EXFO INC.
Form 6-K
January 12, 2017

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 6-K

Report of Foreign Private Issuer Pursuant to Rule 13a-16 or 15d-16
Under the Securities Exchange Act of 1934

For the month of January 2017

EXFO Inc.
(Translation of registrant's name into English)

400 Godin Avenue, Quebec, Quebec, Canada G1M 2K2
(Address of principal executive offices)

Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F.

Form 20-F Form 40-F

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes No

If "Yes" is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82-______.

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On January 10, 2017, EXFO Inc., a Canadian corporation, reported its results of operations for the first fiscal quarter ended November 30, 2016. This report on Form 6-K sets forth the news release relating to EXFO's announcement and certain information relating to EXFO's financial condition and results of operations for the first fiscal quarter of the 2017 fiscal year. This press release and information relating to EXFO's financial condition and results of operations for the first fiscal quarter of the 2017 fiscal year are hereby incorporated as a document by reference to Form F-3 (Registration Statement under the Securities Act of 1933) declared effective as of July 30, 2001 and to Form F 3 (Registration Statement under the Securities Act of 1933) declared effective as of March 11, 2002 and to amend certain material information as set forth in these two Form F-3 documents.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

EXFO INC.

| | |
|---|---|
| By: | /s/ Germain Lamonde |
| Name: | Germain Lamonde |
| Title: | President and Chief Executive Officer |

Date: January 12, 2017

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EXFO Reports First-Quarter Results for Fiscal 2017

§ Sales increase 11.9% year-over-year to US$61.8 million
§ Bookings rise 12.6% year-over-year to US$65.9 million (book-to-bill ratio of 1.07)
§ Gross margin reaches 63.1% of sales
§ Adjusted EBITDA improves 19.6% year-over-year to US$6.3 million (10.2% of sales)

QUEBEC CITY, CANADA, January 10, 2017 — EXFO Inc. (NASDAQ: EXFO; TSX: EXF) reported today financial results for the first quarter ended November 30, 2016.

Sales reached US$61.8 million in the first quarter of fiscal 2017 compared to US$55.2 million in the first quarter of 2016 and US$62.9 million in the fourth quarter of 2016.

Bookings attained US$65.9 million in the first quarter of fiscal 2017 compared to US$58.5 million in the same period last year and US$62.4 million in the fourth quarter of 2016. The company's book-to-bill ratio was 1.07 in the first quarter of 2017.

Gross margin before depreciation and amortization* amounted to 63.1% of sales in the first quarter of fiscal 2017 compared to 63.5% in the first quarter of 2016 and 61.6% in the fourth quarter of 2016.

IFRS net earnings in the first quarter of fiscal 2017 totaled US$3.3 million, or US$0.06 per diluted share, compared US$1.8 million, or US$0.03 per diluted share, in the same period last year and US$2.3 million, or US$0.04 per diluted share, in the fourth quarter of 2016. IFRS net earnings in the first quarter of 2017 included US$0.4 million in after-tax amortization of intangible assets, US$0.3 million in stock-based compensation costs and a foreign exchange gain of US$0.5 million.

Adjusted EBITDA* totaled US$6.3 million, or 10.2% of sales, in the first quarter of fiscal 2017 compared to US$5.3 million, or 9.6% of sales, in the first quarter of 2016 and US$6.2 million, or 9.8% of sales, in the fourth quarter of 2016.

EXFO closed the acquisition of Absolute Analysis' assets in late October for US$5.0 million in cash and US$3.5 million in stock. At the end of the first quarter of fiscal 2017, EXFO had a cash position of US$39.3 million and no debt.

"Fiscal 2017 has gotten off to a strong start with double-digit increases in sales, bookings and adjusted EBITDA in the first quarter, highlighting growing market traction of both of our product groups," said Germain Lamonde, EXFO's Chairman, President and CEO. "I am particularly pleased with robust results from our optical and high-speed transport businesses, where we are gaining market share and taking advantage of the 100G investment cycle in long-haul networks, Metro links and data centers. We also benefited from calendar year-end purchases by some communications service providers and early returns from our industry-only, all-in-one optical RF analyzer for mobile network operators. We remain fully confident about achieving our adjusted EBITDA goal of US$26 million in 2017."

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Selected Financial Information
(In thousands of US dollars)

| | Q1 2017 | Q4 2016 | Q1 2016 |
|---|---|---|---|
| Physical-layer sales | $42,016 | $39,777 | $37,477 |
| Protocol-layer sales | 20,009 | 23,445 | 18,629 |
| Foreign exchange losses on forward exchange contracts | (240) | (364) | (874) |
| Total sales | $61,785 | $62,858 | $55,232 |
| | | | |
| Physical-layer bookings | $44,090 | $39,826 | $38,878 |
| Protocol-layer bookings | 22,009 | 22,969 | 20,469 |
| Foreign exchange losses on forward exchange contracts | (240) | (364) | (874) |
| Total bookings | $65,859 | $62,431 | $58,473 |
| Book-to-bill ratio (bookings/sales) | 1.07 | 0.99 | 1.06 |
| Gross margin before depreciation and amortization* | $38,972 | $38,713 | $35,095 |
| | 63.1 % | 61.6 % | 63.5 % |
| | | | |
| Other selected information: | | | |
| IFRS net earnings | $3,303 | $2,252 | $1,766 |
| Amortization of intangible assets | $427 | $292 | $300 |
| Stock-based compensation costs | $258 | $302 | $376 |
| Net income tax effect of the above items | $(64) | $(31) | $(28) |
| Foreign exchange gain (loss) | $512 | $(293) | $310 |
| Adjusted EBITDA* | $6,321 | $6,172 | $5,286 |

Operating Expenses
Selling and administrative expenses totaled US$21.6 million, or 35.0% of sales in the first quarter of fiscal 2017 compared to US$20.3 million, or 36.7% of sales, in the same period last year and US$21.6 million, or 34.3% of sales, in the fourth quarter of 2016.
Net R&D expenses totaled US$11.3 million, or 18.3% of sales, in the first quarter of fiscal 2017 compared to US$9.9 million, or 18.0% of sales, in the first quarter of 2016 and US$11.3 million, or 18.0% of sales, in the fourth quarter of 2016.
First-Quarter Highlights

- Sales and bookings. Sales and bookings increased 11.9% and 12.6% year-over-year, respectively, mainly due to strong market demand in EXFO's three major selling regions and for optical and high-speed solutions. The company also benefited from a large wireless deal in Asia-Pacific in the first quarter. From a segmented revenue standpoint, 56% of sales originated from the Americas, 23% from EMEA and 21% from Asia-Pacific, while Physical-layer sales represented 68% of total sales and Protocol-layer sales 32%. EXFO's top customer accounted for 13.8% of sales, while the top three represented 23.3%. This represents an unusually high concentration level for EXFO, but reflects greater success with Tier-1 operators.

- Profitability. EXFO generated adjusted EBITDA of US$6.3 million, or 10.2% of sales, in the first quarter of 2017 compared to US$5.3 million, or 9.6% of sales, in the first quarter of 2016.

- Innovation. EXFO acquired substantially all the assets of Absolute Analysis in the first quarter to combine radio frequency (RF) test software with its own optical and Ethernet technologies. EXFO also introduced three other new solutions including a power meter, variable attenuator and optical switch modules for its LTB-8 platform dedicated to the high-speed optical lab market, a segment of increased focus. Finally, EXFO supplied OpenReach, British Telecom's local network business, with an initial order of MaxTesters to support its G.fast pilot project.

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Business Outlook

EXFO forecasts sales between US$58.0 million and US$63.0 million for the second quarter of fiscal 2017, while IFRS net results are expected to range between a loss of US$0.01 per share and earnings of US$0.03 per share. IFRS net results include US$0.01 per share in after-tax amortization of intangible assets and stock-based compensation costs as well as an anticipated foreign exchange loss of US$800,000 based on today's exchange rates.

This guidance was established by management based on existing backlog as of the date of this press release, seasonality, expected bookings for the remaining of the quarter, as well as exchange rates as of the day of this press release.

Conference Call and Webcast

EXFO will host a conference call today at 5 p.m. (Eastern time) to review first-quarter results for fiscal 2017. To listen to the conference call and participate in the question period via telephone, dial 1-704-288-0432. Please take note the following conference ID number will be required: 30629172. Germain Lamonde, Chairman, President and CEO, and Pierre Plamondon, CPA, Vice-President of Finance and Chief Financial Officer, will participate in the call. An audio replay of the conference call will be available two hours after the event until 11:59 p.m. on January 17, 2017. The replay number is 1-855-859-2056 and the conference ID number is 30629172. The audio Webcast and replay of the conference call will also be available on EXFO's Website at www.EXFO.com, under the Investors section.

About EXFO

EXFO provides communications service providers (CSPs) with test automation and 3D analytics solutions to ensure the smooth deployment, maintenance and management of next-generation, physical, virtual, fixed and mobile networks. The company has also forged strong relationships with network equipment manufacturers (NEMs) to develop deep expertise that migrates from the lab to the field and beyond. EXFO's key differentiation comes from combining intelligent, automated and cloud-based test and monitoring solutions with real-time analytics to deliver unmatched end-to-end visibility and assurance—from a network, services and end-user level. EXFO is no. 1 in portable optical testing and boasts the largest active service assurance deployment worldwide. For more information, visit www.EXFO.com and follow us on the EXFO Blog.

Forward-Looking Statements

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

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*NON-IFRS MEASURES
EXFO provides non-IFRS measures (gross margin before depreciation and amortization and adjusted EBITDA) as supplemental information regarding its operational performance. The company uses these measures for the purpose of evaluating historical and prospective financial performance, as well as its performance relative to competitors. These measures also help the company to plan and forecast for future periods as well as to make operational and strategic decisions. EXFO believes that providing this information, in addition to IFRS measures, allows investors to see the company's results through the eyes of management, and to better understand its historical and future financial performance.
The presentation of this additional information is not prepared in accordance with IFRS. Therefore, the information may not necessarily be comparable to that of other companies and should be considered as a supplement to, not a substitute for, the corresponding measures calculated in accordance with IFRS.
Gross margin before depreciation and amortization represents sales less cost of sales, excluding depreciation and amortization.
Adjusted EBITDA represents net earnings before interest, income taxes, depreciation and amortization, stock-based compensation costs and foreign exchange gain.
The following table summarizes the reconciliation of adjusted EBITDA to IFRS net earnings, in thousands of US dollars:
Adjusted EBITDA

| | Q1 2017 | Q4 2016 | Q1 2016 |
|---|---|---|---|
| IFRS net earnings for the period | $3,303 | $2,252 | $1,766 |
| Add (deduct): | | | |
| Depreciation of property, plant and equipment | 903 | 957 | 975 |
| Amortization of intangible assets | 427 | 292 | 300 |
| Interest (income) expense | (20) | (112) | 63 |
| Income taxes | 1,962 | 2,188 | 2,116 |
| Stock-based compensation costs | 258 | 302 | 376 |
| Foreign exchange gain | (512) | (293) | (310) |
| Adjusted EBITDA for the period | $6,321 | $6,172 | $5,286 |
| Adjusted EBITDA in percentage of sales | 10.2 % | 9.8 % | 9.6 % |

For more information
Vance Oliver
Director, Investor Relations
(418) 683-0913, Ext. 23733
vance.oliver@exfo.com

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EXFO Inc.
Condensed Unaudited Interim Consolidated Balance Sheets

(in thousands of US dollars)

| | As at November 30, 2016 | As at August 31, 2016 |
|---|---|---|
| Assets | | |
| Current assets | | |
| Cash | $ 35,061 | $ 43,208 |
| Short-term investments | 4,281 | 4,087 |
| Accounts receivable | | |
| Trade | 43,476 | 42,993 |
| Other | 3,321 | 2,474 |
| Income taxes and tax credits recoverable | 4,047 | 4,208 |
| Inventories | 33,880 | 33,004 |
| Prepaid expenses | 2,781 | 3,099 |
| | 126,847 | 133,073 |
| Tax credits recoverable | 33,800 | 34,594 |
| Property, plant and equipment | 35,530 | 35,978 |
| Intangible assets (note 3) | 10,855 | 3,391 |
| Goodwill | 21,418 | 21,928 |
| Deferred income tax assets | 7,901 | 8,240 |
| Other assets | 372 | 589 |
| | $ 236,723 | $ 237,793 |
| Liabilities | | |
| Current liabilities | | |
| Accounts payable and accrued liabilities | $ 34,779 | $ 37,174 |
| Provisions | 308 | 299 |
| Income taxes payable | 567 | 971 |
| Deferred revenue | 8,910 | 9,486 |
| | 44,564 | 47,930 |
| Deferred revenue | 5,681 | 5,530 |
| Deferred income tax liabilities | 2,546 | 2,857 |
| Other liabilities | 29 | 75 |
| | 52,820 | 56,392 |
| Shareholders' equity | | |
| Share capital (note 5) | 89,352 | 85,516 |
| Contributed surplus | 18,018 | 18,150 |

| | | |
|---|---|---|
| Retained earnings | 129,612 | 126,309 |
| Accumulated other comprehensive loss | (53,079 ) | (48,574 ) |
| | 183,903 | 181,401 |
| | $ 236,723 | $ 237,793 |

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

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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, 2016 | 2015 |
|---|---|---|
| Sales | $61,785 | $55,232 |
| Cost of sales [(1)] (note 6) | 22,813 | 20,137 |
| Selling and administrative (note 6) | 21,595 | 20,252 |
| Net research and development (note 6) | 11,314 | 9,933 |
| Depreciation of property, plant and equipment (note 6) | 903 | 975 |
| Amortization of intangible assets (note 6) | 427 | 300 |
| Interest (income) expense | (20) | 63 |
| Foreign exchange gain | (512) | (310) |
| Earnings before income taxes | 5,265 | 3,882 |
| Income taxes (note 7) | 1,962 | 2,116 |
| Net earnings for the period | $3,303 | $1,766 |
| Basic and diluted net earnings per share | $0.06 | $0.03 |
| Basic weighted average number of shares outstanding (000's) | 53,884 | 53,814 |
| Diluted weighted average number of shares outstanding (000's) (note 8) | 55,001 | 54,535 |

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

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

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EXFO Inc.
Condensed Unaudited Interim Consolidated Statements of Comprehensive Income (Loss)

(in thousands of US dollars)

| | Three months ended November 30, | |
|---|---|---|
| | 2016 | 2015 |
| Net earnings for the period | $3,303 | $1,766 |
| Other comprehensive income (loss), net of income taxes | | |
| Items that will not be reclassified subsequently to net earnings | | |
| Foreign currency translation adjustment | (4,217) | (2,509) |
| Items that may be reclassified subsequently to net earnings | | |
| Unrealized gains/losses on forward exchange contracts | (561) | (270) |
| Reclassification of realized gains/losses on forward exchange contracts in net earnings | 181 | 878 |
| Deferred income tax effect of gains/losses on forward exchange contracts | 92 | (148) |
| Other comprehensive loss | (4,505) | (2,049) |
| Comprehensive loss for the period | $(1,202) | $(283) |

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

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EXFO Inc.
Condensed Unaudited Interim Consolidated Statements of Changes in Shareholders' Equity

(in thousands of US dollars)

| | 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 | $117,409 | $ (52,005) | $ 169,227 |
| 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 | $86,767 | $ 17,396 | $119,175 | $ (54,054) | $ 169,284 |

| | Three months ended November 30, 2016 | | | | |
|---|---|---|---|---|---|
| | Share capital | Contributed surplus | Retained earnings | Accumulated other comprehensive loss | Total shareholders' equity |
| Balance as at September 1, 2016 | $85,516 | $ 18,150 | $126,309 | $ (48,574) | $ 181,401 |
| Issuance of share capital (notes 3 and 5) | 3,490 | – | – | – | 3,490 |
| Reclassification of stock-based compensation costs (note 5) | 346 | (346) | – | – | – |
| Stock-based compensation costs | – | 214 | – | – | 214 |
| Net earnings for the period | – | – | 3,303 | – | 3,303 |
| Other comprehensive loss | | | | | |
| Foreign currency translation adjustment | – | – | – | (4,217) | (4,217) |
| Changes in unrealized gains/losses on forward exchange contracts, net of deferred income taxes of $92 | – | – | – | (288) | (288) |
| Total comprehensive loss for the period | | | | | (1,202) |

| | | | | | |
|---|---|---|---|---|---|
| Balance as at November 30, 2016 | $89,352 | $ 18,018 | $129,612 | $ (53,079 ) | $ 183,903 |

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

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EXFO Inc.
Condensed Unaudited Interim Consolidated Statements of Cash Flows

(in thousands of US dollars)

| | Three months ended November 30, 2016 | 2015 |
|---|---|---|
| Cash flows from operating activities | | |
| Net earnings for the period | $3,303 | $1,766 |
| Add (deduct) items not affecting cash | | |
| Stock-based compensation costs | 258 | 376 |
| Depreciation and amortization | 1,330 | 1,275 |
| Deferred revenue | (75) | 1,511 |
| Deferred income taxes | 147 | 573 |
| Changes in foreign exchange gain/loss | (538) | (344) |
| | 4,425 | 5,157 |
| Changes in non-cash operating items | | |
| Accounts receivable | (2,558) | (2,024) |
| Income taxes and tax credits | (344) | (278) |
| Inventories | (1,248) | (3,226) |
| Prepaid expenses | 258 | 54 |
| Other assets | 13 | 193 |
| Accounts payable, accrued liabilities and provisions | (1,425) | 3,375 |
| Other liabilities | – | (28) |
| | (879) | 3,223 |
| Cash flows from investing activities | | |
| Additions to short-term investments | (296) | (21) |
| Additions to capital assets | (1,237) | (1,309) |
| Business combination (note 3) | (5,000) | – |
| | (6,533) | (1,330) |
| Cash flows from financing activities | | |
| Bank loan | – | 315 |
| Redemption of share capital | – | (1) |
| | – | 314 |
| Effect of foreign exchange rate changes on cash | (735) | (197) |
| Change in cash | (8,147) | 2,010 |
| Cash – Beginning of the period | 43,208 | 25,864 |
| Cash – End of the period | $35,061 | $27,874 |

Supplementary information

| | | |
|---|---|---|
| Income taxes paid | $958 | $608 |

As at November 30, 2015 and 2016, additions to capital assets amounted to $1,309 and $1,179 respectively, and unpaid purchases of capital assets amounted to $377 and $441 respectively.

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

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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 "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 10, 2017.

## 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 will adopt this new standard on September 1, 2018. The company is currently assessing the impact that the new standard will have on its consolidated financial statements.

#### Revenue from contracts with customers

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

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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)

Leases

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

3 Business Combination

On October 31, 2016, the company acquired substantially all of the assets of Absolute Analysis Inc. (Absolute), a privately held company located in United States, supplying solutions for radio frequency testing of fiber-based radio access networks. The acquisition-date fair value of the total consideration transferred amounted to $8,490,000, and consisted of $5,000,000 in cash and the issuance of 793,070 subordinate voting shares, valued at $3,490,000.

This acquisition was accounted 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 based on management's preliminary estimate of their fair value as of the acquisition date. The results of operations of the acquired business have been included in the consolidated financial statements of the company since October 31, 2016, being the date of acquisition.

The fair value of the total consideration transferred was allocated based on a preliminary estimate of fair value of acquired net assets at the date of acquisition as follows:

| | |
|---|---|
| Assets acquired | |
| Core technology | $8,254 |
| Other assets | 236 |
| Net identifiable assets acquired and fair value of the total consideration transferred | $8,490 |

Acquired intangible assets are amortized on a straight-line basis over their estimated useful life of five years.

The allocation of the fair value of the total consideration transferred is preliminary because the acquisition was closed during the quarter and because certain information required to complete the final allocation remains outstanding. The company expects to complete the final allocation for this acquisition in the second quarter of fiscal 2017. Assets and liabilities likely to change upon completing a more detailed valuation and the finalization of the allocation are intangible assets, goodwill and deferred income taxes.

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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)

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, 2016 | | As at August 31, 2016 | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 1 | Level 2 |
| Financial assets | | | | |
| Short-term investments | $4,281 | $– | $4,087 | $– |
| Forward exchange contracts | $– | $461 | $– | $980 |
| Financial Liabilities | | | | |
| Forward exchange contracts | $– | $903 | $– | $1,120 |

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

As at November 30, 2016, the company held contracts to sell US dollars for Canadian dollars and Indian rupees at various forward rates, which are summarized as follows:

US dollars – Canadian dollars

| Expiry dates | Contractual amounts | Weighted average contractual forward rates |
|---|---|---|
| December 2016 to August 2017 | $ 17,900 | 1.2995 |
| September 2017 to August 2018 | 12,700 | 1.3376 |
| September 2018 to December 2018 | 2,500 | 1.3585 |
| Total | $ 33,100 | 1.3185 |

US dollars – Indian rupees

| Expiry dates | Contractual amounts | Weighted average contractual forward rates |
|---|---|---|
| December 2016 to August 2017 | $ 3,000 | 71.06 |
| September 2017 to January 2018 | 2,000 | 70.76 |
| Total | $ 5,000 | 70.94 |

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 $140,000 as at August 31, 2016, and $442,000 as at November 30, 2016.

As at November 30, 2016, forward exchange contracts in the amount of $313,000 are presented as current assets in other accounts receivable; forward exchange contracts in the amount of $148,000 are presented as long-term assets in other long-term assets; and forward exchange contracts in the amount of $903,000 are presented as current liabilities in accounts payable and accrued liabilities in the balance sheet. Forward exchange contracts of $196,000 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, 2016, 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 $392,000.

During the three months ended November 30, 2015 and 2016, the company recognized within its sales foreign exchange losses on forward exchange contracts of $874,000 and $240,000 respectively.

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5 Share Capital

The following tables summarize changes in share capital for the three months ended November 30, 2015 and 2016.

| | Three months ended November 30, 2015 | | | | |
|---|---|---|---|---|---|
| | Multiple voting shares | | Subordinate voting shares | | |
| | Number | Amount | Number | Amount | Total 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 | 31,643,000 | $ 1 | 22,248,271 | $86,766 | $86,767 |

| | Three months ended November 30, 2016 | | | | |
|---|---|---|---|---|---|
| | Multiple voting shares | | Subordinate voting shares | | |
| | Number | Amount | Number | Amount | Total amount |
| Balance as at September 1, 2016 | 31,643,000 | $ 1 | 21,917,942 | $85,515 | $85,516 |
| Issuance of share capital (note 3) | – | – | 793,070 | 3,490 | 3,490 |
| Redemption of restricted share units | – | – | 88,371 | – | – |
| Reclassification of stock-based compensation costs to share capital upon exercise of stock awards | – | – | – | 346 | 346 |
| Balance as at November 30, 2016 | 31,643,000 | $ 1 | 22,799,383 | $89,351 | $89,352 |

6 Statements of Earnings

Net research and development expenses comprise the following:

Three months ended November 30,

| | 2016 | 2015 |
|---|---|---|
| Gross research and development expenses | $12,640 | |