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; our ability to successfully integrate businesses that we acquire; 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; 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 November 24, 2017.

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

COMPANY OVERVIEW

We are a leading provider of next-generation test, service assurance and analytics solutions for fixed and mobile communications service providers (CSPs), web-scale operators as well as network equipment manufacturers (NEMs) 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: 5G, Internet of Things (IoT), 4G/LTE (long-term evolution), wireless backhaul, small cells and distributed antenna systems (DAS), 100G and 400G network upgrades, as well as fiber-to-the-home (FTTH)/fiber-to-the-curb (FTTC)/fiber-to-the-node (FTTN) deployments.

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

Over the years, we have expanded our product portfolio into fiber monitoring, service assurance for next-generation IP (Internet protocol) networks and test equipment for 2G, 3G, 4G/LTE and soon 5G mobile networks. Our fiber monitoring solution leverages EXFO's expertise and market leadership in optical time domain reflectometry (OTDR) by using them as remote test units (RTUs) to monitor an optical plant 24 hours per day, seven days per week. As such, this fiber monitoring solution proactively detects any fiber degradation or locates any fiber cut to optimize quality of service along long-haul, metro and access networks. Our service assurance solution, called the Brix System, is a probe-based hardware and software offering that delivers quality of service and quality of experience visibility as well as real-time service monitoring and verification of next-generation IP networks. We have enriched our service assurance offering with infrastructure performance management tools, analytics software and network discovery topology solutions via technology acquisitions. Built around a distributed architecture, the Brix System enables the successful launch and ongoing profitable operation of IP-based voice, video and data applications and services across fixed and mobile networks.

Our mobile network portfolio mainly consists of network simulators and optical radio frequency (RF) test solutions. Our network simulators simulate real-world, large-scale network traffic and end-user behavior in a laboratory environment in order to predict network behavior, uncover faults and optimize networks before mobile networks and services are deployed. Our optical RF test solutions are dedicated to tuning up and troubleshooting fiber-based mobile networks. These solutions are critical for locating and analyzing RF interference issues in FTTA, DAS, remote radio heads and baseband units that support 4G/LTE and upcoming 5G networks. These software applications can be combined with optical and Ethernet modules in our FTB-1 Pro platform to create an all-in-one test solution for cell technicians and maintenance engineers.

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

We have a staff of approximately 1,600 people in 25 countries, supporting more than 2,000 customers around the world. We operate three main manufacturing sites, which are located in Quebec City, Canada, in Shenzhen, China, and in Oulu, Finland. We also have six main research and development expertise centers in Boston, Toronto, Montreal, Quebec City, Oulu and London, supported by a software development center in India.

We launched 16 new products and/or major enhancements in fiscal 2017, addressing four key technology areas: fiber, Cloud, network virtualization and 5G. New product introductions included a 400 Gbit/s optical transport test solution for the lab and manufacturing markets; an automated inspection probe for testing multi-fiber connectors in data centers and radio access networks; a software-based solution, Universal Virtual Synch, enabling communications service providers to accurately and cost-effectively measure network latency; and optical RF over OBSAI (open base station architecture initiative) link test capabilities to complement optical RF over CPRI (common public radio interface) test technology for centralized radio access networks.

Our sales increased 4.6% to $243.3 million in fiscal 2017 compared to $232.6 million in 2016. Bookings, which represent purchase orders received from customers, increased 4.8% to $251.8 million in fiscal 2017 compared to $240.3 million in 2016, for a book-to-bill ratio of 1.03.

Net earnings amounted to $0.9 million, or $0.02 per diluted share, in fiscal 2017, compared to $8.9 million, or $0.16 per diluted share, in fiscal 2016. Net earnings in fiscal 2017 included net expenses totaling $10.6 million comprising $2.7 million in after-tax amortization of intangible assets, $1.4 million in stock-based compensation costs, $4.8 million in after-tax restructuring charges, $0.4 million in positive change in the fair value of the cash contingent consideration, $1.1 million in after-tax acquisition-related costs, and a foreign exchange loss of $1.0 million. Net earnings in fiscal 2016 included net expenses totaling $2.3 million comprising $1.1 million in after-tax amortization of intangible assets, $1.4 million in stock-based compensation costs, and a foreign exchange gain of $0.2 million.

Adjusted EBITDA (net earnings before interest, income taxes, depreciation and amortization, stock-based compensation costs, restructuring charges, change in fair value of cash contingent consideration, and foreign exchange gain or loss) amounted to $22.0 million, or 9.1% of sales, in fiscal 2017, compared to $22.0 million, or 9.5% of sales, in 2016. As disclosed in the third quarter of fiscal 2017, expected adjusted EBITDA for fiscal 2017 amounted to approximately $20 million, based on the midpoint of our earnings guidance for the fourth quarter. In the fourth quarter of fiscal 2017, actual sales were at the high end of our earnings guidance, which explains higher than expected Adjusted EBITDA for the whole fiscal year. See page 24 of this document for a complete reconciliation of adjusted EBITDA and IFRS net earnings.

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 fiscal 2017 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 $9.2 million and consisted of $7.8 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 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 since March 2, 2017, being the date of acquisition. For additional disclosure on the accounting for the acquisition, see note 3 to our fiscal 2017 consolidated financial statements.

On March 29, 2017, we announced the appointment of Philippe Morin as our 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 EXFO's growth initiatives, customer outreach as well as corporate governance.

On May 2, 2017, we announced a restructuring plan to streamline our passive monitoring solutions portfolio, which falls under our protocol-layer product line. This plan resulted in severance expenses of $4.1 million and inventory writeoffs of $1.0 million, for total restructuring charges of $5.1 million during the year. As a result of this plan, we expect annual savings of approximately $9 million.

On September 8, 2017, we acquired 33.1% of all issued and outstanding shares of Astellia SA ("Astellia"), a publicly traded company on the NYSE Euronext Paris stock exchange. Astellia is a provider of network and subscriber intelligence enabling mobile operators to drive service quality, maximize operational efficiency, reduce churn and develop revenue. Its vendor-independent, real-time monitoring and troubleshooting solution is used to optimize networks end-to-end from radio to core. The acquisition-date fair value of the consideration transferred amounted to €8.6 million (US$10.3 million) in an all-cash deal.

On October 2, 2017, we acquired all issued and outstanding shares of Yenista Optics S.A.S (Yenista), a privately held company located in France, a supplier of advanced optical test equipment for the research and development and manufacturing markets. Its portfolio includes benchtop optical spectrum analyzers, tunable lasers, tunable filters and passive optical component test systems for NEMs and optical component vendors. The acquisition-date fair value of the total consideration amounted to €9.4 million (US$11.1 million) and consisted of €8.3 million (US$9.7 million) in cash, net of Yenista's cash of €1.1 million (US$1.4 million) at the acquisition date. This acquisition will be accounted for by applying the acquisition method as required by IFRS 3, "*Business Comb*inations", and the requirements of IFRS 10, "*Consolidated Financial Statements*"; consequently, the fair value of the total consideration transferred will be 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 will be included in our consolidated financial statements starting October 2, 2017, being the date of acquisition.

On October 10, 2017, we reached an agreement with Astellia to acquire Astellia's remaining shares at a share price of €10, for total consideration of €17.3 million (approximately US$20 million) by way of a public tender offer. The public offering will open in late calendar 2017 or early 2018, subject to the approval of French foreign investment authorities and permission from l'Autorité des marchés financiers. If the public tender offering is successful, the settlement of the acquisition is expected to take place early in calendar 2018.

On October 25, 2017, we modified certain credit facilities whereby existing lines of credits, that provided advances up to CA$4.8 million (US$3.8 million) and up to US$6.0 million for operating purposes, were cancelled and replaced by credit facility of CA$28.9 million (US$23.1 million) mainly for the acquisition of the remaining shares of Astellia under the public tender offer.

Sales

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

In fiscal 2015 and 2016, no customer accounted for more than 10% of our sales, with our top customer representing 7.1% and 7.1% of our sales respectively. In fiscal 2017, our top customer represented 10.1% of our sales, with our top three customers representing 18.4% of our sales.

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

Cost of Sales

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

Operating Expenses

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

Selling and administrative expenses consist primarily of salaries and related expenses for personnel, sales commissions, travel expenses, marketing programs, professional services, information systems, human resources and other corporate expenses.

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

RESULTS OF OPERATIONS

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

Consolidated statement of earnings data [1]:	**2017**	2016	2015	**2017**	2016	2015
Sales	**$ 243,301**	$ 232,583	$ 222,089	**100.0 %**	100.0 %	100.0 %
Cost of sales [2]	**94,329**	87,066	85,039	**38.8**	37.4	38.3
Selling and administrative [3]	**86,256**	82,169	82,200	**35.5**	35.3	37.0
Net research and development	**47,168**	42,687	44,003	**19.4**	18.4	19.8
Depreciation of property, plant and equipment	**3,902**	3,814	4,835	**1.6**	1.6	2.2
Amortization of intangible assets	**3,289**	1,172	2,883	**1.4**	0.5	1.3
Change in fair value of cash contingent consideration	**(383)**	–	–	**(0.2)**	–	–
Interest and other (income) expense	**303**	(828)	(155)	**0.1**	(0.4)	(0.1)
Foreign exchange (gain) loss	**978**	(161)	(7,212)	**0.4**	–	(3.2)
Unusual charge [3]	–	–	603	–	–	0.3
Earnings before income taxes	**7,459**	16,664	9,893	**3.0**	7.2	4.4
Income taxes	**6,608**	7,764	5,036	**2.7**	3.4	2.2
Net earnings for the year	**$ 851**	$ 8,900	$ 4,857	**0.3 %**	3.8 %	2.2 %
Basic net earnings per share	**$ 0.02**	$ 0.17	$ 0.09			
Diluted net earnings per share	**$ 0.02**	$ 0.16	$ 0.08			
Other selected information:						
Gross margin before depreciation and amortization [4]	**$ 148,972**	$ 145,517	$ 137,050	**61.2 %**	62.6 %	61.7 %
Research and development data:						
Gross research and development	**$ 53,124**	$ 47,875	$ 50,148	**21.8 %**	20.6 %	22.6 %
Net research and development	**$ 47,168**	$ 42,687	$ 44,003	**19.4 %**	18.4 %	19.8 %
Restructuring charges included in:						
Cost of sales	**$ 1,697**	$ –	$ 290	**0.7 %**	– %	0.1 %
Selling and administrative expenses	**$ 1,150**	$ –	$ 586	**0.5 %**	– %	0.3 %
Net research and development expenses	**$ 2,232**	$ –	$ 761	**0.9 %**	– %	0.3 %
Adjusted EBITDA [4]	**$ 22,041**	$ 22,039	$ 13,779	**9.1 %**	9.5 %	6.2 %
Consolidated balance sheet data [1]:						
Total assets	**$ 259,241**	$ 237,793	$ 217,478			

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

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

(3) Selling and administrative is exclusive of a one-time charge relating to an unusual bad debt in fiscal 2015.

(4) Refer to page 24 for non-IFRS measures.

RESULTS OF OPERATIONS

Sales and Bookings

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

Sales

	Years ended August 31,		
	2017	2016	2015
Physical-layer product line	$ 161,864	$ 151,910	$ 144,060
Protocol-layer product line	81,905	83,324	80,591
	243,769	235,234	224,651
Foreign exchange losses on forward exchange contracts	(468)	(2,651)	(2,562)
Total sales	$ 243,301	$ 232,583	$ 222,089

Bookings

	Years ended August 31,		
	2017	2016	2015
Physical-layer product line	$ 165,886	$ 155,320	$ 144,673
Protocol-layer product line	86,348	87,631	80,948
	252,234	242,951	225,621
Foreign exchange losses on forward exchange contracts	(468)	(2,651)	(2,562)
Total bookings	$ 251,766	$ 240,300	$ 223,059

Fiscal 2017 vs. 2016

In fiscal 2017, our sales increased 4.6% to $243.3 million, compared to $232.6 million in 2016, while our bookings increased 4.8% year-over-year to $251.8 million in 2017 from $240.3 million in 2016, for a book-to-bill ratio of 1.03 (1.03 in 2016).

Sales

In fiscal 2017, we made progress in sales (6.6%) for our physical-layer product line (optical and copper testing), mainly in the Americas, compared to 2016, mostly due to our leadership position in portable optical testing, a 100G investment cycle among CSPs in this region, and growing business with web-scale operators for their data center interconnects. In addition, in fiscal 2017, we benefited to some extent from calendar year-end budget spending on the part of some CSPs in the Americas, versus a nominal amount in 2016. To a lesser extent, sales of our physical-layer product line increased in Europe, Middle East and Africa (EMEA) despite the decrease in the average value of the British pound and the euro compared to the US dollar year-over-year, which had to some extent a negative impact on our sales and bookings to this region in 2017 compared to 2016. In the Asia-Pacific (APAC) region, sales of our physical-layer product line decreased year-over-year in fiscal 2017, especially in China, mainly due to delayed investments from NEMs.

In fiscal 2017, sales of our protocol-layer product line decreased 1.7% year-over-year, mainly in the Americas, despite the positive impact of newly acquired Absolute. In fiscal 2016, we also had recognized a large order from a North American Tier-1 network operator for our EXFO Xtract solution, and we did not close such large order in fiscal 2017. In addition, the streamlining of our passive monitoring product line in fiscal 2017 had a negative impact on our sales in 2017 compared to 2016. Furthermore, in fiscal 2016, our transport and datacom product line (a subgroup within our protocol-layer product line) benefited, to a greater extent, from the 100G investment cycle, especially in the United States, compared to 2017. Otherwise, sales of our protocol-layer product line increased in the EMEA year-over-year, mainly due to the positive impact of recently acquired Ontology, despite the decrease in the average value of the British pound and the euro compared to the US dollar year-over-year. Sales of our protocol-layer product line were flat overall in APAC year-over-year in fiscal 2017.

Finally, in fiscal 2017, we reported lower losses on our forward exchange contracts, which had a $2.2 million positive impact on our total sales year-over-year.

Overall, the year-over-year increase in total sales in fiscal 2017 comes from the Americas, mainly in Canada and to a lesser extent in the United States, and from the EMEA. On the other hand, sales to APAC slightly decreased year-over-year, as sales to China decreased year-over-year after a robust performance in 2016.

Bookings

In fiscal 2017, we reported a year-over-year increase in total bookings, which mainly comes from the Americas for our physical-layer product line and from the EMEA for our protocol-layer product line, despite negative currency impacts from the British pound and the euro.

In fiscal 2017, our physical-layer product line reported significant year-over-year increase in bookings in the Americas as we 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, as mentioned earlier, 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 a nominal amount in 2016. Otherwise, bookings for our physical-layer product line were flat in the EMEA and APAC year-over-year. The EMEA was to some extent negatively impacted by the decrease in the average value of the British pound and the euro compared to the US dollar year-over-year. In APAC, bookings were negatively impacted by the decrease in bookings in China, mainly due to delayed investments from NEMs, offset by traction gained in the rest of APAC.

Our protocol-layer product lines reported decrease in total bookings in fiscal 2017 compared to 2016. Most of the decrease comes from the Americas, despite the positive impact our newly acquired Absolute and Ontology businesses, as our transport and datacom product line (a subgroup within our protocol-layer product line) did not reach the same level of orders from the 100G investment cycle, especially in the United States compared to 2016. In addition, in 2016, we received a large order from a North American Tier 1 network operator for our EXFO Xtract solution, and we did not close such large order in 2017. Otherwise, we made progress in bookings in the EMEA thanks to the recent acquisition of Ontology. In addition, in fiscal 2017, bookings in APAC slightly increased year-over-year. Finally, the streamlining or our passive monitoring product line in fiscal 2017 negatively impacted the bookings of our protocol-layer product line compared to 2016.

Fiscal 2016 vs. 2015

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

Sales

In fiscal 2016, despite year-over-year sales increase, we suffered from a headwind from a stronger US dollar compared to 2015. Given that we generate a portion of our revenue in Canadian dollars (Americas) and in euros (EMEA) but report our results in US dollars, it had a negative impact on our total sales and bookings year-over-year, as the US dollar increased against these currencies. In fact, in fiscal 2016, our total sales would have increased by approximately 6% and our total bookings would have increased by approximately 9% year-over-year in constant currencies.

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

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

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

Bookings

In fiscal 2016, we delivered solid year-over-year increases in bookings for our two product lines, despite the negative currency impact. The year-over-year increase in bookings was manifested through heightened penetration of mobile network operators for their fronthaul and backhaul networks, increased traction with fixed network operators for their 100G long-haul and metro links, and growing business with web-scale operators for their data center interconnects. In addition, in fiscal 2016, we received orders in the Americas for our EXFO Xtract solution, which resulted in increased bookings for our protocol-layer product line year-over-year.

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

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

Sales by geographic region

The following table summarizes sales by geographic region:

	Years ended August 31,		
	2017	**2016**	**2015**
Americas	55 %	55 %	54 %
EMEA	26	25	26
APAC	19	20	20
	100 %	100 %	100 %

GROSS MARGIN BEFORE DEPRECIATION AND AMORTIZATION
(non-IFRS measure – refer to page 24 of this document)

Gross margin before depreciation and amortization (gross margin) amounted to 61.2%, 62.6% and 61.7% of sales in fiscal 2017, 2016 and 2015 respectively.

Fiscal 2017 vs. 2016

In fiscal 2017, gross margin included $1.7 million or 0.7% of sales in restructuring charges for severance expenses and inventory writeoffs. Excluding those charges, gross margin would have amounted to 61.9% of sales in fiscal 2017, slightly lower (0.7%) compared to 2016.

In fiscal 2017, our gross margin (excluding the impact of our restructuring charges) was unfavorably affected by product mix within both product lines compared to 2016. In particular, in fiscal 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 year as this product delivers strong margins. We did not have such high-margin deals this year. In addition, in 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 fiscal 2017, we recorded in our sales lower foreign exchange losses on our forward exchange contracts, compared to 2016, which contributed to increase our gross margin by 0.3% year-over-year.

In addition, in fiscal 2017, we recorded lower inventory writeoffs compared to 2016, which contributed to increase our gross margin by an additional 0.2% year-over-year.

Fiscal 2016 vs. 2015

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

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

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

Finally, in fiscal 2016, a stronger US dollar compared to other currencies reduced our manufacturing costs and had a positive impact on our gross margin year-over-year.

SELLING AND ADMINISTRATIVE EXPENSES

Selling and administrative expenses amounted to $86.3 million, $82.2 million and $82.2 million for fiscal 2017, 2016 and 2015 respectively. As a percentage of sales, selling and administrative expenses amounted to 35.5%, 35.3% and 37.0% for fiscal 2017, 2016 and 2015 respectively.

Fiscal 2017 vs. 2016

In fiscal 2017, our selling and administrative expenses increased $4.1 million year-over-year due to restructuring charges of $1.2 million, additional expenses following the acquisitions of Absolute and Ontology and to support the growth of our business, inflation, salary increases, as well as one-time acquisition-related costs of $1.1 million following the recent business acquisitions.

Excluding restructuring charges and acquisition-related costs for business combinations, which represent 0.9% of sales, our selling and administrative expenses would have represented 34.6% of sales, lower compared to 35.3% of sales in 2016.

Fiscal 2016 vs. 2015

In fiscal 2016, our selling and administrative expenses were positively affected by the significant increase in the average value of the US dollar compared to the Canadian dollar and the euro year-over-year, as a portion of our selling and administrative expenses are incurred in Canadian dollars and euros and we report our results in US dollars, as well as by the positive impact of our 2015 restructuring plan. In addition, our 2015 restructuring plan resulted in severance expenses of $0.6 million (or 0.3% of sales) recorded in the fourth quarter of 2015 (nil in 2016); these elements offset inflation, salary increases and increased commission expenses on increased sales.

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

RESEARCH AND DEVELOPMENT EXPENSES

Gross research and development expenses

Gross research and development expenses totaled $53.1 million, $47.9 million and $50.1 million for fiscal 2017, 2016 and 2015 respectively. As a percentage of sales, gross research and development expenses amounted to 21.8%, 20.6% and 22.6% for fiscal 2017, 2016 and 2015 respectively, while net research and development expenses accounted for 19.4%, 18.4% and 19.8% of sales for these respective years.

Fiscal 2017 vs. 2016

In fiscal 2017, our gross research and development expenses increased $5.2 million year-over-year due to restructuring charges of $2.2 million, additional expenses 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 2016.

Excluding restructuring charges, which represent 0.9% of sales, our gross research and development expenses would have represented 20.9% of sales, almost flat compared to 20.6% of sales in 2016.

Fiscal 2016 vs. 2015

In fiscal 2016, the year-over-year significant increase in the average value of the US dollar compared to the Canadian dollar and the euro had a positive impact on our gross research and development expenses as a large portion of these expenses are incurred in Canadian dollars and euros and we report our results in US dollars. In addition, the 2015 restructuring plan positively affected our gross research and development expenses in 2016. Finally, our 2015 restructuring plan resulted in severance expenses of $0.8 million (or 0.3% of sales) in 2015 versus nil in 2016. However, these positive effects year-over-year were offset in part by inflation, salary increases, as well as a shift in the mix and timing of research and development projects, compared to 2015.

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

Tax Credits and Grants

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

Tax credits and grants for research and development activities were $6.0 million, $5.2 million and $6.1 million for fiscal 2017, 2016 and 2015 respectively. As a percentage of gross research and development expenses, tax credits and grants reached 11.2%, 10.8% and 12.3% for fiscal 2017, 2016 and 2015 respectively.

Fiscal 2017 vs. 2016

The increase in our tax credits and grants in fiscal 2017, compared to 2016, mainly results from the increase in our gross research and development expenses year-over-year.

In fiscal 2017, the increase in tax credits and grants as a percentage of gross research and development expenses, compared to 2016, mainly comes from the shift in mix of eligible projects.

Fiscal 2016 vs. 2015

The decrease in our tax credits and grants in fiscal 2016, compared to 2015, results from the decrease in our gross research and development expenses, the shift in mix of eligible projects, namely in Finland, as well as from the increase in the average value of the US dollar compared to the Canadian dollar year-over-year, as our tax credits are denominated in Canadian dollars and we report our results in US dollars.

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

DEPRECIATION OF PROPERTY, PLANT AND EQUIPMENT

Depreciation of property, plant and equipment totaled $3.9 million, $3.8 million and $4.8 million for fiscal 2017, 2016 and 2015 respectively.

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

AMORTIZATION OF INTANGIBLE ASSETS

In conjunction with the business combinations we completed, we recorded intangible assets primarily consisting of core technology and customer relationships. In addition, intangible assets include software. These intangible assets resulted in amortization expenses of $3.3 million, $1.2 million and $2.9 million for fiscal 2017, 2016 and 2015 respectively.

Fiscal 2017 vs. 2016

The increase in our amortization expense in fiscal 2017, compared to 2016, was due to the acquisitions of Absolute (October 31, 2016) and Ontology (March 2, 2017).

Fiscal 2016 vs. 2015

The decrease in our amortization expense in fiscal 2016, compared to 2015, is mainly due to the fact that core technology related to the acquisition of NetHawk Oyj (acquired in fiscal 2010) became fully amortized in the third quarter of fiscal 2015, and that the average value of the US dollar increased compared to the Canadian dollar year-over-year, as our amortization expense is incurred in this currency and we report our results in US dollars.

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.

We reported a foreign exchange loss of $1.0 million in fiscal 2017 compared to gain of $0.2 million in 2016 and $7.2 million in 2015.

Fiscal 2017

In fiscal 2017, the period-end value of the Canadian dollar increased versus the US dollar compared to the previous year-end, which resulted in a foreign exchange loss of $1.0 million during the year. The period-end value of the Canadian dollar increased 4.6% versus the US dollar to CA$1.2536 = US$1.00 in fiscal 2017 compared to CA$1.3116 = US$1.00 at the end of the previous year. In fiscal 2017, the average value of the Canadian dollar versus the US dollar was CA$1.3212 = US$1.00.

Fiscal 2016

In fiscal 2016, we witnessed some volatility in the value of the Canadian dollar as it fluctuated compared to the US dollar, which overall resulted in a foreign exchange gain of $0.2 million during that period. The period-end value of the Canadian dollar slightly increased 0.3% versus the US dollar to CA$1.3116 = US$1.00 in fiscal 2016 compared to CA$1.3157 = US$1.00 at the end of the previous year. In fiscal 2016, the average value of the Canadian dollar versus the US dollar was CA$1.3278 = US$1.00.

Fiscal 2015

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

Foreign exchange rate fluctuations also flow through the P&L line items as a portion of our sales are dominated in Canadian dollars and euros and a significant portion of our cost of sales and operating items are denominated in Canadian dollars, euros, Indian rupees and British pounds and we report our results in US dollars. In fiscal 2016, the increase in the average value of the US dollar compared to the Canadian dollar, the euro and the Indian rupee year-over-year, resulted in a positive impact on our financial results. The average value of the US dollar increased 8.9%, 4.6% and 6.3% respectively year-over-year, compared to the Canadian dollar, the euro and the Indian rupee. In fiscal 2017, overall, there were no significant changes in the average value of our main currencies compared to the US dollar, which had no significant impact on our financial results during the year compared to 2016.

INCOME TAXES

In fiscal 2017, we reported income tax expenses of $6.6 million on earnings before income taxes of $7.5 million, compared to income tax expenses of $7.8 million on earnings before income taxes of $16.7 million in 2016 and income tax expenses of $5.0 million on earnings before income taxes of $9.9 million in 2015.

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, a significant portion of our restructuring charges recorded in fiscal 2017 related to these subsidiaries, and acquisition-related costs for business combinations are non-deductible for tax purposes. In addition, we had some other non-deductible losses and expenses, such as stock-based compensation costs. However, a significant portion of our foreign exchange gain or loss was a result of the translation of financial statements of our foreign subsidiaries from their local currency to the functional currency, and was therefore non-taxable or deductible. Otherwise, our effective tax rate would have been closer to the combined Canadian and provincial statutory tax rate of 27% for these years.

Please refer to note 19 to our consolidated financial statements for a full reconciliation of our income tax provision.

LIQUIDITY AND CAPITAL RESOURCES

Cash Requirements and Capital Resources

As at August 31, 2017, cash and short-term investments totaled $39.2 million, while our working capital was at $74.4 million. Our cash and short-term investments decreased $8.1 million in fiscal 2017, compared to 2016. In fiscal 2017, we made cash payments of $12.8 million for the acquisitions of Absolute and Ontology, $7.2 million for the purchase of capital assets and $1.5 million for the repayment of the long-term debt assumed as part of the Ontology acquisition. Otherwise, in fiscal 2017, we generated $12.9 million in cash flows from operating activities and we recorded an unrealized foreign exchange gain on our cash and short-term investments of $0.5 million. This unrealized foreign exchange gain 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 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, and for potential acquisitions. As at August 31, 2017, cash balances included an amount of $6.7 million that bears interest at an annual rate of 1.2%.

We believe that our cash balances and short-term investments of $39.2 million will be sufficient to meet our liquidity and capital requirements for the foreseeable future, including the payment of $10.3 million for the 33.1% investment in Astellia, the payment of $9.7 million for the acquisition of Yenista, and any potential payment for the cash contingent consideration related to the acquisition of Ontology. In addition, on October 25, 2017, to finance the potential acquisition of the remaining share of Astellia under the public tender offer, we modified certain credit facilities whereby existing lines of credits, that provided advances up to CA$4.8 million (US$3.8 million) and up to US$6.0 million for operating purposes, were cancelled and replaced by a credit facility of CA$28.9 million (US$23.1 million). Finally, we have unused available lines of credit totaling $6.2 million for working capital and other general corporate purposes, and unused lines of credit of $25.7 million for foreign currency exposure related to forward exchange contracts.

However, possible operating losses, restructuring charges and/or possible investments in or acquisitions of complementary businesses, products or technologies may require additional financing. There can be no assurance that additional debt or equity financing will be available when required or, if available, that it can be secured on satisfactory terms.

As at August 31, 2017, our commitments under operating leases and license agreements amount to $3.5 million in 2018, $2.2 million in 2019, $2.1 million in 2020, $2.0 million in 2021 and $3.0 million in 2022 and after, for total commitments of $12.8 million.

Sources and Uses of Cash

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

Operating activities

Cash flows provided by operating activities were $12.9 million in fiscal 2017, compared to $24.4 million in 2016 and $6.5 million in 2015.

Fiscal 2017 vs. 2016

Cash flows provided by operating activities in fiscal 2017 were attributable to the net earnings after items not affecting cash of $13.0 million, slightly offset by the negative net change in non-cash operating items of $0.1 million; this was mainly due to the positive effect on cash of the decrease of $4.0 million in our accounts receivable due to the timing of receipts and sales during the year and by the positive effect on cash of the decrease of $0.9 million in our inventories due to improved inventory turns during the year; these positive effects on cash were more than offset by the negative effect on cash of the $2.4 million increase in our income tax and tax credits recoverable due to tax credits earned during the year not yet recovered, the negative effect on cash of the increase of $0.9 million in our prepaid expenses due to timing of payments during the year, and by the negative effect on cash of the decrease of $1.7 million in our accounts payable, accrued liabilities and provisions due to timing of purchases and payments during the year.

Fiscal 2016 vs. 2015

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

Investing activities

Cash flows used by investing activities amounted to $16.5 million in fiscal 2017, compared to $7.0 million in 2016 and $2.3 million in 2015.

Fiscal 2017

In fiscal 2017, we made cash payments of $12.8 million and $7.2 million respectively for the acquisitions of Absolute and Ontology and the purchase of capital assets. Otherwise, we disposed (net of acquisitions) of $3.5 million worth of short-term investments.

Fiscal 2016

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

Fiscal 2015

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

Financing activities

Cash flows used by financing activities amounted to $1.5 million in fiscal 2017, compared to $1.6 million in 2016 and $25.5 million in 2015.

Fiscal 2017

In fiscal 2017, we repaid the long-term debt of $1.5 million assumed as part of the acquisition of Ontology.

Fiscal 2016

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

Fiscal 2015

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

FORWARD EXCHANGE CONTRACTS

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

As at August 31, 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
September 2017 to August 2018	$ 18,300,000	1.3407
September 2018 to August 2019	10,900,000	1.3426
Total	$ 29,200,000	1.3414

US dollars – Indian rupees

Expiry dates	Contractual amounts	Weighted average contractual forward rates
September 2017 to August 2018	$ 3,400,000	69.49
September 2018 to February 2019	1,600,000	67.26
Total	$ 5,000,000	68.78

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 $0.1 million and net gains of $2.3 million as at August 31, 2016 and 2017 respectively. The US dollar – Canadian dollar year-end exchange rate was CA$1.2536 = US$1.00 as at August 31, 2017.

SHARE CAPITAL

As at November 13, 2017, EXFO had 31,643,000 multiple voting shares outstanding, entitling to 10 votes each and 23,224,396 subordinate voting shares outstanding. The multiple voting shares and the subordinate voting shares are unlimited as to number and without par value.

OFF-BALANCE SHEET ARRANGEMENTS

As at August 31, 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 expire at various dates through fiscal 2020.

STRUCTURED ENTITIES

As at August 31, 2017, we did not have interests in any structured entities.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

Critical Judgments in Applying Accounting Policies

(a) Determination of functional currency

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

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

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

Critical Estimates and Assumptions

(a) Inventories

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

(b) Income taxes

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

As at August 31, 2017, we had deferred income tax assets in the consolidated balance sheet in the amount of $3.2 million for operating losses in the United States. To recover these deferred income tax assets, we need to generate approximately $9.5 million in pre-tax earnings in the United States, and to do so over the estimated recovery period of three years, we must generate pre-tax earnings compound annual growth rate (CAGR) of 2%, which we believe is probable. Our losses in the United States can be carried forward over a 20-year period.

(c) Tax credits recoverable

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

As at August 31, 2017, our non-refundable research and development tax credits recognized in the consolidated balance sheet amounted to $40.5 million. To recover these non-refundable research and development tax credits, we need to generate approximately $262 million (CA$328 million) in pre-tax earnings at the Canadian federal level and approximately $12 million at the Canadian provincial level. To generate $262 million in pre-tax earnings at the Canadian federal level over the estimated recovery period of 15 years, we must generate a pre-tax earnings CAGR of 2%, which we believe is probable. Our non-refundable research and development tax credits can be carried forward over a 20-year period.

(d) Impairment of non-financial assets

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

In the fourth quarter of fiscal 2017, we performed our annual goodwill impairment test for all CGUs.

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

EXFO CGU	$ 13,772,000
Brix CGU	13,878,000
Ontology CGU	7,427,000
Total	$ 35,077,000

In performing the goodwill impairment review of our CGUs, we determined the recoverable amount of goodwill based on fair value less costs of disposal. In estimating the recoverable amount of our CGUs, we used a market approach, which is based on sales multiples within the range of 0.6 to 2.9 times sales, for comparable businesses with similar operations within the same industry over the past year. We applied judgment in making certain adjustments for factors such as size, risk profile or profitability of the comparable businesses, when compared to our CGUs.

Furthermore, as the sales and operations of the EXFO CGU constitutes the significant majority of our sales and operations, we also compared the carrying amount of the EXFO CGU to our overall market capitalization, after adjustment for a control premium and the adjustment to deduct the recoverable amount of the Brix and Ontology CGUs. Based on this calculation, we calculated a recoverable amount which resulted in an implied sales multiple that was within the 0.6 to 2.9 times range, as used in our market approach described above.

As at August 31, 2017, the recoverable amount for all CGUs exceeded their carrying value. The recoverable amount of EXFO CGU, Brix CGU and Ontology CGU would equal their carrying value using sales multiples of 0.7, 0.6 and 2.2 times sales respectively.

(e) Purchase price allocation in business combinations

The fair value of the total consideration transferred in business combinations (purchase price) must be allocated based on the estimated fair value of acquired net assets at the date of acquisition. Allocating the purchase price requires management to make estimates and judgments to determine assets acquired and liabilities assumed, useful lives of certain long-lived assets and the respective fair value of assets acquired and liabilities assumed; this may require the use of unobservable inputs, including management's expectations of future revenue growth, operating costs and profit margins as well as discount rates.

i) Growth rates

The assumptions used are based on acquired companies' historical growth, expectations of future revenue growth, expected synergies as well as industry and market trends.

ii) Discount rate

The company uses a discount rate to calculate the present value of estimated future cash flows, which represents its weighted average cost of capital (WACC).

NEW IFRS PRONOUNCEMENTS NOT YET ADOPTED

Financial Instruments

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

Revenue from Contracts with Customers

IFRS 15, "*Revenue from Contracts with Customers*", was issued in May 2014. The objective of this new standard is to provide a single, comprehensive revenue recognition model for all contracts with customers to improve comparability. This new standard contains principles that an entity will apply to determine the measurement of revenue and timing of when it is recognized. The underlying principle is that an entity will recognize revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. This new standard is effective for annual periods beginning on or after January 1, 2018. Early adoption is permitted. We have performed an assessment to identify significant areas of impact, if any, between our current accounting treatment under IAS 18, "*Revenue*" and the new requirements of IFRS 15. Based on the assessments to date, we anticipate that the main areas of impact will relate to the allocation of the transaction price to the various performance obligations under the contracts, the timing of revenue recognition for sales arrangement that contain customer acceptance clauses, and the sale of licenses that provide customers with the "right to use" our intellectual property. We will adopt this new standard on September 1, 2018 using the modified retrospective method, with the cumulative effect of the initial application of the standard recognized as an adjustment to the opening balance of retained earnings as at the date of initial application. We will apply this standard retrospectively only to contracts that are not completed at the date of initial application.

Leases

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

Foreign Currency Transactions and Advance Consideration

IFRIC 22, "*Foreign Currency Transactions and Advance Consideration*", was issued in December 2016. IFRIC 22 addresses how to determine the date of the transaction for the purpose of determining the exchange rate to use on initial recognition of the related asset, expense or income (or part of it) and on the derecognition of a non-monetary asset or non-monetary liability arising from the payment or receipt of advance consideration in a foreign currency. IFRIC 22 is effective for annual periods beginning on or after January 1, 2018. Early adoption is permitted. We will adopt this interpretation on September 1, 2018 and are currently assessing the impact that it will have on our consolidated financial statements.

Uncertainty over Income Tax Treatments

IFRIC 23, "*Uncertainty over Income Tax Treatments*", was issued in June 2017. IFRIC 23 provides guidance on how to value uncertain income tax positions based on the probability of whether the relevant tax authorities will accept the company's tax treatments. A company is to assume that a taxation authority with the right to examine any amounts reported to it will examine those amounts and will have full knowledge of all relevant information when doing so. IFRIC 23 is effective for annual periods beginning on or after January 1, 2019. We will adopt this interpretation on September 1, 2019 and are currently assessing the impact that it will have on our consolidated financial statements.

CONTROLS

As described in Form 20-F/A filed on January 9, 2017, we concluded that EXFO's internal control over financial reporting was not effective as at 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 a failure to maintain appropriate segregation of duties and a lack of supervisory review and monitoring of journal entries recorded to the trade accounts receivable ledger. See item 15(b) of 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. As at August 31, 2017, we concluded, through testing, that these controls were operating effectively and that the material weakness was considered remediated as of that date.

RISKS AND UNCERTAINTIES

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

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

While strategic acquisitions, like those we made in fiscal 2017, those completed or announced in fiscal 2018, and possibly others in the future, are essential to our long-term growth, they also expose us to certain risks and uncertainties related to the rapid and effective integration of these businesses, their products, technologies and personnel as well as key personnel retention. Finally, integration of new acquisitions will require the dedication of management resources, which may detract management's attention from our day-to-day business and operations.

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

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

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

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

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

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

NON-IFRS MEASURES

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

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

Constant currency data represents data before foreign currency impact. Data for the current period is translated using foreign exchange rates of the corresponding period from the preceding year.

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

Adjusted EBITDA represents net earnings before interest, income taxes, depreciation and amortization, stock-based compensation costs, restructuring charges, change in fair value of cash contingent consideration, unusual charge, and foreign exchange gain or loss.

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

Adjusted EBITDA

	Years ended August 31,		
	2017	**2016**	**2015**
IFRS net earnings for the year	$ 851	$ 8,900	$ 4,857
Add (deduct):			
Depreciation of property, plant and equipment	3,902	3,814	4,835
Amortization of intangible assets	3,289	1,172	2,883
Interest and other (income) expense	303	(828)	(155)
Income taxes	6,608	7,764	5,036
Stock-based compensation costs	1,414	1,378	1,295
Restructuring charges	5,079	–	1,637
Change in fair value of cash contingent consideration	(383)	–	–
Unusual charge	–	–	603
Foreign exchange (gain) loss	978	(161)	(7,212)
Adjusted EBITDA for the year	$ 22,041	$ 22,039	$ 13,779
Adjusted EBITDA in percentage of total sales	9.1%	9.5%	6.2%

QUARTERLY SUMMARY FINANCIAL INFORMATION (1)
(tabular amounts in thousands of US dollars, except per share data)

	1st quarter	2nd quarter	3rd quarter	4th quarter	Year ended August 31,
2017					
Sales	$ 61,785	$ 60,030	$ 58,505	$ 62,981	$ 243,301
Cost of sales (2)	$ 22,813	$ 22,989	$ 24,555	$ 23,972	$ 94,329
Net earnings (loss)	$ 3,303	$ 1,008	$ (4,304)	$ 844	$ 851
Basic and diluted net earnings (loss) per share	$ 0.06	$ 0.02	$ (0.08)	$ 0.02	$ 0.02

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

(1) Quarterly financial information has been derived from our unaudited condensed interim consolidated financial statements, which are prepared in accordance with the IFRS, as issued by the IASB, applicable to the preparation of interim financial statements, including IAS 34, "*Interim Financial Reporting*". The presentation currency is the US dollar, which differs from the functional currency of the company (Canadian dollar).
(2) The cost of sales is exclusive of depreciation and amortization.
(3) Per share data is calculated independently for each quarter presented. Therefore, the sum of this quarterly information does not equal the corresponding annual information.

Quarterly Sales Analysis

Overall in fiscal 2017, our sales increased 4.6% to $243.3 million compared to $232.6 million in 2016. Refer to section ''Sales and bookings'' elsewhere in this document for explanations about the year-over-year annual increase in sales. On a quarterly basis, our sales fluctuate from quarter to quarter due to timing and magnitude of orders.

Fourth-Quarter Results

Gross margin

In the fourth quarter of fiscal 2017, our gross margin reached 61.9%, slightly higher compared to 61.6% for the same period last year.

First, we recorded lower inventory writeoffs in the fourth quarter of fiscal 2017 compared to the same period last year, which increased our gross margin by 1.3% year-over-year.

Also, in the fourth quarter of fiscal 2017, we reported lower foreign exchange losses on our forward exchange contracts, which had a positive impact of 0.2% on our gross margin year-over-year.

However, in the fourth quarter 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. In addition, in the fourth quarter of fiscal 2017, our gross margin was unfavorably affected by product mix within our physical-layer product line compared to the same period last year, which further reduced our gross margin year-over-year.

Finally, in the fourth quarter of fiscal 2017, we recorded $0.1 million in restructuring charges in the cost of sales (nil in 2016), which negatively affected our gross margin for that quarter (0.2%).

Net earnings

Net earnings amounted to $0.8 million, or $0.02 per diluted share, in the fourth quarter of fiscal 2017 compared to $2.3 million, or $0.04 per diluted share, for the same period last year.

First, in the fourth quarter of fiscal 2017, we recorded restructuring charges of $1.3 million compared to nil in 2016.

In addition, in the fourth quarter of fiscal 2017, we incurred a foreign exchange loss of $2.9 million compared to $0.3 million in the same period last year due to the fluctuation of the period-end foreign exchange rates.

Otherwise, in the fourth quarter of fiscal 2017, excluding restructuring charges, our operating expenses (selling, administrative, net research and development, depreciation and amortization expenses) were $1.0 million lower compared to the same period last year, despite general inflation and salary increases and the impact of our recent acquisitions. The decrease in our operating expenses year-over-year mainly comes from the effect or our recent restructuring plan. This was offset in part by higher amortization expense following the recent acquisitions.

In addition, in the fourth quarter of fiscal 2017, we recorded a positive change in the fair value of the cash contingent consideration payable for the acquisition of Ontology in the amount of $0.4 million.

Finally, in the fourth quarter of fiscal 2017, we recorded an income tax expense of $1.1 million compared to $2.2 million for the same period last year, which increased our net earnings year-over-year.