can be utilized.

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Deferred tax liabilities are recognized for all taxable temporary differences and for taxable temporary differences arising on investments in subsidiaries, except where the reversal of these temporary differences can be controlled and it is probable that the differences will not reverse in the foreseeable future.

Deferred income tax assets and liabilities are presented as non-current in the consolidated balance sheets.

Uncertain tax positions

The company is subject to income tax laws and regulations in several jurisdictions. There are many transactions and calculations during the course of business for which the ultimate tax determination is uncertain. The company maintains provisions for uncertain tax positions that it believes appropriately reflect its risk. These provisions are made using the best estimate of the amount expected to be paid based on a qualitative assessment of all relevant factors. The company reviews the adequacy of these provisions at the end of the reporting periods and any changes in the provisions are recognized in the consolidated statements of earnings when they occur. However, it is possible that at some future dates, liabilities in excess of the company's provisions could result from audits by, or litigation with, the relevant taxing authorities. Where the final outcome of these tax-related matters is different from the amounts that were initially recorded, such differences will be recognized in the consolidated statement of earnings in the period in which such determination is made.

Earnings per share

Basic earnings per share are calculated by dividing net earnings attributable to common equity holders of the company by the weighted average number of common shares outstanding during the year.

Diluted earnings per share are calculated by dividing net earnings attributable to common equity holders of the company by the weighted average number of common shares outstanding during the year, plus the effect of dilutive potential common shares outstanding during the year. This method requires that diluted earnings per share be calculated (using the treasury stock method) as if all dilutive potential common shares had been exercised at the latest at the beginning of the year or on the date of issuance, as the case may be, and that the funds obtained thereby (plus an amount equivalent to the unamortized portion of related stock-based compensation costs) be used to purchase common shares of the company at the average market price of the common shares during the year.

Stock-based compensation

Equity-settled awards

The company's stock options, restricted share units and deferred share units are equity-settled awards. The company accounts for stock-based compensation costs on equity-settled awards using the Black-Scholes option valuation model. The fair value of equity-settled awards is measured at the date of grant. Stock-based compensation costs are amortized to expense over the vesting periods together with a corresponding change in contributed surplus in the shareholders' equity. For equity-settled awards with graded vesting, each tranche is considered a separate grant with a different vesting date and fair value, and each tranche are accounted for separately.

Cash-settled awards

The company's stock appreciation rights are cash-settled awards. The company accounts for stock-based compensation costs on cash-settled awards using the Black-Scholes option valuation model. The fair value of the cash-settled awards is remeasured at the end of each reporting period, with any changes in the fair value recognized in the consolidated statements of earnings.

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Operating segments

Operating segments are defined as components of an entity engaged in business activities from which it may earn revenues and incur expenses, and whose operating results are regularly reviewed by the chief operating decision maker (CODM) to make decisions about resources to be allocated to segments and assess their performance and for which discrete information is available. The function of the CODM is performed by the Chief Executive Officer who reviews consolidated results for the purposes of allocating resources and evaluating performance. Accordingly, the company determines that it has one operating segment as of, and for the years ended August 31, 2014, 2015 and 2016. Entity-wide disclosures are presented in note 20.

Critical accounting judgments in applying accounting policies and estimates

The preparation of financial statements in accordance with IFRS requires management to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses as well as the disclosures of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those judgments, estimates and assumptions.

Critical judgments, estimates and assumptions are the following:

Critical judgments in applying accounting policies

(a) Determination of functional currency

The company operates in multiple countries and generates revenue and incurs 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 the company and its subsidiaries may require significant judgment. In determining the functional currency of the company and its subsidiaries, management takes into account primary, secondary and tertiary indicators. When indicators are mixed and the functional currency is not obvious, management uses its 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 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

The company states its inventories at the lower of cost, determined on an average cost basis, and net realizable value, and provides reserves for excess and obsolete inventories. The company determines its 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.

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(b) Income taxes

The company is 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 laws and regulations and the amount and timing of future taxable income. The company maintains provisions for uncertain tax positions that it believes appropriately reflect its risk based on its interpretation of laws and regulations. In addition, management has made reasonable estimates and assumptions to determine the amount of deferred tax assets that can be recognized in the consolidated financial statements, based upon the likely timing and level of anticipated future taxable income together with tax planning strategies. The ultimate realization of the company's 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.

(c) Tax credits recoverable

Tax credits are recorded provided that there is reasonable assurance that the company has 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 the company's non-refundable tax credits is dependent upon the generation of sufficient future taxable income during the tax credits carry-forward periods. Management has made reasonable estimates and assumptions to determine the amount of non-refundable tax credits that can be recognized in the consolidated financial statements, based upon the likely timing and level of anticipated future taxable income together with tax planning strategies (note 18).

(d) Impairment of non-financial assets

Impairment exists when the carrying value of an asset or group of assets (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 the company's CGUs is based on a market approach that relies on unobservable inputs based on valuation multiples and recent transactions for comparable assets or businesses, within the same industry. The company applies judgment in making adjustments to the unobservable inputs for factors such as size, risk profile or profitability. The company also considers the company's value derived from its market capitalization, adjusting for a control premium considered appropriate based on other comparable companies with significant controlling interests. Depending on the market evidence available, the company, from time to time, may further supplement this market approach with an income approach that considers discounted cash flows to determine fair value less costs of disposal. The discounted cash flow model involves significant judgment with respect to estimating cash flows (based on market participant assumptions) and the appropriate discount rate.

New IFRS pronouncements not yet adopted

Financial instruments

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

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Revenue from contracts with customers

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

Leases

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

3 Restructuring Charges

In the fourth quarter of fiscal 2015, the company implemented a restructuring plan to align its cost structure to the challenging market environment. This plan resulted in one-time severance expenses of \$1,637,000 for employees laid off during the fourth quarter of 2015 (notes 10 and 16). These expenses were fully paid in fiscal 2016.

4 Capital Disclosures

The company is not subject to any external restrictions on its capital.

The company’s objectives when managing capital are:

- To maintain a flexible capital structure that optimizes the cost of capital at acceptable risk;
- To sustain future development of the company, including research and development activities, market development and potential acquisitions of complementary businesses or products; and
- To provide the company’s shareholders with an appropriate return on their investment.

No changes were made to the objectives and policies during the years ended August 31, 2015 and 2016.

The company defines its capital as shareholders’ equity, excluding accumulated other comprehensive loss. The capital of the company amounted to \$221,232,000 and \$229,975,000 as at August 31, 2015 and 2016 respectively.

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5 Financial Instruments

The following tables summarize financial instruments by category:

	As at August 31, 2016				
	Loans and receivable	Available for sale	Other financial liabilities	Derivatives used for hedging	Total
Financial assets					
Cash	\$ 43,208	\$ –	\$ –	\$ –	\$ 43,208
Short-term investments	\$ –	\$ 4,087	\$ –	\$ –	\$ 4,087
Accounts receivable	\$ 45,467	\$ –	\$ –	\$ –	\$ 45,467
Other assets	\$ 35	\$ –	\$ –	\$ –	\$ 35
Forward exchange contracts	\$ –	\$ –	\$ –	\$ 980	\$ 980
Financial liabilities					
Accounts payable and accrued liabilities	\$ –	\$ –	\$ 36,099	\$ –	\$ 36,099
Forward exchange contracts	\$ –	\$ –	\$ –	\$ 1,120	\$ 1,120

	As at August 31, 2015				
	Loans and receivable	Available for sale	Other financial liabilities	Derivatives used for hedging	Total
Financial assets					
Cash	\$ 25,864	\$ –	\$ –	\$ –	\$ 25,864
Short-term investments	\$ –	\$ 1,487	\$ –	\$ –	\$ 1,487
Accounts receivable	\$ 48,369	\$ –	\$ –	\$ –	\$ 48,369
Other assets	\$ 103	\$ –	\$ –	\$ –	\$ 103
Financial liabilities					
Accounts payable and accrued liabilities	\$ –	\$ –	\$ 29,029	\$ –	\$ 29,029
Forward exchange contracts	\$ –	\$ –	\$ –	\$ 4,154	\$ 4,154

Fair value

Cash, accounts receivable and accounts payable and accrued liabilities are financial instruments whose carrying values approximate their fair values due to their short-term maturities. The fair value of other assets approximates their carrying value due to their relatively short-term maturities.

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

	As at August 31, 2016		As at August 31, 2015	
	Level 1	Level 2	Level 1	Level 2
Financial assets				
Short-term investments	\$ 4,087	\$ –	\$ 1,487	\$ –
Forward exchange contracts	\$ –	\$ 980	\$ –	\$ –
Financial liabilities				
Forward exchange contracts	\$ –	\$ 1,120	\$ –	\$ 4,154

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Market risk

Currency risk

The functional currency of the company is the Canadian dollar. The company is exposed to a currency risk as a result of its export sales of products manufactured in Canada, China and Finland, the majority of which are denominated in US dollars and euros. This risk is partially hedged by forward exchange contracts and certain cost of sales and operating expenses (US dollars and euros). In addition, the company is exposed to a currency risk as a result of its research and development activities in India (Indian rupees). This risk is 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, 2015 and 2016, the company held contracts to sell US dollars for Canadian dollars and Indian rupees at various forward rates, which are summarized as follows:

US dollars – Canadian dollars

<u>Expiry dates</u>	<u>Contractual amounts</u>	<u>Weighted average contractual forward rates</u>
As at August 31, 2015		
September 2015 to August 2016	\$ 20,200	1.1180
September 2016 to August 2017	8,000	1.1530
September 2017 to December 2017	1,600	1.2135
Total	<u>\$ 29,800</u>	<u>1.1326</u>
As at August 31, 2016		
September 2016 to August 2017	\$ 22,200	1.2784
September 2017 to August 2018	9,900	1.3367
September 2018 to December 2018	1,900	1.3639
Total	<u>\$ 34,000</u>	<u>1.3002</u>

US dollars – Indian rupees

<u>Expiry dates</u>	<u>Contractual amounts</u>	<u>Weighted average contractual forward rates</u>
As at August 31, 2015		
September 2015 to July 2016	<u>\$ 3,900</u>	<u>66.41</u>
As at August 31, 2016		
September 2016 to August 2017	<u>\$ 3,800</u>	<u>70.92</u>

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 \$4,154,000 and \$140,000 as at August 31, 2015 and 2016.

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As at August 31, 2016, forward exchange contracts in the amount of \$635,000 are presented as current assets in other accounts receivable; forward exchange contracts in the amount of \$345,000 are presented as long-term assets in other long-term assets; forward exchange contracts in the amount of \$1,075,000 are presented as current liabilities in accounts payable; and accrued liabilities and forward exchange contracts in the amount of \$45,000 are presented as long-term liabilities in other long-term liabilities in the balance sheet. Forward exchange contracts of \$277,000, included in accounts payable and accrued liabilities, for which related hedged sales are recognized, are recorded in the consolidated statement of earnings. Otherwise, other forward exchange contracts are not yet recorded in the consolidated statement of earnings and are recorded in other comprehensive income.

As at August 31, 2015, forward exchange contracts in the amount of \$3,460,000 were presented as current liabilities in accounts payable and accrued liabilities, and forward exchange contracts in the amount of \$694,000 were presented as long-term liabilities in other long-term liabilities in the balance sheet.

Based on the portfolio of forward exchange contracts as at August 31, 2016, the company estimates that the portion of net unrealized losses on these contracts as of that date, which will be realized and reclassified from accumulated other comprehensive income to net earnings over the next 12 months, amounts to \$163,000.

For the years ended August 31, 2014, 2015 and 2016, the company recorded within its sales the following foreign exchange losses on forward exchange contracts:

	Years ended August 31,		
	2016	2015	2014
Losses on forward exchange contracts	\$ 2,651	\$ 2,562	\$ 909

The following table summarizes significant derivative and non-derivative financial assets and liabilities that are subject to currency risk as at August 31, 2015 and 2016 and for which such risk is charged to earnings:

	As at August 31,			
	2016		2015	
	Carrying/nominal amount (in thousands of US dollars)	Carrying/nominal amount (in thousands of euros)	Carrying/nominal amount (in thousands of US dollars)	Carrying/nominal amount (in thousands of euros)
Financial assets				
Cash	\$ 13,090	€ 2,927	\$ 9,226	€ 3,448
Accounts receivable	30,141	5,963	37,019	4,488
	43,231	8,890	46,245	7,936
Financial liabilities				
Accounts payable and accrued liabilities	14,251	1,081	12,873	1,047
Forward exchange contracts (nominal value)	4,000	–	3,800	–
	18,251	1,081	16,673	1,047
Net exposure	\$ 24,980	€ 7,809	\$ 29,572	€ 6,889

In addition to these assets and liabilities, the company has derivative financial liabilities for its outstanding forward exchange contracts in the amount (nominal value) of \$29,900,000 and \$33,800,000 as at August 31, 2015 and 2016 respectively for which the currency risk is charged to other comprehensive income.

The value of the Canadian dollar compared to the US dollar was CA\$1.3157 = US\$1.00 and CA\$1.3116 = US\$1.00 as at August 31, 2015 and 2016 respectively.

The value of the Canadian dollar compared to the euro was CA\$1.4755 = €1.00 and CA\$1.4601 = €1.00 as at August 31, 2015 and 2016 respectively.

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The following sensitivity analysis summarizes the effect that a change in the value of the Canadian dollar (compared to the US dollar and euro) on derivative and non-derivative financial assets and liabilities denominated in US dollars and euros would have on net earnings, net earnings per diluted share and comprehensive income, based on the foreign exchange rates as at August 31, 2015 and 2016:

- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the US dollar would decrease (increase) net earnings by \$2,677,000, or \$0.05 per diluted share, and \$2,342,000, or \$0.04 per diluted share, as at August 31, 2015 and 2016 respectively.
- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the euro would decrease (increase) net earnings by \$834,000, or \$0.01 per diluted share, and \$830,000 or \$0.02 per diluted share, as at August 31, 2015 and 2016 respectively.
- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the US dollar would increase (decrease) other comprehensive income by \$2,066,000 and \$2,176,000 as at August 31, 2015 and 2016 respectively.

The impact of the change in the value of the Canadian dollar compared to the US dollar and the euro on these derivative and non-derivative financial assets and liabilities is recorded in the foreign exchange gain or loss line item in the consolidated statements of earnings, except for outstanding forward contracts, whose impact is recorded in other comprehensive income. The change in the value of the Canadian dollar compared to the US dollar and the euro also affects the company's balances of income tax recoverable or payable, as well as deferred income tax assets and liabilities denominated in US dollars and euros; this may result in additional and significant foreign exchange gains or losses. However, these tax-related assets and liabilities are not considered financial instruments and are therefore excluded from the sensitivity analysis above. The foreign exchange rate fluctuations also flow through the consolidated statements of earnings line items, as a significant portion of the company's cost of sales and operating expenses are denominated in Canadian dollars, euros and Indian rupees, and the company reports its results in US dollars; that effect is not reflected in the sensitivity analysis above.

Interest rate risk

The company has limited exposure to interest rate risk. The company is mainly exposed to interest rate risks through its cash and short-term investments.

Cash

As at August 31, 2015 and 2016, the company's cash balances included an amount of \$10,783,000 and \$23,277,000 respectively that bears interest at an annual rate of 1.0% and 1.2% respectively.

Short-term investments

Short-term investments consist of the following:

	As at August 31	
	2016	2015
Term deposit denominated in Canadian dollars, bearing interest at an annual rate of 1.5%, maturing in May 2017	\$ 2,668	\$ –
Term deposits denominated in Indian rupees, bearing interest at annual rates of 6.0% to 7.3% in 2016 and 4.5% to 8.5% in 2015, maturing on different dates between November 2016 and October 2018 in 2016 and November 2015 and October 2018 in 2015	1,419	1,487
	\$ 4,087	\$ 1,487

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Due to their short-term maturity, the company's short-term investments are not subject to a significant fair value interest rate risk. Accordingly, changes in fair value have been nominal to the degree that amortized cost approximates the fair value. Any change in the fair value of the company's short-term investments, all of which are classified as available for sale, is recorded in other comprehensive income.

Other financial instruments

Accounts receivable, other assets and accounts payable and accrued liabilities are non-interest-bearing financial assets and liabilities.

Credit risk

Financial instruments that potentially subject the company to credit risk consist of cash, short-term investments, accounts receivable, other assets and forward exchange contracts (with a positive fair value). As at August 31, 2016, the company's short-term investments consist of debt instruments issued by high-credit quality corporations. These debt instruments are not expected to be affected by a significant credit risk. The company's cash and forward exchange contracts are held with or issued by high-credit quality financial institutions; therefore, the company considers the risk of non-performance on these instruments to be limited.

Generally, the company does not require collateral or other security from customers for trade accounts receivable; however, credit is extended to customers following an evaluation of creditworthiness. In addition, the company performs ongoing credit reviews of all its customers and establishes an allowance for doubtful accounts receivable when accounts are determined to be uncollectible. Allowance for doubtful accounts amounted to \$2,935,000 and \$3,752,000 as at August 31, 2015 and 2016 respectively.

For the years ended August 31, 2014, 2015 and 2016, no customer represented more than 10% of sales.

The following table summarizes the age of trade accounts receivable:

	As at August 31,	
	2016	2015
Current	\$ 38,411	\$ 36,723
Past due, 0 to 30 days	1,286	5,164
Past due, 31 to 60 days	868	1,027
Past due, more than 60 days, net of allowance for doubtful accounts of \$2,935 and \$3,752 as at August 31, 2015 and 2016, respectively	2,428	3,071
	\$ 42,993	\$ 45,985

Changes in the allowance for doubtful accounts are as follows:

	Years ended August 31,	
	2016	2015
Balance – Beginning of year	\$ 2,935	\$ 1,876
Addition charged to earnings	817	1,107
Write-off of uncollectible accounts	–	(48)
Balance – End of year	\$ 3,752	\$ 2,935

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Liquidity risk

Liquidity risk is defined as the potential that the company cannot meet its obligations as they become due.

The following tables summarize the contractual maturity of the company's derivative and non-derivative financial liabilities:

	As at August 31, 2016		
	0-12 months	13-24 months	25-36 months
Accounts payable and accrued liabilities	\$ 36,099	\$ –	\$ –
Forward exchange contracts			
Outflow	26,000	9,900	1,900
Inflow	(25,653)	(10,089)	(1,976)
Total	<u>\$ 36,446</u>	<u>\$ (189)</u>	<u>\$ (76)</u>
	As at August 31, 2015		
	0-12 months	13-24 months	25-36 months
Accounts payable and accrued liabilities	\$ 29,029	\$ –	\$ –
Forward exchange contracts			
Outflow	24,100	8,000	1,600
Inflow	(21,082)	(7,011)	(1,476)
Total	<u>\$ 32,047</u>	<u>\$ 989</u>	<u>\$ 124</u>

As at August 31, 2016, the company had \$47,295,000 in cash and short-term investments and \$45,467,000 in accounts receivable. In addition to these financial assets, the company has unused available lines of credit totaling \$14,932,000 for working capital and other general corporate purposes, including potential acquisitions and its share repurchase program as well as unused lines of credit totaling \$21,567,000 for foreign currency exposure related to its forward exchange contracts (note 9).

6 Inventories

	As at August 31,	
	2016	2015
Raw materials	\$ 18,692	\$ 15,972
Work in progress	1,067	998
Finished goods	13,245	10,981
	<u>\$ 33,004</u>	<u>\$ 27,951</u>

The cost of sales comprised almost exclusively the amount of inventory recognized as an expense during the reporting years, and amounts to \$90,445,000, \$88,098,000 and \$89,058,000 for the years ended August 31, 2014, 2015 and 2016 respectively, including related depreciation and amortization, which are shown separately in operating expenses (note 16).

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Notes to Consolidated Financial Statements

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

Inventory write-down amounted to \$4,600,000, \$4,066,000 and \$3,678,000 for the years ended August 31, 2014, 2015 and 2016 respectively.

7 Property, Plant and Equipment

	Land and land improvements	Buildings	Equipment	Leasehold improvements	Total
Cost as at September 1, 2014	\$ 5,222	\$ 35,597	\$ 38,970	\$ 2,442	\$ 82,231
Additions	–	153	3,638	1,443	5,234
Disposals	–	(12)	(4,999)	(753)	(5,764)
Foreign currency translation adjustment	(913)	(6,266)	(6,400)	(338)	(13,917)
Cost as at August 31, 2015	<u>4,309</u>	<u>29,472</u>	<u>31,209</u>	<u>2,794</u>	<u>67,784</u>
Additions	–	201	3,626	226	4,053
Disposals	–	(11)	(4,280)	(121)	(4,412)
Foreign currency translation adjustment	13	93	162	19	287
Cost as at August 31, 2016	<u>\$ 4,322</u>	<u>\$ 29,755</u>	<u>\$ 30,717</u>	<u>\$ 2,918</u>	<u>\$ 67,712</u>
Accumulated depreciation as at September 1, 2014	\$ 1,327	\$ 6,984	\$ 29,888	\$ 1,252	\$ 39,451
Depreciation for the year	51	485	3,919	380	4,835
Disposals	–	(12)	(4,999)	(753)	(5,764)
Foreign currency translation adjustment	(236)	(1,514)	(4,595)	(88)	(6,433)
Accumulated depreciation as at August 31, 2015	<u>1,142</u>	<u>5,943</u>	<u>24,213</u>	<u>791</u>	<u>32,089</u>
Depreciation for the year	45	639	2,811	319	3,814
Disposals	–	(11)	(4,258)	(121)	(4,390)
Foreign currency translation adjustment	5	31	136	49	221
Accumulated depreciation as at August 31, 2016	<u>\$ 1,192</u>	<u>\$ 6,602</u>	<u>\$ 22,902</u>	<u>\$ 1,038</u>	<u>\$ 31,734</u>
Net carrying value as at:					
August 31, 2015	\$ 3,167	\$ 23,529	\$ 6,996	\$ 2,003	\$ 35,695
August 31, 2016	\$ 3,130	\$ 23,153	\$ 7,815	\$ 1,880	\$ 35,978

As at August 31, 2015 and 2016, unpaid additions to property, plant and equipment amounted to \$377,000 and \$499,000 respectively.

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8 Intangible Assets and Goodwill

Intangible assets

	Core technology	Customer relationships	Brand name	Software	Total
Cost as at September 1, 2014	\$ 12,686	\$ 5,979	\$ 596	\$ 12,925	\$ 32,186
Additions	153	-	-	567	720
Disposals	(93)	-	-	(652)	(745)
Foreign currency translation adjustment	(2,225)	(1,044)	(104)	(2,112)	(5,485)
Cost as at August 31, 2015	<u>10,521</u>	<u>4,935</u>	<u>492</u>	<u>10,728</u>	<u>26,676</u>
Additions	147	-	-	313	460
Disposals	(6,414)	(4,935)	(492)	(310)	(12,151)
Foreign currency translation adjustment	48	-	-	112	160
Cost as at August 31, 2016	<u><u>\$ 4,302</u></u>	<u><u>\$ -</u></u>	<u><u>\$ -</u></u>	<u><u>\$ 10,843</u></u>	<u><u>\$ 15,145</u></u>
Accumulated amortization as at September 1, 2014	\$ 8,062	\$ 5,346	\$ 534	\$ 10,951	\$ 24,893
Amortization for the year	808	569	57	1,449	2,883
Disposals	(93)	-	-	(652)	(745)
Foreign currency translation adjustment	(865)	(980)	(99)	(2,507)	(4,451)
Accumulated amortization as at August 31, 2015	<u>7,912</u>	<u>4,935</u>	<u>492</u>	<u>9,241</u>	<u>22,580</u>
Amortization for the year	700	-	-	472	1,172
Disposals	(6,414)	(4,935)	(492)	(297)	(12,138)
Foreign currency translation adjustment	109	-	-	31	140
Accumulated amortization as at August 31, 2016	<u><u>\$ 2,307</u></u>	<u><u>\$ -</u></u>	<u><u>\$ -</u></u>	<u><u>\$ 9,447</u></u>	<u><u>\$ 11,754</u></u>
Net carrying value as at:					
August 31, 2015	\$ 2,609	\$ -	\$ -	\$ 1,487	\$ 4,096
August 31, 2016	\$ 1,995	\$ -	\$ -	\$ 1,396	\$ 3,391
Remaining amortization period as at August 31, 2016	3 years	-	-	4 years	

Goodwill

	Years ended August 31,	
	<u>2016</u>	<u>2015</u>
Balance – Beginning of year	\$ 21,860	\$ 26,488
Foreign currency translation adjustment	68	(4,628)
Balance – End of year	<u><u>\$ 21,928</u></u>	<u><u>\$ 21,860</u></u>

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In the fourth quarter of fiscal 2015 and 2016, the company performed its annual goodwill impairment test for its two CGUs, EXFO and Brix. 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:

	As at August 31,	
	2016	2015
EXFO CGU	\$ 8,663	\$ 8,636
Brix CGU	13,265	13,224
Total	\$ 21,928	\$ 21,860

In performing the goodwill impairment review of both CGUs, the company determined the recoverable amount of goodwill based on fair value less costs of disposal. In estimating the recoverable amount of the EXFO CGU, the company 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. The company 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, the company 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 the company's sales and operations, the company also compared the carrying amount of the EXFO CGU to the company'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, management 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 company's market approach described above.

As the valuation techniques used by the company require the use of unobservable inputs, the recoverable amount of the company's CGUs is classified within Level 3 of the fair value hierarchy.

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.

9 Credit Facilities

The company has lines of credit that provide for advances of up to CA\$11,000,000 (US\$8,387,000) and up to US\$2,000,000. These lines of credit bear interest at the Canadian prime rate. As at August 31, 2016, an amount of CA\$539,000 (US\$411,000) was drawn from these lines of credit for letters of guarantee in the normal course of the company's operations for its own selling and purchasing requirements. The company also has a line of credit that provides for advances of up to CA\$6,500,000 (US\$4,956,000). This line of credit bears interest at the Canadian prime rate.

In addition, the company has lines of credit totaling \$23,672,000 for the foreign currency risk exposure related to its US dollar – Canadian dollar forward exchange contracts (note 5). As at August 31, 2016, an amount of \$3,344,000 was reserved from these lines of credit.

Finally, the company has a line of credit of INR 120,805,000 (US\$1,800,000) for the foreign currency risk exposure related to its US dollar – Indian rupee forward exchange contracts (note 5). As at August 31, 2016, an amount of INR 37,651,000 (US\$561,000) was reserve from this line of credit.

Accounts receivable were pledged as collateral against all these lines of credit, which are also subject to a negative pledge whereby the company has agreed with the banks not to pledge its assets to any other party without its consent.

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Notes to Consolidated Financial Statements

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10 Accounts Payable and Accrued Liabilities

	As at August 31,	
	2016	2015
Trade	\$ 16,940	\$ 14,402
Salaries and social benefits	16,188	11,088
Forward exchange contracts (note 5)	1,075	3,460
Restructuring charges (note 3)	–	1,637
Other	2,971	3,539
	\$ 37,174	\$ 34,126

11 Commitments

The company entered into operating leases for certain of its premises and equipment, which expire at various dates through 2023. Minimum rentals payable under operating leases are as follows:

	As at August 31,	
	2016	2015
No later than 1 year	\$ 3,337	\$ 2,112
Later than 1 year and no later than 5 years	3,876	3,620
Later than 5 years	1,037	1,766
	\$ 8,250	\$ 7,498

For the years ended August 31, 2014, 2015 and 2016, rental expenses amounted to \$2,892,000, \$2,845,000 and \$2,728,000 respectively.

12 Share Capital

Authorized – unlimited as to number, without par value

Subordinate voting and participating, bearing a non-cumulative dividend to be determined by the Board of Directors, ranking *pari passu* with multiple voting shares

Multiple voting and participating, entitling to 10 votes each, bearing a non-cumulative dividend to be determined by the Board of Directors, convertible at the holder's option into subordinate voting shares on a one-for-one basis, ranking *pari passu* with subordinate voting shares

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Notes to Consolidated Financial Statements

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The following table summarizes the share capital activity:

	Multiple Voting Shares		Subordinate Voting Shares		Total amount
	Number	Amount	Number	Amount	
Balance as at September 1, 2013	31,643,000	\$ 1	28,401,790	\$ 109,836	\$ 109,837
Exercise of stock options (note 14)	–	–	52,800	225	225
Redemption of restricted share units (note 14)	–	–	425,620	–	–
Redemption of deferred share units (note 14)	–	–	38,010	–	–
Redemption of share capital	–	–	(214,470)	(831)	(831)
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	–	–	–	2,260	2,260
Balance as at August 31, 2014	31,643,000	1	28,703,750	111,490	111,491
Redemption of restricted share units (note 14)	–	–	229,559	–	–
Redemption of deferred share units (note 14)	–	–	48,697	–	–
Redemption of share capital	–	–	(6,889,972)	(26,827)	(26,827)
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	–	–	–	1,381	1,381
Balance as at August 31, 2015	31,643,000	1	22,092,034	86,044	86,045
Redemption of restricted share units (note 14)	–	–	277,805	–	–
Redemption of deferred share units (note 14)	–	–	653	–	–
Redemption of share capital	–	–	(452,550)	(1,768)	(1,768)
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	–	–	–	1,239	1,239
Balance as at August 31, 2016	<u>31,643,000</u>	<u>\$ 1</u>	<u>21,917,942</u>	<u>\$ 85,515</u>	<u>\$ 85,516</u>

- a) On January 8, 2014, the company announced that its Board of Directors had approved the renewal of its share repurchase program, by way of a normal course issuer bid on the open market of up to 10% of its issued and outstanding subordinate voting shares, representing 2,043,101 subordinate voting shares at the prevailing market price. The normal course issuer bid started on January 13, 2014, and ended on January 12, 2015. All shares repurchased under the bid were cancelled.

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Notes to Consolidated Financial Statements

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

- b) On January 7, 2015, the company announced that its Board of Directors had authorized a substantial issuer bid (the "Offer") to purchase for cancellation up to 7,142,857 subordinate voting shares for an aggregate purchase price not to exceed CA\$30,000,000. On February 20, 2015, pursuant to the Offer, the company purchased for cancellation 6,521,739 subordinate voting shares for an aggregate purchase price of CA\$30,000,000 (US\$24,027,000), plus related fees of \$223,000. The company used cash to fund the purchase of shares.
- c) On March 25, 2015, the company announced that its Board of Directors had approved the renewal of its share repurchase program, by way of a normal course issuer bid on the open market of up to 10% of the issued and outstanding subordinate voting shares, representing 1,397,598 subordinate voting shares at the prevailing market price. The normal course issuer bid started on March 27, 2015, and ended on March 26, 2016. All shares repurchased under the bid were cancelled.
- d) On March 29, 2016, the company announced that its Board of Directors had approved the renewal of its share repurchase program, by way of a normal course issuer bid on the open market of up to 6.6% of the issued and outstanding subordinate voting shares, representing 900,000 subordinate voting shares at the prevailing market price. The normal course issuer bid started on April 1, 2016, and will end on March 31, 2017, or on an earlier date if the company repurchases the maximum number of shares permitted under the bid. The program does not require that the company repurchases any specific number of shares, and it may be modified, suspended or terminated at any time and without prior notice. All shares repurchased under the bid are cancelled.

13 Accumulated Other Comprehensive Loss

Changes in accumulated other comprehensive loss are as follows:

	Foreign currency translation adjustment	Cash-flow hedge	Accumulated other comprehensive loss
Balance as at September 1, 2013	\$ (3,582)	\$ 159	\$ (3,423)
Foreign currency translation adjustment	(7,086)	-	(7,086)
Changes in unrealized losses on forward exchange contracts, net of deferred income taxes	-	250	250
Balance as at August 31, 2014	(10,668)	409	(10,259)
Foreign currency translation adjustment	(39,175)	-	(39,175)
Changes in unrealized losses on forward exchange contracts, net of deferred income taxes	-	(2,571)	(2,571)
Balance as at August 31, 2015	(49,843)	(2,162)	(52,005)
Foreign currency translation adjustment	707	-	707
Changes in unrealized gains/losses on forward exchange contracts, net of deferred income taxes	-	2,724	2,724
Balance as at August 31, 2016	\$ (49,136)	\$ 562	\$ (48,574)

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14 Stock-Based Compensation Plans

The following table summarizes the stock-based compensation costs recognized for employee services received during the years ended August 31, 2014, 2015 and 2016:

	Years ended August 31,		
	2016	2015	2014
Stock-based compensation costs arising from equity-settled awards	\$ 1,394	\$ 1,323	\$ 1,683
Stock-based compensation costs arising from cash-settled awards	(16)	(28)	13
	\$ 1,378	\$ 1,295	\$ 1,696

The maximum number of additional subordinate voting shares issuable under the Long-Term Incentive Plan and the Deferred Share Unit Plan cannot exceed 6,306,153 shares. The maximum number of subordinate voting shares that may be granted to any individual on an annual basis cannot exceed 5% of the number of outstanding subordinate voting shares. The company settles equity-settled awards through the issuance of common shares from treasury.

Long-Term Incentive Plan

The company established the Long-Term Incentive Plan for its directors, executive officers and employees and those of its subsidiaries, as determined by the Board of Directors. The plan, which includes stock options and restricted share units, was approved by the shareholders of the company.

Stock Options

The exercise price of stock options granted under the Long-Term Incentive Plan is the market price of the common shares on the date of grant. Stock options granted under the plan expire 10 years from the date of grant and generally vest over a four-year period, being the required period of service from employees, generally with 25% vesting on an annual basis commencing on the first anniversary of the date of grant.

The following table summarizes stock option activity for the years ended August 31, 2014, 2015 and 2016:

	Years ended August 31,					
	2016		2015		2014	
	Number	Weighted average exercise price (CA\$)	Number	Weighted average exercise price (CA\$)	Number	Weighted average exercise price (CA\$)
Outstanding – Beginning of year	17,099	\$ 6	87,454	\$ 6	201,254	\$ 6
Exercised	–	–	–	–	(52,800)	5
Forfeited	–	–	(2,000)	6	(4,500)	6
Expired	(17,099)	6	(68,355)	6	(56,500)	6
Outstanding – End of year	–	\$ –	17,099	\$ 6	87,454	\$ 6
Exercisable – End of year	–	\$ –	17,099	\$ 6	87,454	\$ 6

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The weighted-average market price of the shares at the date of exercise of stock options for the years ended August 31, 2014 was \$5.08.

Restricted Share Units (RSUs)

RSUs are stock awards that rise and fall in value based on the market price of the company's subordinate voting shares and are redeemable for actual subordinate voting shares. Vesting dates are also established by the Board of Directors on the date of grant. The vesting dates are subject to a minimum term of three years and a maximum term of 10 years from the award date, being the required period of service from employees. Fair value of RSUs equals the market price of the common shares on the date of grant.

The following table summarizes RSU activity for the years ended August 31, 2014, 2015 and 2016:

	Years ended August 31,		
	2016	2015	2014
Outstanding – Beginning of year	1,299,958	1,225,135	1,333,092
Granted	572,008	409,521	336,685
Redeemed	(277,805)	(229,559)	(425,620)
Forfeited	(42,606)	(105,139)	(19,022)
Outstanding – End of year	<u>1,551,555</u>	<u>1,299,958</u>	<u>1,225,135</u>

None of the RSUs outstanding as at August 31, 2015 and 2016, were redeemable. The weighted average grant-date fair value of RSUs granted during the years ended August 31, 2014, 2015 and 2016, amounted to \$4.84, \$3.63 and \$3.23 respectively.

The weighted-average market price of the shares at the date of redemption of RSUs redeemed during the years ended August 31, 2014, 2015 and 2016, was \$5.21, \$3.60 and \$3.03 respectively.

Deferred Share Unit Plan

The company established a Deferred Share Unit (DSU) Plan for the members of the Board of Directors as part of their annual retainer fees. Each DSU entitles the Board members to receive one subordinate voting share. DSUs are acquired on the date of grant and are redeemed in subordinate voting shares when the Board member ceases to be Director of the company. This plan was approved by the shareholders of the company.

The following table summarizes DSU activity for the years ended August 31, 2014, 2015 and 2016:

	Years ended August 31,		
	2016	2015	2014
Outstanding – Beginning of year	114,810	117,701	119,908
Granted	44,970	45,806	35,803
Redeemed	(653)	(48,697)	(38,010)
Outstanding – End of year	<u>159,127</u>	<u>114,810</u>	<u>117,701</u>

As at August 31, 2016, none of the DSUs outstanding were redeemable. As at August 31, 2015, 653 outstanding DSUs were redeemable. The weighted average grant-date fair value of DSUs granted during the years ended August 31, 2014, 2015 and 2016, amounted to \$4.59, \$3.38 and \$3.33 respectively.

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The weighted-average market price of the shares at the date of redemption of DSUs redeemed during the years ended August 31, 2014, 2015 and 2016, was \$5.21, \$3.49 and \$3.04 respectively.

Stock Appreciation Rights Plan

The company established the Stock Appreciation Rights Plan for certain employees. Under that plan, eligible employees are entitled to receive a cash amount equivalent to the difference between the market price of the common shares on the date of exercise and the exercise price determined on the date of grant. Stock appreciation rights granted under the plan expire 10 years from the date of grant and generally vest over a four-year period, being the required period of service from employees, generally with 25% vesting on an annual basis commencing on the first anniversary of the date of grant. This plan was approved by the shareholders of the company.

The following table summarizes stock appreciation rights activity for the years ended August 31, 2014, 2015 and 2016:

	Years ended August 31,					
	2016		2015		2014	
	Number	Weighted average exercise price	Number	Weighted average exercise price	Number	Weighted average exercise price
Outstanding – Beginning of year	42,324	\$ 1	39,874	\$ 2	37,224	\$ 3
Granted	7,800	–	6,150	–	7,150	–
Exercised	(12,927)	5	(500)	6	–	–
Expired	(1,500)	7	(2,000)	5	(4,500)	5
Forfeited	(2,197)	–	(1,200)	6	–	–
Outstanding – End of year	<u>33,500</u>	<u>\$ 1</u>	<u>42,324</u>	<u>\$ 1</u>	<u>39,874</u>	<u>\$ 2</u>
Exercisable – End of year	<u>14,000</u>	<u>\$ 3</u>	<u>22,924</u>	<u>\$ 3</u>	<u>22,374</u>	<u>\$ 3</u>

The liability arising from stock appreciation rights as at August 31, 2015 and 2016, amounted to \$91,000 and \$76,000 respectively and is recorded in accounts payable and accrued liabilities in the balance sheets.

The following table summarizes information about outstanding stock appreciation rights as at August 31, 2016:

Exercise price	Stock appreciation rights outstanding		Weighted average remaining contractual life	Stock appreciation rights exercisable	
	Number	Weighted average remaining contractual life		Number	Weighted average remaining contractual life
\$ –	19,500	8 years		–	
\$2.36	8,250	2 years		8,250	
\$3.74	4,000	3 years		4,000	
\$6.28	1,750	1 year		1,750	
	<u>33,500</u>	<u>6 years</u>		<u>14,000</u>	

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15 Related-Party Disclosures

Ultimate controlling party

Mr. Germain Lamonde, the company's Chairman, President and Chief Executive Officer, is the company's ultimate controlling party.

Related party transaction

During the year ended August 31, 2015, following the merger of one subsidiary with the parent company, the subsidiary redeemed one share owned by G. Lamonde Investissements financiers, a company controlled by Mr. Germain Lamonde, for a cash consideration of \$1, representing its paid-up capital.

Compensation of key management personnel

	Years ended August 31,		
	2016	2015	2014
Salaries and short-term employee benefits	\$ 3,701	\$ 3,025	\$ 3,627
Stock-based compensation costs	826	617	906
	<u>\$ 4,527</u>	<u>\$ 3,642</u>	<u>\$ 4,533</u>

Key management personnel includes senior management and directors.

16 Statements of Earnings

Net research and development

Net research and development expenses comprise the following:

	Years ended August 31,		
	2016	2015	2014
Gross research and development expenses	\$ 47,875	\$ 50,148	\$ 52,423
Research and development tax credits and grants	(5,188)	(6,145)	(7,577)
Net research and development expenses for the year	<u>\$ 42,687</u>	<u>\$ 44,003</u>	<u>\$ 44,846</u>

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Depreciation and amortization

Depreciation and amortization expenses by functional area are as follows:

	Years ended August 31,		
	2016	2015	2014
Cost of sales			
Depreciation of property, plant and equipment	\$ 1,290	\$ 1,519	\$ 1,522
Amortization of intangible assets	702	1,540	2,087
	<u>1,992</u>	<u>3,059</u>	<u>3,609</u>
Selling and administrative expenses			
Depreciation of property, plant and equipment	501	524	951
Amortization of intangible assets	75	790	1,534
	<u>576</u>	<u>1,314</u>	<u>2,485</u>
Net research and development expenses			
Depreciation of property, plant and equipment	2,023	2,792	2,522
Amortization of intangible assets	395	553	777
	<u>2,418</u>	<u>3,345</u>	<u>3,299</u>
	<u>\$ 4,986</u>	<u>\$ 7,718</u>	<u>\$ 9,393</u>
Depreciation of property, plant and equipment	\$ 3,814	\$ 4,835	\$ 4,995
Amortization of intangible assets	1,172	2,883	4,398
Total depreciation and amortization expenses for the year	<u>\$ 4,986</u>	<u>\$ 7,718</u>	<u>\$ 9,393</u>

Employee compensation

Employee compensation comprises the following:

	Years ended August 31,		
	2016	2015	2014
Salaries and benefits	\$ 112,569	\$ 114,868	\$ 121,515
Restructuring charges	–	1,637	–
Stock-based compensation costs	1,378	1,295	1,696
Total employee compensation for the year	<u>\$ 113,947</u>	<u>\$ 117,800</u>	<u>\$ 123,211</u>

Restructuring charges by functional area are as follows:

	Years ended August 31,		
	2016	2015	2014
Cost of sales	\$ –	\$ 290	\$ –
Selling and administrative expenses	–	586	–
Net research and development costs	–	761	–
Total restructuring charges for the year	<u>\$ –</u>	<u>\$ 1,637</u>	<u>\$ –</u>

EXFO Inc.

Notes to Consolidated Financial Statements

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

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

	Years ended August 31,		
	2016	2015	2014
Cost of sales	\$ 107	\$ 159	\$ 191
Selling and administrative expenses	972	791	1,140
Net research and development expenses	299	345	365
Total stock-based compensation costs for the year	\$ 1,378	\$ 1,295	\$ 1,696

17 Other Disclosures

Government grants

The company is entitled to receive grants on certain eligible research and development projects conducted in Finland from TEKES, a Finnish technology organization, which funds Finnish companies' high technology, research and innovations. The company's eligible research and development projects must be pre-approved by TEKES and the grant is subject to certain conditions. In the event that a condition is not met, TEKES can require reimbursement of a portion or the entire amount of the grant received. A liability to repay the funding is recognized in the period in which conditions arise that will cause the funding to be repayable. As at August 31, 2016, the company was in compliance with the conditions of the funding. This funding is accounted for as a reduction of gross research and development expenses in the consolidated statements of earnings. For the years ended August 31, 2014, 2015 and 2016, the company recorded \$1,348,000, \$919,000 and \$299,000 respectively, under that program in the consolidated statements of earnings.

Defined contribution pension plans

The company maintains separate defined contribution pension plans for certain eligible employees. These plans, which are accounted for on an accrual basis, are summarized as follows:

- Canadian defined contribution pension plan

The company maintains a plan for certain eligible employees residing in Canada, under which the company may elect to match the employees' contributions up to a maximum of 4% (3% prior to January 1, 2014) of an employee's gross salary. Cash contributions to this plan and expenses for the years ended August 31, 2014, 2015 and 2016, amounted to \$1,451,000, \$1,492,000 and \$1,374,000 respectively.

- US defined contribution pension plan (401K plan)

The company maintains a 401K plan for eligible employees residing in the U.S. Under this plan, the company must contribute an amount equal to 3% of an employee's current compensation. In addition, eligible employees may contribute up to the lesser of 1% of eligible compensation or the statutorily prescribed annual limit to the 401K plan. The 401K plan permits but does not require the company to make additional matching contributions to the 401K plan on behalf of the eligible participants, subject to a maximum of 50% of the first 6% of the participant's current compensation subject to certain legislated maximum contribution limits. During the years ended August 31, 2014, 2015 and 2016, the company recorded cash contributions and expenses totaling \$616,000, \$628,000 and \$622,000 respectively.

EXFO Inc.

Notes to Consolidated Financial Statements

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

18 Income Taxes

The reconciliation of the income tax provision calculated using the combined Canadian federal and provincial statutory income tax rate with the income tax provision in the financial statements is as follows:

	Years ended August 31,		
	2016	2015	2014
Income tax provision at combined Canadian federal and provincial statutory tax rate (27%)	\$ 4,499	\$ 2,671	\$ 1,226
Increase (decrease) due to:			
Foreign income/loss taxed at different rates	(1,025)	482	(20)
Non-taxable (income)/loss	5	2,540	(540)
Non-deductible expenses	411	664	1,011
Foreign exchange effect of translation of foreign subsidiaries in the functional currency	566	(3,641)	(547)
Unrecognized deferred income tax assets on temporary deductible differences and unused tax losses	3,702	2,556	3,013
Other	(394)	(236)	143
Income tax provision for the year	<u>\$ 7,764</u>	<u>\$ 5,036</u>	<u>\$ 4,286</u>

	Years ended August 31,		
	2016	2015	2014
The income tax provision consists of the following:			
Current			
Current income taxes	\$ 6,186	\$ 4,633	\$ 3,588
Deferred			
Deferred income taxes relating to the origination and reversal of temporary differences	(2,124)	(2,153)	(2,315)
Unrecognized deferred income tax assets on temporary deductible differences and unused tax losses	3,702	2,556	3,013
	<u>1,578</u>	<u>403</u>	<u>698</u>
Income tax provision for the year	<u>\$ 7,764</u>	<u>\$ 5,036</u>	<u>\$ 4,286</u>

EXFO Inc.

Notes to Consolidated Financial Statements

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

Deferred taxes

	As at August 31,	
	2016	2015
Deferred income tax assets		
Deferred income tax assets recoverable within 12 months	\$ 4,224	\$ 3,512
Deferred income tax assets recoverable after 12 months	4,016	5,947
	8,240	9,459
Deferred income tax liabilities		
Deferred income tax liabilities payable within 12 months	645	398
Deferred income tax liabilities payable after 12 months	2,212	1,126
	2,857	1,524
Deferred income tax assets net	\$ 5,383	\$ 7,935

The changes in deferred income tax assets and liabilities for the year ended August 31, 2015 are as follows:

	Balance as at September 1, 2014	Credited (charged) to the statement of earnings	Credited (charged) to shareholders' equity	Foreign currency translation adjustment	Balance as at August 31, 2015
Deferred income tax assets					
Long-lived assets	\$ 2,837	\$ 468	\$ -	\$ (456)	\$ 2,849
Provisions and accruals	4,335	422	905	(638)	5,024
Deferred revenue	1,638	(156)	-	(174)	1,308
Research and development expenses	2,732	(17)	-	(475)	2,240
Losses carried forward	7,406	(819)	-	(36)	6,551
Deferred income tax liabilities					
Long-lived assets	(41)	41	-	-	-
Research and development tax credits	(11,781)	(342)	-	2,086	(10,037)
Total	\$ 7,126	\$ (403)	\$ 905	\$ 307	\$ 7,935
Classified as follows:					
Deferred income tax assets	\$ 10,213				\$ 9,459
Deferred income tax liabilities	(3,087)				(1,524)
	\$ 7,126				\$ 7,935

EXFO Inc.

Notes to Consolidated Financial Statements

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

The changes in deferred income tax assets and liabilities for the year ended August 31, 2016 are as follows:

	<u>Balance as at September 1, 2015</u>	<u>Credited (charged) to the statement of earnings</u>	<u>Credited (charged) to shareholders' equity</u>	<u>Foreign currency translation adjustment</u>	<u>Balance as at August 31, 2016</u>
Deferred income tax assets					
Long-lived assets	\$ 2,849	\$ (595)	\$ -	\$ 1	\$ 2,255
Provisions and accruals	5,024	177	(935)	(20)	4,246
Deferred revenue	1,308	1,015	-	7	2,330
Research and development expenses	2,240	112	-	9	2,361
Losses carried forward	6,551	(1,951)	-	(2)	4,598
Deferred income tax liabilities					
Research and development tax credits	(10,037)	(336)	-	(34)	(10,407)
Total	<u>\$ 7,935</u>	<u>\$ (1,578)</u>	<u>\$ (935)</u>	<u>\$ (39)</u>	<u>\$ 5,383</u>
Classified as follows:					
Deferred income tax assets	\$ 9,459				\$ 8,240
Deferred income tax liabilities	(1,524)				(2,857)
	<u>\$ 7,935</u>				<u>\$ 5,383</u>

Unrecognized deferred income tax assets on temporary deductible differences, unused tax losses and research and development expenses are as follows:

	<u>As at August 31,</u>	
	<u>2016</u>	<u>2015</u>
Temporary deductible differences	\$ 1,676	\$ 1,433
Losses carried forward	38,287	34,693
Research and development expenses	-	221
	<u>\$ 39,963</u>	<u>\$ 36,347</u>

EXFO Inc.

Notes to Consolidated Financial Statements

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

As at August 31, 2016, the year of expiry of operating losses for which no deferred income tax assets were recognized in the balance sheets are as follows, presented by tax jurisdiction:

Year of expiry	Finland	United States
2017	\$ 3	\$ –
2018	418	741
2019	–	3,470
2020	7,387	7,991
2021	6,400	2,211
2022	11,097	7,435
2023	7,189	1,972
2024	5,550	1,351
2025	6,918	1,351
2026	237	1,351
2027	–	1,351
2028	–	2,447
2030	–	2,713
2031	–	109
2033	–	4,681
2034	–	4,851
2035	–	2,616
2036	–	8,528
	\$ 45,199	\$ 55,169

Furthermore, as at August 31, 2016, the company had available capital losses in Canada amounting to \$52,024,000 (CA\$68,235,000) at the federal level and \$55,181,000 (CA\$72,375,000) at the provincial level for which no deferred income tax assets were recognized. These losses can be carried forward indefinitely against capital gains.

As at August 31, 2016, non-refundable research and development tax credits recognized in the balance sheet amounted to \$37,204,000. In order to recover these non-refundable research and development tax credits, the company needs to generate approximately \$240,000,000 (CA\$315,000,000) in pre-tax earnings at the Canadian federal level and approximately \$12,000,000 at the Canadian provincial level. In order to generate \$240,000,000 in pre-tax earnings at the Canadian Federal level over the estimated recovery period of 12 years, the company must generate a pre-tax earnings compound annual growth rate (CAGR) of 2%, which the company believes is probable. The company's non-refundable research and development tax credits can be carried forward over a twenty-year period.

In addition, as at August 31, 2016, the company had deferred income tax assets in the balance sheet in the amount of \$4,598,000 for operating losses in the United States. In order to recover these deferred income tax assets, the company needs to generate approximately \$13,500,000 in pre-tax earnings at the United States, and in order to do so over the estimated recovery period of four years, the company must generate a pre-tax earnings CAGR of 2%, which the company believes is probable. The company's operating losses in the United States can be carried forward over a twenty-year period.

As at August 31, 2016, no income taxes were recognized on taxable temporary differences of \$15,280,000; such taxes would be payable on the unremitted earnings of certain of the company's subsidiaries, as the company has determined that:

- (1) Undistributed profits of its foreign subsidiaries will not be distributed in the foreseeable future; and
- (2) Undistributed profits of its domestic subsidiaries will not be taxable when distributed.

EXFO Inc.

Notes to Consolidated Financial Statements

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

19 Earnings per Share

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

	Years ended August 31,		
	2016	2015	2014
Basic weighted average number of shares outstanding (000's)	53,863	56,804	60,329
Plus dilutive effect of (000's):			
Restricted share units	675	549	574
Deferred share units	131	104	103
Stock options	–	–	9
Diluted weighted average number of shares outstanding (000's)	54,669	57,457	61,015
Stock awards excluded from the calculation of the diluted weighted average number of shares outstanding because their exercise price was greater than the average market price of the common shares (000's)	75	57	77

20 Segment Information

Sales for products and services are detailed as follows:

	Years ended August 31,		
	2016	2015	2014
Products	\$ 205,371	\$ 193,427	\$ 201,724
Services	27,212	28,662	29,082
	\$ 232,583	\$ 222,089	\$ 230,806

EXFO Inc.

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

Sales to external customers by geographic region are detailed as follows:

	Years ended August 31,		
	2016	2015	2014
United States	\$ 95,388	\$ 82,227	\$ 83,172
Canada	18,027	19,722	19,482
Other	14,129	17,547	19,195
Americas	127,544	119,496	121,849
United Kingdom	11,032	9,151	12,736
Other	46,140	48,123	51,243
Europe, Middle-East and Africa	57,172	57,274	63,979
China	25,281	21,526	22,468
Other	22,586	23,793	22,510
Asia-Pacific	47,867	45,319	44,978
	\$ 232,583	\$ 222,089	\$ 230,806

Sales were allocated to geographic regions based on the country of residence of the related customers.

Long-lived assets by geographic region are detailed as follows:

	As at August 31, 2016			As at August 31, 2015		
	Property, plant and equipment	Intangible assets	Goodwill	Property, plant and equipment	Intangible assets	Goodwill
Canada	\$ 27,048	\$ 1,330	\$ –	\$ 27,174	\$ 1,310	\$ –
United States	1,174	1,637	13,265	948	1,255	13,224
Finland	572	354	8,663	295	1,433	8,636
India	3,602	37	–	4,011	65	–
China	2,657	33	–	2,500	30	–
Other	925	–	–	767	3	–
	\$ 35,978	\$ 3,391	\$ 21,928	\$ 35,695	\$ 4,096	\$ 21,860

21 Subsequent Event

On October 31, 2016, the company 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.