

EXFO Inc.

Condensed Unaudited Interim Consolidated Balance Sheets

(in thousands of US dollars)

	As at November 30, 2015	As at August 31, 2015
	<u> </u>	<u> </u>
Assets		
Current assets		
Cash	\$ 27,874	\$ 25,864
Short-term investments	1,490	1,487
Accounts receivable		
Trade	48,959	48,068
Other	2,797	2,384
Income taxes and tax credits recoverable	3,477	3,855
Inventories	30,741	27,951
Prepaid expenses	2,711	2,801
	<u>118,049</u>	<u>112,410</u>
Tax credits recoverable	35,443	35,625
Property, plant and equipment	35,374	35,695
Intangible assets	3,867	4,096
Goodwill	21,539	21,860
Deferred income tax assets	8,365	8,900
Other assets	218	416
	<u>\$ 222,855</u>	<u>\$ 219,002</u>
Liabilities		
Current liabilities		
Bank loan	\$ 312	\$ –
Accounts payable and accrued liabilities	36,750	34,126
Provisions	335	427
Income taxes payable	519	779
Deferred revenue	7,376	7,647
	<u>45,292</u>	<u>42,979</u>
Deferred revenue	4,553	2,957
Deferred income tax liabilities	1,695	1,524
Other liabilities	507	791
	<u>52,047</u>	<u>48,251</u>
Shareholders' equity		
Share capital (note 5)	86,767	86,045
Contributed surplus	17,396	17,778
Retained earnings	120,699	118,933
Accumulated other comprehensive loss	(54,054)	(52,005)
	<u>170,808</u>	<u>170,751</u>
	<u>\$ 222,855</u>	<u>\$ 219,002</u>

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

EXFO Inc.
Condensed Unaudited Interim Consolidated Statements of Earnings

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

	Three months ended November 30,	
	2015	2014
Sales	\$ 55,232	\$ 56,724
Cost of sales ⁽¹⁾ (note 6)	20,137	21,237
Selling and administrative (note 6)	20,252	21,032
Net research and development (note 6)	9,933	11,658
Depreciation of property, plant and equipment (note 6)	975	1,245
Amortization of intangible assets (note 6)	300	1,098
Interest (income) expense	63	(217)
Foreign exchange gain	(310)	(1,975)
Earnings before income taxes	3,882	2,646
Income taxes (note 7)	2,116	1,165
Net earnings for the period	\$ 1,766	\$ 1,481
Basic and diluted net earnings per share	\$ 0.03	\$ 0.02
Basic weighted average number of shares outstanding (000's)	53,814	60,335
Diluted weighted average number of shares outstanding (000's) (note 8)	54,535	60,980

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

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

EXFO Inc.

Condensed Unaudited Interim Consolidated Statements of Comprehensive Loss

(in thousands of US dollars)

	Three months ended November 30,	
	2015	2014
Net earnings for the period	\$ 1,766	\$ 1,481
Other comprehensive income (loss), net of income taxes		
Items that will not be reclassified subsequently to net earnings		
Foreign currency translation adjustment	(2,509)	(11,735)
Items that may be reclassified subsequently to net earnings		
Unrealized losses on forward exchange contracts	(270)	(1,505)
Reclassification of realized losses on forward exchange contracts in net earnings	878	162
Deferred income tax effect of losses on forward exchange contracts	(148)	373
Other comprehensive loss	(2,049)	(12,705)
Comprehensive loss for the period	\$ (283)	\$ (11,224)

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

EXFO Inc.

Condensed Unaudited Interim Consolidated Statements of Changes in Shareholders' Equity

(in thousands of US dollars)

	Three months ended November 30, 2014				
	Share capital	Contributed surplus	Retained earnings	Accumulated other comprehensive loss	Total shareholders' equity
Balance as at September 1, 2014	\$ 111,491	\$ 16,503	\$ 113,635	\$ (10,259)	\$ 231,370
Redemption of share capital (note 5)	(919)	66	-	-	(853)
Reclassification of stock-based compensation costs (note 5)	443	(443)	-	-	-
Stock-based compensation costs	-	414	-	-	414
Net earnings for the period	-	-	1,481	-	1,481
Other comprehensive loss					
Foreign currency translation adjustment	-	-	-	(11,735)	(11,735)
Changes in unrealized losses on forward exchange contracts, net of deferred income taxes of \$373	-	-	-	(970)	(970)
Total comprehensive loss for the period					(11,224)
Balance as at November 30, 2014	<u>\$ 111,015</u>	<u>\$ 16,540</u>	<u>\$ 115,116</u>	<u>\$ (22,964)</u>	<u>\$ 219,707</u>

	Three months ended November 30, 2015				
	Share capital	Contributed surplus	Retained earnings	Accumulated other comprehensive loss	Total shareholders' equity
Balance as at September 1, 2015	\$ 86,045	\$ 17,778	\$ 118,933	\$ (52,005)	\$ 170,751
Redemption of share capital (note 5)	(1)	-	-	-	(1)
Reclassification of stock-based compensation costs (note 5)	723	(723)	-	-	-
Stock-based compensation costs	-	341	-	-	341
Net earnings for the period	-	-	1,766	-	1,766
Other comprehensive income (loss)					
Foreign currency translation adjustment	-	-	-	(2,509)	(2,509)
Changes in unrealized losses on forward exchange contracts, net of deferred income taxes of \$148	-	-	-	460	460
Total comprehensive loss for the period					(283)
Balance as at November 30, 2015	<u>\$ 86,767</u>	<u>\$ 17,396</u>	<u>\$ 120,699</u>	<u>\$ (54,054)</u>	<u>\$ 170,808</u>

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

EXFO Inc.

Condensed Unaudited Interim Consolidated Statements of Cash Flows

(in thousands of US dollars)

	Three months ended November 30,	
	2015	2014
Cash flows from operating activities		
Net earnings for the period	\$ 1,766	\$ 1,481
Add (deduct) items not affecting cash		
Stock-based compensation costs	376	400
Depreciation and amortization	1,275	2,343
Deferred revenue	1,511	(1,027)
Deferred income taxes	573	(332)
Changes in foreign exchange gain/loss	(344)	(1,028)
	5,157	1,837
Changes in non-cash operating items		
Accounts receivable	(2,024)	(5,036)
Income taxes and tax credits	(278)	(212)
Inventories	(3,226)	(1,181)
Prepaid expenses	54	(336)
Other assets	193	1
Accounts payable, accrued liabilities and provisions	3,375	6,836
Other liabilities	(28)	(19)
	3,223	1,890
Cash flows from investing activities		
Additions to short-term investments	(21)	(13,691)
Proceeds from disposal and maturity of short-term investments	–	13,766
Additions to capital assets	(1,309)	(754)
	(1,330)	(679)
Cash flows from financing activities		
Bank loan	315	–
Redemption of share capital	(1)	(853)
	314	(853)
Effect of foreign exchange rate changes on cash	(197)	(2,258)
Change in cash	2,010	(1,900)
Cash – Beginning of the period	25,864	54,121
Cash – End of the period	\$ 27,874	\$ 52,221
Supplementary information		
Income taxes paid	\$ 608	\$ 367

As at November 30, 2014 and 2015, additions to capital assets amounted to \$1,045 and \$1,309 respectively, and unpaid purchases of capital assets amounted to \$492 and \$377 respectively.

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

EXFO Inc.

Notes to Condensed Unaudited Interim 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 network visibility solutions for fixed and mobile network operators, web-scale service providers as well as 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 condensed interim consolidated financial statements were authorized for issue by the Board of Directors on January 6, 2016.

2 Basis of Presentation

These condensed interim consolidated financial statements have been prepared in accordance with the *International Financial Reporting Standards* (IFRS), as issued by the *International Accounting Standards Board* (IASB) applicable to the preparation of interim financial statements, including IAS 34, “*Interim Financial Reporting*”, and using the same accounting policies and methods used in the preparation of the company’s most recent annual consolidated financial statements. Consequently, these condensed interim consolidated financial statements should be read in conjunction with the company’s most recent annual consolidated financial statements, which have been prepared in accordance with IFRS as issued by the IASB.

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 has not yet assessed the impact that the new standard will have on its consolidated financial statements.

Revenue from contracts with customers

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

EXFO Inc.

Notes to Condensed Unaudited Interim Consolidated Financial Statements

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

3 Restructuring Charges

In the fourth quarter of the year ended August 31, 2015, the company implemented a restructuring plan to align its cost structure to the challenging market conditions. This plan resulted in severance expenses of \$1,637,000 recorded in fiscal 2015. These expenses were fully paid during the three months ended November 30, 2015.

4 Financial Instruments

Fair Value of Financial Instruments

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

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 exchange rates at the balance sheet dates.

The fair value of forward exchange contracts represents the amount at which they could be settled based on estimated current market rates.

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

	As at November 30, 2015		As at August 31, 2015	
	Level 1	Level 2	Level 1	Level 2
Financial assets				
Short-term investments	\$ 1,490	\$ -	\$ 1,487	\$ -
Forward exchange contracts	\$ -	\$ 19	\$ -	\$ -
Financial Liabilities				
Forward exchange contracts	\$ -	\$ 3,512	\$ -	\$ 4,154

Derivative Financial Instruments

The functional currency of the company is the Canadian dollar. The company is exposed to 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 currency risk as a result of its research and development activities in India (Indian rupees). This risk is partially hedged by forward exchange contracts. The company's forward exchange contracts, which are designated as cash flow hedging instruments, qualify for hedge accounting.

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Notes to Condensed Unaudited Interim Consolidated Financial Statements

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

As at November 30, 2015, 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

Expiry dates	Contractual amounts	Weighted average contractual forward rates
December 2015 to August 2016	\$ 14,500	1.1225
September 2016 to August 2017	12,000	1.2139
September 2017 to December 2017	1,600	1.2135
Total	\$ 28,100	1.1667

US dollars – Indian rupees

Expiry dates	Contractual amounts	Weighted average contractual forward rates
December 2015 to August 2016	\$ 2,900	67.08
September 2016	200	68.98
Total	\$ 3,100	67.20

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 as at August 31, 2015, and \$3,493,000 as at November 30, 2015.

As at November 30, 2015, forward exchange contracts in the amount of \$19,000 are presented as current assets in other accounts receivable, forward exchange contracts in the amount of \$3,072,000 are presented as current liabilities in accounts payable and accrued liabilities, and forward exchange contracts of \$440,000 are presented as long-term liabilities in other long-term liabilities in the balance sheet. Forward exchange contracts of \$603,000 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.

Based on the portfolio of forward exchange contracts as at November 30, 2015, the company estimates that the portion of the 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 \$2,450,000.

During the three months ended November 30, 2014 and 2015, the company recognized within its sales foreign exchange losses on forward exchange contracts of \$292,000 and \$874,000 respectively.

EXFO Inc.

Notes to Condensed Unaudited Interim Consolidated Financial Statements

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

5 Share Capital

The following tables summarize changes in share capital for the three months ended November 30, 2014 and 2015.

	Three months ended November 30, 2014				
	Multiple voting shares		Subordinate voting shares		Total amount
	Number	Amount	Number	Amount	
Balance as at September 1, 2014	31,643,000	\$ 1	28,703,750	\$ 111,490	\$ 111,491
Redemption of restricted share units	-	-	115,669	-	-
Redemption of share capital	-	-	(236,486)	(919)	(919)
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	-	-	-	443	443
Balance as at November 30, 2014	<u>31,643,000</u>	<u>\$ 1</u>	<u>28,582,933</u>	<u>\$ 111,014</u>	<u>\$ 111,015</u>

	Three months ended November 30, 2015				
	Multiple voting shares		Subordinate voting shares		Total amount
	Number	Amount	Number	Amount	
Balance as at September 1, 2015	31,643,000	\$ 1	22,092,034	\$ 86,044	\$ 86,045
Redemption of restricted share units	-	-	155,784	-	-
Redemption of deferred share units	-	-	653	-	-
Redemption of share capital	-	-	(200)	(1)	(1)
Reclassification of stock-based compensation costs to share capital upon exercise of stock awards	-	-	-	723	723
Balance as at November 30, 2015	<u>31,643,000</u>	<u>\$ 1</u>	<u>22,248,271</u>	<u>\$ 86,766</u>	<u>\$ 86,767</u>

6 Statements of Earnings

Net research and development expenses comprise the following:

	Three months ended November 30,	
	2015	2014
Gross research and development expenses	\$ 11,279	\$ 13,309
Research and development tax credits and grants	(1,346)	(1,651)
Net research and development expenses for the period	<u>\$ 9,933</u>	<u>\$ 11,658</u>

EXFO Inc.

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

Inventory write-down is as follows:

	Three months ended November 30,	
	2015	2014
Inventory write-down for the period	\$ 847	\$ 933

Depreciation and amortization expenses by functional area are as follows:

	Three months ended November 30,	
	2015	2014
Cost of sales		
Depreciation of property, plant and equipment	\$ 323	\$ 395
Amortization of intangible assets	177	671
	<u>500</u>	<u>1,066</u>
Selling and administrative expenses		
Depreciation of property, plant and equipment	146	142
Amortization of intangible assets	18	364
	<u>164</u>	<u>506</u>
Net research and development expenses		
Depreciation of property, plant and equipment	506	708
Amortization of intangible assets	105	63
	<u>611</u>	<u>771</u>
	<u>\$ 1,275</u>	<u>\$ 2,343</u>
Depreciation of property, plant and equipment	\$ 975	\$ 1,245
Amortization of intangible assets	300	1,098
	<u>\$ 1,275</u>	<u>\$ 2,343</u>

Employee compensation comprises the following:

	Three months ended November 30,	
	2015	2014
Salaries and benefits	\$ 26,964	\$ 30,210
Stock-based compensation costs	376	400
Total employee compensation for the period	<u>\$ 27,340</u>	<u>\$ 30,610</u>

EXFO Inc.

Notes to Condensed Unaudited Interim 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:

	Three months ended November 30,	
	2015	2014
Cost of sales	\$ 31	\$ 45
Selling and administrative expenses	266	263
Net research and development expenses	79	92
Total stock-based compensation for the period	<u>\$ 376</u>	<u>\$ 400</u>

7 Income Taxes

For the three months ended November 30, 2014 and 2015, 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:

	Three months ended November 30,	
	2015	2014
Income tax provision at combined Canadian federal and provincial statutory tax rate (27%)	\$ 1,048	\$ 714
Increase (decrease) due to:		
Foreign income taxed at different rates	(158)	(5)
Non-taxable (income)/loss	204	831
Non-deductible expenses	170	202
Foreign exchange effect of translation of foreign subsidiaries	(150)	(993)
Unrecognized deferred income tax assets on temporary deductible differences and unused tax losses	1,012	604
Other	(10)	(188)
Income tax provision for the period	<u>\$ 2,116</u>	<u>\$ 1,165</u>

The income tax provision consists of the following:

	Three months ended November 30,	
	2015	2014
Current	\$ 1,543	\$ 1,497
Deferred	573	(332)
	<u>\$ 2,116</u>	<u>\$ 1,165</u>

EXFO Inc.

Notes to Condensed Unaudited Interim Consolidated Financial Statements

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

8 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:

	Three months ended November 30,	
	2015	2014
Basic weighted average number of shares outstanding (000's)	53,814	60,335
Plus dilutive effect of (000's):		
Restricted share units	607	527
Deferred share units	114	118
Diluted weighted average number of shares outstanding (000's)	<u>54,535</u>	<u>60,980</u>
Stock awards excluded from the calculation of diluted weighted average number of shares because their exercise price was greater than the average market price of the common shares (000's)	<u>57</u>	<u>109</u>