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

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

The following discussion and analysis of financial condition and results of operations is dated June 29, 2017.

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, service assurance and analytics solutions for fixed and mobile communications service providers (CSPs), web-scale operators as well as network equipment manufacturers in the global telecommunications industry. Our intelligent solutions with contextually relevant analytics are designed to improve end-user quality of experience, enhance network performance and drive operational efficiencies throughout the network and service delivery lifecycles. We target high-growth market opportunities related to increasing bandwidth and improving quality of experience on network infrastructures: 4G/LTE (long-term evolution), wireless backhaul, small cells and distributed antenna systems (DAS), 100G network upgrades and fiber-to-the-home (FTTH)/fiber-to-the-curb (FTTC)/fiber-to-the-node (FTTN) deployments.

Our sales decreased 3.9% to $58.5 million in the third quarter of fiscal 2017 compared to $60.9 million for the same period last year. Bookings increased 6.6% to $63.7 million in the third quarter of fiscal 2017, for a book-to-bill ratio of 1.09, from $59.7 million for the same period last year.

Net loss amounted to $4.3 million, or $0.08 per share, in the third quarter of fiscal 2017, compared to net earnings of $0.9 million, or $0.02 per diluted share, for the same period last year. Net loss for the third quarter of fiscal 2017 included $3.6 million in after-tax restructuring charges, $0.9 million in after-tax amortization of intangible assets, $0.4 million in stock-based compensation costs and a foreign exchange gain of $1.7 million. For the same period last year, net earnings included $0.3 million in after-tax amortization of intangible assets, $0.4 million in stock-based compensation costs and a foreign exchange loss of $1.0 million.

Adjusted EBITDA (net earnings (loss) before interest, income taxes, depreciation and amortization, stock-based compensation costs, restructuring charges, and foreign exchange gain or loss) amounted to $2.3 million, or 3.9% of sales, in the third quarter of fiscal 2017, compared to $5.3 million, or 8.7% of sales for the same period last year. See page 15 of this document for a complete reconciliation of adjusted EBITDA to IFRS net earnings (loss). Despite our restructuring plan implemented in the third quarter of fiscal 2017 discussed further in this document, we expect to fall short of our $26 million adjusted EBITDA target for fiscal 2017. Delayed spending by communications service providers on large, systems-based solutions and an unprofitable passive wireless monitoring product line prompted us to revise our plans. Based on actual results after nine months into fiscal 2017 and expected sales and results of operations for the last quarter of the year, we expect our adjusted EBITDA for fiscal 2017 to reach approximately $20 million.

On October 31, 2016, we acquired substantially all the assets of Absolute Analysis Inc. (Absolute), a privately held company located in the United States, supplying solutions for radio frequency testing of fiber-based radio access networks. The acquisition-date fair value of the total consideration amounted to $8.5 million, and consisted of $5.0 million in cash and the issuance of 793,070 subordinate voting shares, valued at $3.5 million. This acquisition was accounted for by applying the acquisition method as required by IFRS 3, “Business Combinations”, and the requirements of IFRS 10, “Consolidated Financial Statements”; consequently, the fair value of the total consideration was allocated to the assets acquired and liabilities assumed based on management’s estimate of their fair value as at the acquisition date. The results of operations of the acquired business have been included in our consolidated financial statements since October 31, 2016, being the date of acquisition. For additional disclosure on the accounting for the acquisition, see Note 3 to our unaudited interim consolidated financial statements.

On March 2, 2017, we acquired all issued and outstanding shares of Ontology Partners Limited (Ontology), a privately held company located in the United Kingdom, a supplier of real-time network topology discovery and service-chain mapping. The acquisition-date fair value of the total consideration amounted to $9.1 million and consisted of $7.7 million in cash, net of Ontology’s cash of $2.2 million at the acquisition date, plus a cash contingent consideration based on certain sales volume of Ontology products over the 12-month period following the acquisition, valued at $1.4 million at the acquisition date. This acquisition was accounted for by applying the acquisition method as required by IFRS 3, “Business Combinations”, and the requirements of IFRS 10, “Consolidated Financial Statements”; consequently, the fair value of the total consideration transferred was allocated to the assets acquired and liabilities assumed based on management’s preliminary estimate of their fair value as at the acquisition date. The results of operations of the acquired business were included in our consolidated financial statements starting on March 2, 2017, being the date of acquisition. Due to the proximity of the acquisition date to the release date of our interim consolidated financial statements, we have not finalized the initial accounting for the acquisition as the valuation of assets acquired and liabilities assumed has not been completed. Assets and liabilities likely to change upon completing a more detailed valuation and the finalization of the allocation are accounts receivable, intangible assets, goodwill and the related deferred income tax effects. We expect to complete the purchase price allocation in the fourth quarter of fiscal 2017. For additional disclosure on the accounting for the acquisition, see Note 3 to our unaudited interim consolidated financial statements.

On March 29, 2017, EXFO announced the appointment of Philippe Morin as its new Chief Executive Officer (CEO), effective April 1, 2017. Mr. Morin, who has more than 25 years of experience in the telecommunications industry, initially was named EXFO's Chief Operating Officer in November 2015. Prior to joining EXFO, Mr. Morin was Senior Vice-President of Worldwide Sales and Field Operations at Ciena. He also held senior management positions at Nortel Networks, including President of the Optical Networking Division. EXFO founder Germain Lamonde, who had fulfilled the roles of CEO and Chairman of the Board for more than 30 years, became Executive Chairman. He maintains leadership of EXFO's acquisition strategy and remains actively involved in defining the company's growth initiatives, customer outreach as well as corporate governance.

On May 2, 2017, we announced a restructuring plan to streamline our monitoring solutions portfolio, which falls under our protocol-layer product line. This plan will result in one-time expenses totaling $4 million, mainly for severance expenses and inventory write-offs. During the three months ended May 31, 2017, we recorded severance expenses of $2.8 million and inventory write-offs of $1.0 million, for total restructuring charges of $3.8 million during the quarter. The remaining restructuring charges of approximately $0.2 million will be recorded during the fourth quarter of fiscal 2017. See Note 4 to our unaudited interim consolidated financial statements.

We launched 7 new solutions in the third quarter of fiscal 2017 and 15 since the beginning of the fiscal year. Key product introductions in the third quarter included a 400G test solution for the lab and manufacturing markets; a four-slot FTB-4 Pro platform for high-speed network testing in the field, data centers and R&D labs; a software-based solution, Universal Virtual Sync, enabling communications service providers to accurately and cost-effectively measure network latency; a tunable optical time domain reflectometer (OTDR) that characterizes coarse wavelength division multiplexing (CWDM) channels in metro Ethernet links and centralized radio access networks (C-RANs); as well as an optical spectrum analyzer and two optical power meters for the lab and manufacturing markets.

RESULTS OF OPERATIONS

(in thousands of US dollars, except per share data for the periods indicated)

	Three months ended May 31, 2017	Three months ended May 31, 2016	Nine months ended May 31, 2017	Nine months ended May 31, 2016
Sales	**$ 58,505**	$ 60,896	**$ 180,320**	$ 169,725
Cost of sales [1]	**24,555**	23,880	**70,357**	62,921
Selling and administrative	**22,572**	20,798	**65,422**	60,615
Net research and development	**13,263**	11,303	**35,841**	31,398
Depreciation of property, plant and equipment	**1,029**	958	**2,894**	2,857
Amortization of intangible assets	**1,046**	294	**2,241**	880
Interest and other (income) expenses	**57**	(309)	**28**	(716)
Foreign exchange (gain) loss	**(1,725)**	957	**(1,965)**	(454)
Earnings (loss) before income taxes	**(2,292)**	3,015	**5,502**	12,224
Income taxes	**2,012**	2,096	**5,495**	5,576
Net earnings (loss) for the period	**$ (4,304)**	$ 919	**$ 7**	$ 6,648
Basic and diluted net earnings (loss) per share	**$ (0.08)**	$ 0.02	**$ 0.00**	$ 0.12
Other selected information:				
Gross margin before depreciation and amortization [2]	**$ 33,950**	$ 37,016	**$ 109,963**	$ 106,804
Research and development:				
Gross research and development	**$ 14,710**	$ 12,612	**$ 40,067**	$ 35,363
Net research and development	**$ 13,263**	$ 11,303	**$ 35,841**	$ 31,398
Restructuring charges included in:				
Cost of sales	**$ 1,582**	$ –	**$ 1,582**	$ –
Selling and administrative	**$ 919**	$ –	**$ 919**	$ –
Net research and development	**$ 1,312**	$ –	**$ 1,312**	$ –
Adjusted EBITDA [2]	**$ 2,300**	$ 5,301	**$ 13,496**	$ 15,867

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

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

RESULTS OF OPERATIONS
(as a percentage of sales for the periods indicated)

	Three months ended May 31, 2017	**Three months ended May 31, 2016**	**Nine months ended May 31, 2017**	**Nine months ended May 31, 2016**
Sales	**100.0 %**	100.0 %	**100.0 %**	100.0 %
Cost of sales (1)	**42.0**	39.2	**39.0**	37.1
Selling and administrative	**38.6**	34.2	**36.3**	35.7
Net research and development	**22.7**	18.6	**19.9**	18.5
Depreciation of property, plant and equipment	**1.8**	1.5	**1.6**	1.7
Amortization of intangible assets	**1.8**	0.5	**1.2**	0.5
Interest and other (income) expense	**–**	(0.5)	**–**	(0.4)
Foreign exchange (gain) loss	**(3.0)**	1.5	**(1.1)**	(0.3)
Earnings (loss) before income taxes	**(3.9)**	5.0	**3.1**	7.2
Income taxes	**3.5**	3.5	**3.1**	3.3
Net earnings (loss) for the period	**(7.4) %**	1.5 %	**– %**	3.9 %

Other selected information:

Gross margin before depreciation and amortization (2)	**58.0 %**	60.8 %	**61.0 %**	62.9 %
Research and development:				
Gross research and development	**25.1 %**	20.7 %	**22.2 %**	20.8 %
Net research and development	**22.7 %**	18.6 %	**19.9 %**	18.5 %
Restructuring charges included in:				
Cost of sales	**2.7 %**	– %	**0.9 %**	– %
Selling and administrative	**1.6 %**	– %	**0.5 %**	– %
Net research and development	**2.2 %**	– %	**0.7 %**	– %
Adjusted EBITDA (2)	**3.9 %**	8.7 %	**7.5 %**	9.3 %

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

RESULTS OF OPERATIONS

SALES AND BOOKINGS

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

Sales

	Three months ended May 31, 2017	Three months ended May 31, 2016	Nine months ended May 31, 2017	Nine months ended May 31, 2016
Physical-layer product line	**$ 41,007**	$ 42,074	**$ 121,061**	$ 112,133
Protocol-layer product line	**17,678**	19,260	**59,784**	59,879
	58,685	61,334	**180,845**	172,012
Foreign exchange losses on forward exchange contracts	**(180)**	(438)	**(525)**	(2,287)
Total sales	**$ 58,505**	$ 60,896	**$ 180,320**	$ 169,725

Bookings

	Three months ended May 31, 2017	Three months ended May 31, 2016	Nine months ended May 31, 2017	Nine months ended May 31, 2016
Physical-layer product line	**$ 47,157**	$ 41,797	**$ 125,278**	$ 115,549
Protocol-layer product line	**16,691**	18,389	**60,692**	64,662
	63,848	60,186	**185,970**	180,211
Foreign exchange losses on forward exchange contracts	**(180)**	(438)	**(525)**	(2,287)
Total bookings	**$ 63,668**	$ 59,748	**$ 185,445**	$ 177,924

Sales by geographic region

The following table summarizes sales by geographic region as a percentage of sales:

	Three months ended May 31, 2017	Three months ended May 31, 2016	Nine months ended May 31, 2017	Nine months ended May 31, 2016
Americas	**62 %**	59 %	**56 %**	55 %
Europe, Middle-East and Africa	**20**	22	**24**	25
Asia-Pacific	**18**	19	**20**	20
	100 %	100 %	**100 %**	100 %

Sales

For the three months ended May 31, 2017, our sales decreased 3.9% to $58.5 million, from $60.9 million for the same period last year, while our bookings increased 6.6% to $63.7 million, from $59.7 million for the same period last year, for a book-to-bill ratio of 1.09.

For the nine months ended May 31, 2017, our sales increased 6.2% to $180.3 million, from $169.7 million for the same period last year, while our bookings increased 4.2% to $185.4 million, from $177.9 million for the same period last year, for a book-to-bill ratio of 1.03.

In the third quarter of fiscal 2017, timing of bookings mainly explains the year-over-year decrease in sales as globally, after nine months into fiscal 2017, sales and bookings increased compared to the same period last year. In fact, global sales for the third quarter were impacted by weaker bookings received in the second quarter, as we started the current quarter with a much lower backlog compared to the same period last year. Also, although global bookings increased in the third quarter of fiscal 2017 compared to the same period last year, timing and nature of orders received during the quarter prevented us from recognizing a portion of them in sales.

In the third quarter of fiscal 2017, both product lines reported decreases in sales year-over-year. Sales of our physical-layer product line decreased 2.5% year-over-year, mainly in Asia-Pacific (APAC) as sales to the Americas and Europe, Middle East and Africa (EMEA) were almost flat year-over-year. Sales of our protocol-layer product line decreased 8.2% year-over-year, despite the positive impact of our two recent acquisitions, which are included in this product line. The decrease in sales of our protocol-layer product line comes from the Americas and EMEA as sales to APAC were flat year-over-year. In the third quarter of fiscal 2017, longer-than-expected sales cycles impacted our sales for that product line year-over-year. In addition, our restructuring plan announced May 2, 2017, to reduce our investment in passive wireless monitoring, explains to some extent the decrease in sales and bookings year-over-year for our protocol-layer product line.

In the first nine months of fiscal 2017, we made progress in sales for our physical-layer product line, mainly in the Americas, compared to the same period last year, mainly due to our leadership position in portable optical testing and a 100G investment cycle among communications service providers (CSPs) in this region. To a lesser extent, our sales of physical-layer product line increased in EMEA despite the recent decrease in the value of the British pound and the euro compared to the US dollar, which had to some extent a negative impact on our sales and bookings to this region year-over-year.

In the first nine months of fiscal 2017, sales of our protocol-layer product line decreased year-over-year mainly in EMEA due to longer-than-expected sales cycles for systems-related solutions and to some extent to the recent decrease in the value of the British pound and the euro compared to the US dollar. They also slightly decreased in the Americas, despite the positive impact of new acquired Absolute, which is included in our protocol-layer product line. Otherwise, sales of our protocol-layer product line increased in APAC in the first nine months of fiscal 2017 compared to the same period last year.

Bookings

In the third quarter of fiscal 2017, we reported a year-over-year increase in total bookings, which comes from the Americas, mainly from our physical-layer product line. Otherwise, both product lines reported a decrease in bookings in the EMEA and APAC regions.

For the first nine months of fiscal 2017, we reported a year-over-year increase in total bookings, which mainly comes from the Americas for our physical-layer product line. So far in fiscal 2017, our physical-layer product line benefited from heightened penetration of mobile network operators for their fronthaul and backhaul networks, increased traction with fixed network operators for their 100G long-haul and metro links and growing business with web-scale operators for their data center interconnects. In addition, in fiscal 2017, we have benefited to some extent from calendar year-end budget spending on the part of some CSPs in the Americas, versus nominal amount in 2016.

The year-over-year decrease in bookings for our protocol-layer product line for the first nine months of fiscal 2017 comes from the Americas and to a lesser extent to EMEA; this is due in part to the large Xtract solution orders received last year and longer-than-expected sales cycles for systems-related solutions that negatively impacted our bookings for that product line year-over-year; this was offset in part by the positive impact of the recent acquisitions of Absolute and Ontology.

As we evolve from a supplier of dedicated test instruments to a supplier of end-to-end solutions, our quarterly sales and bookings are increasingly subject to quarterly fluctuations, as we are managing more complex, multi-million dollar deals that have prolonged sales and revenue recognition cycles related to our Protocol-layer products. This has been amplified with the recent acquisition of Ontology.

Customer concentration

We sell our products to a broad range of customers, including communications service providers, web-scale operators as well as network equipment manufacturers. In the third quarters of fiscal 2016 and 2017, no customer accounted for more than 10% of our sales, and our top three customers accounted for 14.7% and 24.0% of sales respectively. In the first nine months of fiscal 2017, our top customer accounted for 11.3% of our sales, and our top three customers accounted for 20.4% of sales. In the first nine months of fiscal 2016, no customer accounted for more than 10% of our sales, and our top three customers accounted for 14.2% of our sales.

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

Gross margin before depreciation and amortization (gross margin) reached 58.0% of sales for the three months ended May 31, 2017, compared to 60.8% for the same period last year.

Gross margin reached 61.0% of sales for the nine months ended May 31, 2017, compared to 62.9% for the same period last year.

In the third quarter and the first nine months of fiscal 2017, gross margin included $1.6 million in restructuring charges for severances and inventory write-offs. Excluding these charges, gross margin would have amounted to 60.7% of sales in the third quarter, almost flat year-over-year, and 61.9% of sales in the first nine months of fiscal 2017, slightly lower (1.0%) compared to the same period last year.

In the third quarter of fiscal 2017, our gross margin (excluding the impact of our restructuring plan) was almost flat year-over-year as we delivered similar product mix compared to the same period last year.

In the first nine months of fiscal 2017, our gross margin (excluding the impact of our restructuring charges) was unfavorably affected mainly by product mix within our protocol-layer product line compared to the same period last year. In fact, in the first nine months of 2016, we recognized a large order with a Tier-1 network operator for our EXFO Xtract solution, which had a positive impact on our gross margin during that period, as this product delivers strong margins. We did not have such deal this year. In addition, during the first nine months of fiscal 2017, our physical-layer product line represented a larger portion of our sales year-over-year and this product line delivers lower margins than our protocol-layer product line (protocol-layer products have a richer software content), which had a negative impact on our gross margin year-over-year.

However, in the first nine months of fiscal 2017, we recorded in our sales lower foreign exchange losses on our forward exchange contracts, compared to the same period last year, which contributed to the increase in gross margin by 0.4% year-over-year.

In addition, in the first nine months of fiscal 2017, we recorded lower inventory write down (excluding the impact of our restructuring plan) compared to the same period last year, which contributed to the increase in gross margin by 0.4% year-over-year.

Finally, in the first nine months of fiscal 2017, increased sales year-over-year resulted in a better absorption of our fixed manufacturing costs, which had a positive impact on our gross margin compared to the same period last year.

SELLING AND ADMINISTRATIVE EXPENSES

For the three months ended May 31, 2017, selling and administrative expenses were $22.6 million, or 38.6% of sales, compared to $20.8 million, or 34.2% of sales for the same period last year.

For the nine months ended May 31, 2017, selling and administrative expenses were $65.4 million, or 36.3% of sales, compared to $60.6 million, or 35.7% of sales for the same period last year.

In the third quarter and the first nine months of fiscal 2017, selling and administrative expenses included $0.9 million in restructuring charges. Excluding these charges, they would have amounted to $21.7 million, or 37.0% of sales and $64.5 million, or 35.8% of sales respectively for these periods.

In the third quarter and the first nine months of fiscal 2017, excluding restructuring charges, our selling and administrative expenses increased year-over-year due to some additional headcounts following the acquisitions of Absolute and Ontology and to support the growth of our business, inflation and salary increases, as well as one-time acquisition-related costs following the two recent business acquisitions.

In the third quarter of fiscal 2017, excluding restructuring charges, our selling and administrative expenses increased as a percentage of sales compared to the same period last year, as these expenses increased and sales decreased year-over-year.

RESEARCH AND DEVELOPMENT EXPENSES

Gross research and development expenses

For the three months ended May 31, 2017, gross research and development expenses totaled $14.7 million, or 25.1% of sales, compared to $12.6 million, or 20.7% of sales for the same period last year.

For the nine months ended May 31, 2017, gross research and development expenses totaled $40.1 million, or 22.2% of sales, compared to $35.4 million, or 20.8% of sales for the same period last year.

In the third quarter and the first nine months of fiscal 2017, gross research and development expenses included $1.3 million in restructuring charges. Excluding these charges, they would have amounted to $13.4 million, or 22.9% of sales and $38.8 million, or 21.5% of sales respectively for these periods.

In the third quarter and the first nine months of fiscal 2017, excluding restructuring charges, our gross research and development expenses increased year-over-year due to some additional headcounts following the acquisitions of Absolute and Ontology and to support the growth of our business, inflation, salary increases, as well as a shift in the mix and timing of research and development projects, compared to the same periods last year.

As percentage of sales, excluding restructuring charges, our gross research and development expenses increased in the third quarter of fiscal 2017 compared to the same period last year as these expenses increased and sales decreased year-over-year.

AMORTIZATION OF INTANGIBLE ASSETS

For the three months ended May 31, 2017, amortization of intangible assets amounted to $1.0 million compared to $0.3 million for the same period last year.

For the nine months ended May 31, 2017, amortization of intangible assets amounted to $2.2 million compared to $0.9 million for the same period last year.

The increase in our amortization expenses in the third quarter and the first nine months of fiscal 2017, compared to the same periods last year, was mainly due to the acquisitions of Absolute (October 31, 2016) and Ontology (March 2, 2017).

FOREIGN EXCHANGE GAIN (LOSS)

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

For the three months ended May 31, 2017, we recorded a foreign exchange gain of $1.7 million compared to a foreign exchange loss of $1.0 million for the same period last year.

For the nine months ended May 31, 2017, foreign exchange gain amounted to $2.0 million compared to $0.5 million for the same period last year.

During the third quarter of fiscal 2017, the period-end value of the Canadian dollar decreased versus the US dollar and the euro, compared to the previous quarter, which resulted in a foreign exchange gain of $1.7 million during the quarter. The period-end value of the Canadian dollar decreased 1.6% versus the US dollar to CA$1.3501 = US$1.00 in the third quarter of fiscal 2017, compared to CA$1.3280 = US$1.00 at the end of the previous quarter and decreased 7.2% versus the euro to CA$1.5164 = €1.00 in the third quarter, compared to CA$1.4065 = €1.00 at the end of the previous quarter.

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

For the first nine months of fiscal 2017, the period-end value of the Canadian dollar decreased versus the US dollar and the euro, compared to the previous year-end, which resulted in a foreign exchange gain of $2.0 million during the period. The period-end value of the Canadian dollar decreased 2.8% versus the US dollar to CA$1.3501 = US$1.00 in the first nine months of fiscal 2017, compared to CA$1.3116 = US$1.00 at the end of the previous year and decreased 3.7% versus the euro to CA$1.5164 = €1.00 in the first nine months, compared to CA$1.4601 = €1.00 at the end of the previous year.

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

INCOME TAXES

For the three months ended May 31, 2017, we reported income tax expenses of $2.0 million on a loss before income taxes of $2.3 million. For the corresponding period, last year, we reported income tax expenses of $2.1 million on earnings before income taxes of $3.0 million.

For the nine months ended May 31, 2017, we reported income tax expenses of $5.5 million on earnings before income taxes of $5.5 million. For the corresponding period, last year, we reported income tax expenses of $5.6 million on earnings before income taxes of $12.2 million.

These distorted tax rates mainly resulted from the fact that we did not recognize deferred income tax assets for some of our subsidiaries at loss and a significant portion of our restructuring charges recorded in fiscal 2017 related to these subsidiaries. In addition, we had some non-deductible losses and expenses, such as stock-based compensation costs. However, a significant portion of our foreign exchange gain or loss was created by the translation of financial statements of our foreign subsidiaries into the functional currency, and was therefore non-taxable or non-deductible. Otherwise, our effective tax rate would have been closer to the combined Canadian and provincial statutory tax rate of 27% for both periods.

Please refer to note 8 to our unaudited condensed interim consolidated financial statements for a full reconciliation of our income tax provision.

LIQUIDITY AND CAPITAL RESOURCES

Cash requirements and capital resources

As at May 31, 2017, cash and short-term investments totaled $37.7 million, while our working capital was $67.7 million. Our cash and short-term investments decreased by $14.7 million in the third quarter of fiscal 2017, compared to the previous quarter. During the third quarter of fiscal 2017, we made cash payments of $7.5 million, $2.6 million and $1.5 million respectively, for the acquisition of Ontology, the purchase of capital assets, and the repayment of the long-term debt assumed as part of the Ontology acquisition, which reduced our cash. In addition, our operating activities used $2.8 million in cash. Finally, we recorded an unrealized foreign exchange loss on our cash and short-term investments of $0.3 million. This unrealized foreign exchange loss resulted from the translation, into 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 debt instruments issued by high-credit quality corporations; therefore, we consider the risk of non-performance of these financial instruments to be limited. These debt instruments are not expected to be affected by a significant liquidity risk. For the purposes 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 as well as potential acquisitions.

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 any potential payment for the cash contingent consideration related to the acquisition of Ontology and the payments related to our restructuring plan. In addition to these assets, we have unused available lines of credit totaling $14.5 million for working capital and other general corporate purposes and unused lines of credit of $20.7 million for foreign currency exposure related to forward exchange contracts. However, possible operating losses, additional restructuring costs and/or possible investments in or acquisitions of complementary businesses, products or technologies may require additional financing. There can be no assurance that additional debt or equity financing will be available when required or, if available, that it can be secured on satisfactory terms.

Sources and uses of cash

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

Operating activities

Cash flows used by operating activities were $2.8 million for the three months ended May 31, 2017, compared to cash flows generated of $2.3 million for the same period last year.

Cash flows provided by operating activities were $10.7 million for the nine months ended May 31, 2017, compared to $20.8 million for the same period last year.

Cash flows used by operating activities in the third quarter of fiscal 2017 were attributable to the net loss after items not affecting cash of $1.6 million, and the negative net change in non-cash operating items of $1.2 million; this was mainly due to the negative effect on cash of the increase of $0.9 million in our accounts receivable due to the timing of receipts and sales during the quarter, the $0.8 million increase in our income tax and tax credits recoverable due to tax credits earned during the quarter not yet recovered, and the $0.9 million increase in our prepaid expenses due to timing of payments during the quarter. These negative effects on cash were offset in part by the $1.2 million increase in our accounts payable and accrued liabilities, mainly due to unpaid severance expenses at the end of the quarter.

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

Cash flows provided by operating activities in the first nine months of fiscal 2017 were attributable to the net earnings after items not affecting cash of $9.4 million, and the positive net change in non-cash operating items of $1.3 million; this was mainly due to the positive effect on cash of the decrease of $1.7 million in our accounts receivable due to the timing of receipts and sales during the period and the $1.8 million increase in our accounts payable, accrued liabilities and provisions, mainly due to unpaid severance expenses at the end of the period. These positive effects on cash were offset in part by the negative effect on cash of the $1.2 million increase in our income tax and tax credits recoverable due to tax credits earned during the period not yet recovered, and the $0.8 million increase in our prepaid expenses due to timing of payments during the period.

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

Investing activities

Cash flows used by investing activities were $9.3 million for the three months ended May 31, 2017, compared to $4.2 million for the same period last year.

Cash flows used by investing activities were $17.2 million for the nine months ended May 31, 2017, compared to $6.0 million for the same period last year.

In the third quarter of fiscal 2017, we made cash payments of $7.5 million and $2.6 million respectively for the acquisition of Ontology and the purchase of capital assets, but we disposed (net of acquisitions) of $0.8 million worth of short-term investments.

For the corresponding period last year, we acquired $3.1 million worth of short-term investment and we paid $1.1 million for the purchase of capital assets.

In the first nine months of fiscal 2017, we made cash payments of $12.5 million and $5.4 million respectively for the acquisitions of Absolute and Ontology and the purchase of capital assets.

For the corresponding period last year, we acquired (net of disposals) $2.6 million worth of short-term investments, and we paid $3.4 million for the purchase of capital assets.

Financing activities

Cash flows used by investing activities were $1.5 million for the three and nine months ended May 31, 2017, compared to nominal amounts for the corresponding periods last year.

In the third quarter and the first nine months of fiscal 2017, we repaid the long-term debt of $1.5 million assumed as part of the acquisition of Ontology.

FORWARD EXCHANGE CONTRACTS

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

As at May 31, 2017, we held forward exchange contracts to sell US dollars for Canadian dollars and Indian rupees at various forward rates, which are summarized as follows:

US dollars – Canadian dollars

Expiry dates		Contractual amounts	Weighted average contractual forward rates
June 2017 to August 2017	$	6,000,000	1.3059
September 2017 to August 2018		18,300,000	1.3407
September 2018 to August 2019		10,900,000	1.3426
Total	$	35,200,000	1.3353

US dollars – Indian rupees

Expiry dates		Contractual amounts	Weighted average contractual forward rates
June 2017 to August 2017	$	1,600,000	69.66
September 2017 to August 2018		3,400,000	69.49
Total	$	5,000,000	69.54

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 a net loss of $0.1 million as at August 31, 2016 and a net gain of $4,000 as at May 31, 2017.

SHARE CAPITAL

As at June 29, 2017, EXFO had 31,643,000 multiple voting shares outstanding, entitling to 10 votes each and 23,061,447 subordinate voting shares outstanding. The multiple voting shares and the subordinate voting shares are unlimited as to number and without par value.

OFF-BALANCE SHEET ARRANGEMENTS

As at May 31, 2017, our off-balance sheet arrangements consisted of letters of guarantee amounting to $0.6 million for our own selling and purchasing requirements, which were reserved from our lines of credit; these letters of guarantee will expire at various dates through fiscal 2020.

STRUCTURED ENTITIES

As at May 31, 2017, 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/A for the year ended August 31, 2016, filed with the U.S. Securities and Exchange Commission and the Canadian securities commissions.

NEW IFRS PRONOUNCEMENTS

Refer to note 2 to our unaudited condensed interim consolidated financial statements for the three and nine months ended May 31, 2017 and to our consolidated financial statements for the year ended August 31, 2016, for discussion of certain recent accounting pronouncements that are not yet adopted. For IFRS 15 specifically, we are still in the process of performing an assessment of the potential impact the new revenue standard may have on our financial results and operations. We will adopt this new standard effective September 1, 2018, but have not yet determined the method of transition (modified retrospective or full retrospective) that will be applied at that time. Additional disclosures will be provided by management in the consolidated financial statements and MD&A as it becomes known.

RISKS AND UNCERTAINTIES

For the third quarter of fiscal 2017, there have been no material changes from the risk factors disclosed in our Annual Report on Form 20-F/A for the year ended August 31, 2016.

CONTROLS

As described in the Form 20-F/A filed on January 9, 2017, we concluded that EXFO's internal control over financial reporting was not effective as of August 31, 2016, as a result of the identification of a material weakness as we did not maintain sufficient controls over the trade accounts receivable ledger, which included failure to maintain appropriate segregation of duties and lack of supervisory review and monitoring of journal entries recorded to the trade accounts receivable ledger. See item 15(b) of the Form 20-F/A filed on January 9, 2017 for more details on the impact of the material weakness on EXFO's financial reporting.

In the second quarter of fiscal 2017, we completed the implementation of our remediation plans to address the material weakness, which included additional segregation of duties. The material weakness cannot be considered remediated until the remedial controls operate for a sufficient period of time and management has time to conclude, through testing, that these controls are operating effectively.

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 plan and forecast future periods as well as make operational and strategic decisions. We believe that providing this information to our investors, in addition to the IFRS measures, allows them to see the company's results through the eyes of management, and to better understand our historical and future financial performance.

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

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, stock-based compensation costs, restructuring charges, and foreign exchange gain or loss.

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

Adjusted EBITDA

	Three months ended May 31, 2017	Three months ended May 31, 2016	**Nine months ended May 31, 2017**	Nine months ended May 31, 2016
IFRS net earnings (loss) for the period	**$ (4,304)**	$ 919	**$ 7**	$ 6,648
Add (deduct):				
Depreciation of property, plant and equipment	**1,029**	958	**2,894**	2,857
Amortization of intangible assets	**1,046**	294	**2,241**	880
Interest and other (income) expense	**57**	(309)	**28**	(716)
Income taxes	**2,012**	2,096	**5,495**	5,576
Stock-based compensation costs	**372**	386	**983**	1,076
Restructuring charges	**3,813**	–	**3,813**	–
Foreign exchange (gain) loss	**(1,725)**	957	**(1,965)**	(454)
Adjusted EBITDA for the period	**$ 2,300**	$ 5,301	**$ 13,496**	$ 15,867
Adjusted EBITDA as a percentage of sales	**3.9%**	8.7%	**7.5%**	9.3%

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

	Quarters ended			
	May 31, 2017	**February 28, 2017**	**November 30, 2016**	**August 31, 2016**
Sales	$ 58,505	$ 60,030	$ 61,785	$ 62,858
Cost of sales (1)	$ 24,555	$ 22,989	$ 22,813	$ 24,145
Net earnings (loss)	$ (4,304)	$ 1,008	$ 3,303	$ 2,252
Basic and diluted net earnings (loss) per share	$ (0.08)	$ 0.02	$ 0.06	$ 0.04

	Quarters ended			
	May 31, 2016	**February 29, 2016**	**November 30, 2015**	**August 31, 2015**
Sales	$ 60,896	$ 53,597	$ 55,232	$ 56,594
Cost of sales (1)	$ 23,880	$ 18,904	$ 20,137	$ 21,975
Net earnings	$ 919	$ 3,963	$ 1,766	$ 1,882
Basic and diluted net earnings per share	$ 0.02	$ 0.07	$ 0.03	$ 0.03

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