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

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

The following discussion and analysis of financial condition and results of operations is dated March 25, 2014.

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

COMPANY OVERVIEW AND RECENT DEVELOPMENTS

We are a leading provider of next-generation test and service assurance solutions for network operators and equipment manufacturers in the global telecommunications industry. We offer core-to-edge solutions that enable customers to increase network capacity and optimize reliability on their wireline and wireless IP (Internet protocol) networks. As such, we target high-growth market opportunities related to increasing bandwidth and improving quality of experience on network infrastructures: 4G/LTE (long-term evolution), wireless backhaul, small cells and distributed antenna systems (DAS), 100G network upgrades and fiber-to-the-home (FTTH)/fiber-to-the-curb (FTTC)/fiber-to-the-node (FTTN) deployments.

We launched seven new products in the second quarter of fiscal 2014, including among others a voice-over-LTE (VoLTE) service assurance suite that enables mobile network operators to troubleshoot and proactively monitor the health of new VoLTE infrastructures through live traffic generation and measurement of key performance indicators. We also introduced an industry-first, polarization-multiplexed (Pol-Mux) optical spectrum analyzer for characterizing coherent 40G and 100G systems; we integrated auto-focus capabilities on our fiber inspection probe to render the task of inspecting fiber connectors fully automated; and we expanded our multiservice Power Blazer offering by adding bidirectional EtherSAM capabilities on all 10M to 100G Ethernet interfaces. At the halfway mark of fiscal 2014, EXFO has released a total of 16 new products or major product upgrades.

We reported sales of $51.2 million in the second quarter of fiscal 2014, which represents a decrease of 18.2% compared to $62.6 million for the same period last year. Bookings increased 10.0% to $58.7 million in the second quarter of fiscal 2014, for a book-to-bill ratio of 1.15, compared to $53.4 million for the same period last year.

Net loss amounted to $1.3 million, or $0.02 per share, in the second quarter of fiscal 2014, compared to net earnings of $39,000, or $0.00 per diluted share, for the same period last year. Net loss for the second quarter of fiscal 2014 included $1.0 million in after-tax amortization of intangible assets, $402,000 in stock-based compensation costs and a foreign exchange gain of $2.3 million.

Adjusted EBITDA (net earnings (loss) before interest, income taxes, depreciation and amortization, restructuring charges, stock-based compensation costs and foreign exchange gain) reached minus $1.0 million, or minus 2.0% of sales in the second quarter of fiscal 2014, compared to $4.4 million, or 7.1% of sales for the same period last year. See page 13 in this document for a complete reconciliation of adjusted EBITDA to IFRS net earnings (loss).

On January 8, 2014, we announced that our Board of Directors approved the renewal of our share repurchase program, by way of a normal course issuer bid on the open market of up to 10% of the issued and outstanding subordinate voting shares, representing 2,043,101 subordinate voting shares at the prevailing market price. We expect to use cash, short-term investments or future cash flow from operations to fund the repurchase of shares. The normal course issuer bid started on January 13, 2014, and will end on January 12, 2015, or on an earlier date if we repurchase the maximum number of shares permitted under the bid. The program does not require that we repurchase any specific number of shares, and it may be modified, suspended or terminated at any time and without prior notice. All shares repurchased under the bid will be cancelled.

RESULTS OF OPERATIONS

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

	Three months ended February 28,		Six months ended February 28,	
	2014	2013	**2014**	2013
Sales	**$ 51,179**	$ 62,576	**$ 107,182**	$ 122,397
Cost of sales [1]	**20,073**	23,664	**41,258**	47,321
Selling and administrative	**21,537**	23,074	**43,245**	45,364
Net research and development	**10,973**	11,960	**22,254**	23,562
Depreciation of property, plant and equipment	**1,243**	1,504	**2,518**	3,109
Amortization of intangible assets	**1,074**	1,922	**2,256**	3,884
Interest (income) expenses	**(49)**	25	**(76)**	(8)
Foreign exchange gain	**(2,292)**	(1,700)	**(3,094)**	(2,456)
Earnings (loss) before income taxes	**(1,380)**	2,127	**(1,179)**	1,621
Income taxes	**(41)**	2,088	**907**	3,220
Net earnings (loss) for the period	**$ (1,339)**	$ 39	**$ (2,086)**	$ (1,599)
Basic and diluted net earnings (loss) per share	**$ (0.02)**	$ 0.00	**$ (0.03)**	$ (0.03)

Other selected information:

	Three months ended February 28, 2014	2013	Six months ended February 28, 2014	2013
Gross margin before depreciation and amortization[2]	**$ 31,106**	$ 38,912	**$ 65,924**	$ 75,076
Research and development:				
Gross research and development [3]	**$ 13,046**	$ 14,126	**$ 26,355**	$ 28,024
Net research and development [3]	**$ 10,973**	$ 11,960	**$ 22,254**	$ 23,562
Adjusted EBITDA [2]	**$ (1,002)**	$ 4,435	**$ 1,290**	$ 7,155

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

(2) Refer to page 13 for non-IFRS measures.

(3) Include $89 in restructuring charges for the three months and six months ended February 28, 2013 (nil in fiscal 2014).

	Three months ended February 28,		Six months ended February 28,	
	2014	**2013**	**2014**	**2013**
Sales	**100.0 %**	100.0 %	**100.0 %**	100.0 %
Cost of sales [1]	**39.2**	37.8	**38.5**	38.7
Selling and administrative	**42.1**	36.9	**40.3**	37.1
Net research and development	**21.4**	19.1	**20.8**	19.2
Depreciation of property, plant and equipment	**2.4**	2.4	**2.3**	2.5
Amortization of intangible assets	**2.1**	3.1	**2.1**	3.2
Interest (income) expenses	**(0.1)**	–	**(0.1)**	–
Foreign exchange gain	**(4.4)**	(2.7)	**(2.8)**	(2.0)
Earnings (loss) before income taxes	**(2.7)**	3.4	**(1.1)**	1.3
Income taxes	**(0.1)**	3.3	**0.8**	2.6
Net earnings (loss) for the period	**(2.6) %**	0.1 %	**(1.9) %**	(1.3) %

Other selected information:

Gross margin before depreciation and amortization [2]	**60.8 %**	62.2 %	**61.5 %**	61.3 %
Research and development:				
Gross research and development [3]	**25.5 %**	22.6 %	**24.6 %**	22.9 %
Net research and development [3]	**21.4 %**	19.1 %	**20.8 %**	19.2 %
Adjusted EBITDA [2]	**(2.0) %**	7.1 %	**1.2 %**	5.8 %

(1) The cost of sales is exclusive of depreciation and amortization, shown separately.
(2) Refer to page 13 for non-IFRS measures.
(3) Include 0.1% in restructuring charges for the three months and six months ended February 28, 2013 (nil in fiscal 2014).

SALES AND BOOKINGS

For the three months ended February 28, 2014, our sales decreased 18.2% to $51.2 million, from $62.6 million for the same period last year, and our bookings increased 10.0% to $58.7 million, from $53.4 million for the same period last year, for a book-to-bill ratio of 1.15.

For the six months ended February 28, 2014, our sales decreased 12.4% to $107.2 million, from $122.4 million for the same period last year. For the first half of fiscal 2014, bookings amounted to $116.6 million, compared to $117.7 million for the same period last year, for a book-to-bill ratio of 1.09.

In the second quarter and the first half of fiscal 2014, most of the year-over-year decrease in sales in dollars comes from the Americas as market conditions in this region continues to be challenging due to order delays and lower spending levels, especially among key customers. We believe projects and strategic initiatives were not cancelled, but rather pushed until later in calendar 2014. In addition, during the second quarter of fiscal 2014, despite the fact that our bookings increased 10.0% year-over-year, bookings came late in the period, leaving us with not enough time to ship and recognize all of them in the quarter, which negatively impacted our sales year-over-year. Also, in the second quarter and the first half of fiscal 2013, we shipped large orders of copper-access products to some tier-1 network operators in the Americas. We did not have such large orders for the same periods this year, which reduced our sales year-over-year.

Furthermore, in the second quarter and the first half of fiscal 2014, we faced, to some extent, increased competition and pricing pressure compared to the same periods last year, which negatively impacted our sales and bookings year-over-year.

In addition, in the second quarter of fiscal 2014, we recorded (in our sales) foreign exchange losses of $285,000 on our forward exchange contracts, compared to foreign exchange gains of $153,000 for the same period last year, which contributed to decreasing our sales 0.7% year-over-year. In the first half of fiscal 2014, we recorded foreign exchange losses of $369,000 on our forward exchange contracts, compared to foreign exchange gains of $355,000 for the same period last year, which contributed to decreasing our sales 0.6% year-over-year.

Finally, in the first half of fiscal 2014, we did not benefit from any calendar year-end budget spending on the part of network operators in the Americas due to tight management of budgets, while we benefited from some of this spending in the same period last year, reducing our sales year-over-year.

In terms of bookings, although in the second quarter of fiscal 2014 our sales decreased compared to the same period last year, our bookings increased in every region, for an overall increase of 10.0% year-over-year.

Geographic distribution

In the second quarter of fiscal 2014, sales to the Americas, Europe, Middle-East and Africa (EMEA) and Asia-Pacific accounted for 45%, 32% and 23% of sales respectively, compared to 49%, 29% and 22% for the same period last year respectively. In the first half of fiscal 2014, sales to the Americas, EMEA and Asia-Pacific accounted for 48%, 31% and 21% of sales respectively, compared to 52%, 28% and 20% for the same period last year respectively.

Customer concentration

We sell our products to a broad range of customers, including network service providers, network equipment manufacturers, wireless operators and cable TV operators. In the second quarters of fiscal 2013 and 2014, no customer accounted for more than 10% of our sales, and our top three customers accounted for 13.1% for both periods. In the first halves of fiscal 2013 and 2014, no customer accounted for more than 10% of our sales, and our top three customers accounted for 13.9% and 11.3% of our sales respectively.

GROSS MARGIN BEFORE DEPRECIATION AND AMORTIZATION (non-IFRS measure — refer to page 13 of this document)

Gross margin before depreciation and amortization (gross margin) reached 60.8% of sales for the three months ended February 28, 2014, compared to 62.2% for the same period last year.

Gross margin reached 61.5% of sales for the six months ended February 28, 2014, compared to 61.3% for the same period last year.

The decrease in our gross margin in the second quarter of fiscal 2014 compared to the same period last year can be explained by the following factors.

In the second quarter of fiscal 2014, a lower sales volume compared to the same period last year resulted in a lower absorption of our fixed manufacturing costs, which decreased our gross margin year-over-year.

In addition, in the second quarter of fiscal 2014, we recorded in our sales foreign exchange losses of $285,000 on our forward exchange contracts, compared to foreign exchange gains of $153,000 for the same period last year, which contributed to decreasing our gross margin by 1.0% year-over-year.

Finally, in the second quarter of fiscal 2014, we faced, to some extent, increased competition and pricing pressure compared to the same period last year, which negatively impacted our gross margin year-over-year.

However, in the second quarter of fiscal 2013, our gross margin was unfavorably affected by our product mix. Namely, in the second quarter of 2013, we shipped large orders of low-margin copper-access test solutions, which negatively impacted our gross margin for that period. We did not have such orders in the same period this year.

The slight increase in our gross margin in the first half of fiscal 2014 compared to the same period last year can be explained by the following factors.

In the first half of fiscal 2013, our gross margin was unfavorably affected by our product mix. Namely, in the first half of 2013, we shipped large orders of low-margin copper-access test solutions, which negatively impacted our gross margin for that period. We did not have such orders in the same period this year.

However, in the first half of fiscal 2014, a lower sales volume compared to the same period last year resulted in a lower absorption of our fixed manufacturing costs, which decreased our gross margin year-over-year.

In addition, in the first half of fiscal 2014, we recorded in our sales foreign exchange losses of $369,000 on our forward exchange contracts, compared to foreign exchange gains of $355,000 for the same period last year, which contributed to decreasing our gross margin 0.6% year-over-year.

Finally, in the first half of fiscal 2014, we faced, to some extent, increased competition and pricing pressure compared to the same period last year, which negatively impacted our gross margin year-over-year.

SELLING AND ADMINISTRATIVE EXPENSES

For the three months ended February 28, 2014, selling and administrative expenses were $21.5 million, or 42.1% of sales, compared to $23.1 million, or 36.9% of sales for the same period last year.

For the six months ended February 28, 2014, selling and administrative expenses were $43.2 million, or 40.3% of sales, compared to $45.4 million, or 37.1% of sales for the same period last year.

In the second quarter and the first half of fiscal 2014, our selling and administrative expenses decreased due to tight control on expenses and to the increase in the average value of the US dollar compared to the Canadian dollar year-over-year, as a portion of our selling and administrative expenses are incurred in this currency and we report our results in US dollars.

In addition, in the second quarter and the first half of fiscal 2014, commission expenses to our sales channels were lower compared to the same periods last year due to a lower sales volume year-over-year.

In the second quarter and the first half of fiscal 2014, although our selling and administrative expenses decreased in dollars year-over-year, they increased as a percentage of sales as our sales also decreased year-over-year and a large portion of these expenses are relatively fixed in the short term.

RESEARCH AND DEVELOPMENT EXPENSES

Gross research and development expenses

For the three months ended February 28, 2014, gross research and development expenses totaled $13.0 million, or 25.5% of sales, compared to $14.1 million, or 22.6% of sales for the same period last year.

For the six months ended February 28, 2014, gross research and development expenses totaled $26.4 million, or 24.6% of sales, compared to $28.0 million, or 22.9% of sales for the same period last year.

In the second quarter and the first half of fiscal 2014, the year-over-year increase in the average value of the US dollar compared to the Canadian dollar and the Indian rupee had a positive impact on our gross research and development expenses as most of these expenses are incurred in these currencies and we report our results in US dollars.

In addition, in the second quarter and the first half of fiscal 2014, a shift in the mix and timing of research and development projects resulted in decreased gross research and development expenses compared to the same periods last year, with reduction of subcontracting and consultant expenses.

Finally, in the second quarter and the first half of fiscal 2013, our gross research and development expenses included $89,000 in restructuring charges, compared to nil for the same periods this year.

In the second quarter and the first half of fiscal 2014, although our gross research and development expenses decreased in dollars year-over-year, they increased as a percentage of sales as our sales also decreased year-over-year and a large portion of these expenses are relatively fixed in the short term.

Tax credits and grants

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

For the three months ended February 28, 2014, tax credits and grants for research and development activities were $2.1 million, or 15.9% of gross research and development expenses, compared to $2.2 million, or 15.3% of gross research and development expenses for the same period last year.

For the six months ended February 28, 2014, tax credits and grants for research and development activities were $4.1 million, or 15.6% of gross research and development expenses, compared to $4.5 million, or 15.9% of gross research and development expenses for the same period last year.

The decrease in our tax credits and grants in the second quarter and the first half of fiscal 2014, compared to the same periods last year, mainly results from the decrease in gross research and development expenses year-over-year as we were entitled to the same tax credit and grant programs year-over-year.

DEPRECIATION OF PROPERTY, PLANT AND EQUIPMENT

In the second quarter of fiscal 2014, depreciation of property, plant and equipment amounted to $1.2 million, compared to $1.5 million for the same period last year.

In the first half of fiscal 2014, depreciation of property, plant and equipment amounted to $2.5 million, compared to $3.1 million for the same period last year.

The decrease in depreciation expenses in the second quarter and the first half of fiscal 2014, compared to the same periods last year, was due to the fact that some assets became fully depreciated in fiscal 2013 as well as to the increase in the average value of the US dollar versus the Canadian dollar and the Indian rupee year-over-year, as a significant portion of our depreciation expenses is incurred in these currencies and we report our results in US dollars.

AMORTIZATION OF INTANGIBLE ASSETS

In the second quarter of fiscal 2014, amortization of intangible assets amounted to $1.1 million, compared to $1.9 million for the same period last year.

In the first half of fiscal 2014, amortization of intangible assets amounted to $2.3 million, compared to $3.9 million for the same period last year.

The decrease in amortization expenses in the second quarter and the first half of fiscal 2014 compared to the same periods last year is mainly due to the fact that core technology related to the acquisition of Brix Networks Inc. (acquired in fiscal 2008) became fully amortized during fiscal 2013, and that the average value of the US dollar increased compared to the Canadian dollar year-over-year, as a significant portion of our amortization expense is incurred in this currency and we report our results in US dollars.

FOREIGN EXCHANGE GAIN

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

For the three months ended February 28, 2014, we recorded a foreign exchange gain of $2.3 million compared to $1.7 million for the same period last year.

For the six months ended February 28, 2014, we recorded a foreign exchange gain of $3.1 million compared to $2.5 million for the same period last year.

During the second quarter of fiscal 2014, the period-end value of the Canadian dollar significantly decreased versus the US dollar and the euro, compared to the previous quarter, which resulted in a foreign exchange gain of $2.3 million during that period. In fact, the period-end value of the Canadian dollar decreased 4.1% versus the US dollar to CA$1.1075= US$1.00 in the second quarter of fiscal 2014, compared to CA$1.0620 = US$1.00 at the end of the previous quarter, and decreased 6.0% versus the euro to CA$1.5291 = €1.00 in the second quarter of fiscal 2014, compared to CA$1.4420 = €1.00 at the end of the previous quarter.

During the same period last year, the period-end value of the Canadian dollar significantly decreased versus the US dollar, compared to the previous quarter, which resulted in a foreign exchange gain of $1.7 million during that period. In fact, the period-end value of the Canadian dollar decreased 3.7% to CA$1.0314 = US$1.00 in the second quarter of fiscal 2013, compared to CA$0.9932 = US$1.00 at the end of the previous quarter.

During the first half of fiscal 2014, the period-end value of the Canadian dollar significantly decreased versus the US dollar and the euro, compared to the previous year end, which resulted in a foreign exchange gain of $3.1 million during that period. In fact, the period-end value of the Canadian dollar decreased 4.9% versus the US dollar to CA$1.1075 = US$1.00 in the first half of fiscal 2014, compared to CA$1.0530 = US$1.00 at the end of the previous year, and decreased 9.7% versus the euro to CA$1.5291 = €1.00 in the first half of fiscal 2014, compared to CA$1.3936 = €1.00 at the end of the previous year.

During the same period last year, the period-end value of the Canadian dollar significantly decreased versus the US dollar, compared to the previous year end, which resulted in a foreign exchange gain of $2.5 million during that period. The period-end value of the Canadian dollar decreased 4.4% to CA$1.0314 = US$1.00 in the first half of fiscal 2013, compared to CA$0.9863 = US$1.00 at the end of the previous year.

Foreign-exchange-rate fluctuations also flow through the statement of earnings line items as a significant portion of our operating items are denominated in Canadian dollars and Indian rupees, and we report our results in US dollars. Consequently, the increase in the average value of the US dollar in the second quarter and the first quarter of fiscal 2014, compared to these currencies year-over-year, resulted in a positive impact on our financial results. In fact, the average value of the US dollar in the second quarter of fiscal 2014 increased 8.4% and 12.5% respectively year-over-year, compared to the Canadian dollar and the Indian rupee. During the first half of fiscal 2014, it increased 6.8% and 12.5% respectively year-over-year, compared to the Canadian dollar and the Indian rupee.

INCOME TAXES

For the three months ended February 28, 2014, we reported an income tax recovery of $41,000 on a loss before income taxes of $1.4 million. For the corresponding period last year, we reported income tax expenses of $2.1 million on earnings before income taxes of $2.1 million.

For the six months ended February 28, 2014, we reported income tax expenses of $907,000 on a loss before income taxes of $1.2 million. For the corresponding period last year, we reported income tax expenses of $3.2 million on earnings before income taxes of $1.6 million.

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

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

LIQUIDITY AND CAPITAL RESOURCES

Cash requirements and capital resources

As at February 28, 2014, cash and short-term investments totaled $51.7 million, while our working capital was at $102.7 million. Our cash and short-term investments decreased $897,000 in the second quarter of fiscal 2014, compared to the previous quarter. During the second quarter of fiscal 2014, operating activities generated $3.6 million in cash. However, during the quarter, we made cash payments of $1.7 million for the purchase of capital assets, $937,000 for the redemption of share capital under our share repurchase program and $307,000 for the repayment of our long-term debt. In addition, we recorded an unrealized foreign exchange loss on our cash and short-term investments of $1.7 million. This unrealized foreign exchange loss resulted from the translation, in US dollars, of our Canadian-dollar-denominated cash and short-term investments and was included in the accumulated other comprehensive income in the balance sheet.

Our short-term investments consist of a commercial paper issued by high-credit-quality corporation, maturing in March 2014; therefore, we consider the risk of non-performance of this financial instrument to be limited. This debt instrument is not expected to be affected by a significant liquidity risk. For the purpose of managing our cash position, we have established a cash management policy, which we follow and monitor on a regular basis. Our cash and short-term investments will be used for working capital and other general corporate purposes, potential acquisitions as well as our share repurchase program. As at February 28, 2014, cash balances included an amount of $31.5 million that bears interest at an annual rate of 1.5%.

We believe that our cash balances and short-term investments will be sufficient to meet our liquidity and capital requirements for the foreseeable future, including the effect of our normal course issuer bid. In addition to these assets, we have unused available lines of credit totaling $15.1 million for working capital and other general corporate purposes, and unused lines of credit of $17.9 million for foreign currency exposure related to forward exchange contracts. However, possible operating losses, additional restructuring costs and/or possible investments in or acquisitions of complementary businesses, products or technologies may require additional financing. There can be no assurance that additional debt or equity financing will be available when required or, if available, that it can be secured on satisfactory terms.

Sources and uses of cash

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

Operating activities

Cash flows provided by operating activities were $3.6 million for the three months ended February 28, 2014, compared to $2.1 million for the same period last year.

Cash flows provided by operating activities were $7.0 million for the six months ended February 28, 2014, compared to cash flows used of $2.7 million for the same period last year.

Cash flows provided by operating activities in the second quarter of fiscal 2014 were attributable to the net earnings after items not affecting cash of $1.3 million, and the positive net change in non-cash operating items of $2.3 million; this was mainly due to the positive effect on cash of the decrease of $6.2 million in our accounts receivable due to the timing of receipts and sales during the quarter. This positive effect on cash was offset in part by the negative effect on cash of the increase of $1.7 million in our income tax and tax credits recoverable due to tax credits earned during the quarter not yet recovered, the negative effect on cash of the increase of $1.2 million in our inventories to meet future demand, as well as the negative effect on cash of the increase of $787,000 in our prepaid expenses due to timing of payments during the quarter.

Cash flows provided by operating activities in the second quarter of fiscal 2013 were attributable to the net earnings after items not affecting cash of $4.3 million offset in part by the negative net change in non-cash operating items of $2.2 million; this was mainly due to the negative effect on cash of the decrease of $3.7 million in our accounts payable, accrued liabilities and provisions due to timing of purchases and payments during the quarter as well as the negative effect on cash of the increase of $1.3 million in our income tax and tax credits recoverable due to tax credits earned during the quarter not yet recovered. These negative effects on cash were offset in part by the positive effect on cash of the decrease of $2.0 million in our accounts receivable due to the timing of receipts and sales during the quarter and the decrease of $1.2 million in our inventories due to an improved inventory turn during the quarter.

Cash flows provided by operating activities in the first half of fiscal 2014 were attributable to the net earnings after items not affecting cash of $2.2 million, and the positive net change in non-cash operating items of $4.8 million; this was mainly due to the positive effect on cash of the decrease of $4.5 million in our accounts receivable due to the timing of receipts and sales during the period and the positive effect on cash of the increase of $5.4 million in our accounts payable and accrued liabilities due to timing of purchases and payments during the period. These positive effects on cash were offset in part by the negative effect on cash of the increase of $943,000 in our income tax and tax credits recoverable due to tax credits earned during the period not yet recovered, the negative effect on cash of the increase of $3.5 million in our inventories to meet future demand as well as the negative effect on cash of the increase of $616,000 in our prepaid expenses due to timing of payments during the period.

Cash flows used by operating activities in the first half of fiscal 2013 were attributable to the net earnings after items not affecting cash of $5.8 million more than offset by the negative net change in non-cash operating items of $8.5 million; this was mainly due to the negative effect on cash of the increase of $6.1 million in our accounts receivable due to the increase and timing of receipts and sales during the period as well as the negative effect on cash of the increase of $3.2 million in our income tax and tax credits recoverable due to tax credits earned during the period not yet recovered. These negative effects on cash were offset in part by the positive effect on cash of the decrease of $1.1 million in our inventories due to an improved inventory turn during the period.

Investing activities

Cash flows used by investing activities were $1.7 million for the three months ended February 28, 2014, compared to cash flows provided of $543,000 for the same period last year.

Cash flows used by investing activities were $2.4 million for the six months ended February 28, 2014, compared to cash flows provided of $1.5 million for the same period last year.

In the second quarter of fiscal 2014, we paid $1.7 million for the purchase of capital assets.

For the corresponding period last year, we disposed (net of acquisitions) of $3.0 million worth of short-term investments but we paid $2.5 million for the purchase of capital assets.

In the first half of fiscal 2014, we paid $2.4 million for the purchase of capital assets.

For the corresponding period last year, we paid $4.5 million for the purchase of capital assets but we disposed (net of acquisitions) of $3.0 million worth of short-term investments.

Financing activities

Cash flows used by financing activities were $1.2 million for the three months ended February 28, 2014, compared to $424,000 for the same period last year.

Cash flows used by financing activities were $1.0 million for the six months ended February 28, 2014, compared to $1.3 million for the same period last year.

In the second quarter of fiscal 2014, we redeemed share capital for a cash consideration of $937,000 and we made a repayment of $307,000 of our long-term debt. However, we received $89,000 from the exercise of stock options.

For the corresponding period last year, we redeemed share capital for a cash consideration of $167,000 and we made a repayment of $293,000 of our long-term debt. However, we received $36,000 from the exercise of stock options.

In the first half of fiscal 2014, we redeemed share capital for a cash consideration of $937,000 and we made a repayment of $307,000 of our long-term debt. However, we received $195,000 from the exercise of stock options.

For the corresponding period last year, we redeemed share capital for a cash consideration of $1.1 million and we made a repayment of $293,000 of our long-term debt. However, we received $87,000 from the exercise of stock options.

FORWARD EXCHANGE CONTRACTS

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

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

As at February 28 2014, we held forward exchange contracts to sell US dollars at various forward rates, which are summarized as follows:

Expiry dates		Contractual amounts	Weighted average contractual forward rates
March 2014 to August 2014	$	10,800,000	1.0308
September 2014 to August 2015		18,200,000	1.0589
September 2015 to August 2016		13,400,000	1.0923
September 2016 to December 2016		3,400,000	1.1063
Total	$	45,800,000	1.0656

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 $808,000 as at August 31, 2013 and $2.1 million as at February 28, 2014. The quarter-end exchange rate was CA$1.1075 = US$1.00 as at February 28, 2014.

SHARE CAPITAL

Share capital

As at March 25, 2014, EXFO had 31,643,000 multiple voting shares outstanding, entitling to 10 votes each and 28,684,473 subordinate voting shares outstanding. The multiple voting shares and the subordinate voting shares are unlimited as to number and without par value.

OFF-BALANCE SHEET ARRANGEMENTS

As at February 28, 2014, our off-balance sheet arrangements consisted of letters of guarantee amounting to $443,000 for our own selling and purchasing requirements, which were reserved from our lines of credit; these letters of guarantee expire at various dates through fiscal 2017.

STRUCTURED ENTITIES

As at February 28, 2014, we did not have interests in any structured entities.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

For a description of the critical accounting policies, judgments in applying accounting policies as well as estimates and assumptions used in the preparation of our consolidated financial statements, refer to our Annual Report on Form 20-F for the year ended August 31, 2013, filed with the U.S. Securities and Exchange Commission and the Canadian securities commissions.

NEW IFRS PRONOUNCEMENTS AND AMENDMENTS

Refer to note 2 to our condensed unaudited interim consolidated financial statements for the three and six months ended February 28, 2014 and to our consolidated financial statements for the year ended August 31, 2013 for the effect of certain recent accounting pronouncements on our consolidated financial statements.

RISKS AND UNCERTAINTIES

For the first half of fiscal 2014, there have been no material changes from the risk factors disclosed in our Annual Report on Form 20-F for the year ended August 31, 2013.

NON-IFRS MEASURES

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

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

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

** Adjusted EBITDA represents net earnings (loss) before interest, income taxes, depreciation and amortization, restructuring charges, stock-based compensation costs and foreign exchange gain.

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

Adjusted EBITDA

	Three months ended February 28,		Six months ended February 28,	
	2014	**2013**	**2014**	**2013**
IFRS net earnings (loss) for the period	**$ (1,339)**	$ 39	**$ (2,086)**	$ (1,599)
Add (deduct):				
Depreciation of property, plant and equipment	**1,243**	1,504	**2,518**	3,109
Amortization of intangible assets	**1,074**	1,922	**2,256**	3,884
Interest (income) expenses	**(49)**	25	**(76)**	(8)
Income taxes	**(41)**	2,088	**907**	3,220
Restructuring charges	**–**	89	**–**	89
Stock-based compensation costs	**402**	468	**865**	916
Foreign exchange gain	**(2,292)**	(1,700)	**(3,094)**	(2,456)
Adjusted EBITDA for the period	**$ (1,002)**	$ 4,435	**$ 1,290**	$ 7,155
Adjusted EBITDA in percentage of sales	**(2.0)%**	7.1%	**1.2%**	5.8%

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

	Quarters ended			
	February 28, 2014	**November 30, 2013**	**August 31, 2013**	**May 31, 2013**
Sales	$ 51,179	$ 56,003	$ 60,888	$ 58,865
Cost of sales (1)	$ 20,073	$ 21,185	$ 22,574	$ 22,574
Net earnings (loss)	$ (1,339)	$ (747)	$ 3,802	$ (862)
Basic and diluted net earnings (loss) per share	$ (0.02)	$ (0.01)	$ 0.06	$ (0.01)

	Quarters ended			
	February 28, 2013	**November 30, 2012**	**August 31, 2012**	**May 31, 2012**
Sales	$ 62,576	$ 59,821	$ 57,156	$ 59,505
Cost of sales (1)	$ 23,664	$ 23,657	$ 21,257	$ 23,549
Net earnings (loss)	$ 39	$ (1,638)	$ (3,714)	$ (3,720)
Basic and diluted net earnings (loss) per share	$ 0.00	$ (0.03)	$ (0.06)	$ (0.06)

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