EXFO INC.
Form 6-K
November 24, 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 November 2017

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

400 Godin Avenue, Quebec City, 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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In November 2017, EXFO Inc., a Canadian corporation, issued its annual audited financial statements and management's discussion and analysis thereof for its fiscal year ended August 31, 2017. At the same time, it also issued a cover letter, its notice of its annual and special shareholders' meeting, its form of proxy and its management proxy circular. This report of Form 6-K sets forth said documents.

The Form 6-K containing the Corporation's annual audited financial statements and management's discussion and analysis for its fiscal year ended August 31, 2017, a cover letter, its notice of annual and special shareholders' meeting, its form of proxy and its management proxy circular are hereby incorporated as documents 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/ Philippe Morin |
| Name: | Philippe Morin |
| Title: | Chief Executive Officer |

Date: November 24, 2017

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Independent Auditor's Report

To the Shareholders of
EXFO Inc.

We have completed integrated audits of EXFO Inc.'s and its subsidiaries' 2017, 2016 and 2015 consolidated financial statements and their internal control over financial reporting as at August 31, 2017. Our opinions, based on our audits, are presented below.

Report on the consolidated financial statements
We have audited the accompanying consolidated financial statements of EXFO Inc. and its subsidiaries, which comprise the consolidated balance sheets as at August 31, 2017 and August 31, 2016 and the consolidated statements of earnings, comprehensive income (loss), changes in shareholder's equity and cash flows for each of the three years in the period ended August 31, 2017, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements
Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility
Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement. Canadian generally accepted auditing standards also require that we comply with ethical requirements.

An audit involves performing procedures to obtain audit evidence, on a test basis, about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting principles and policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion on the consolidated financial statements.

PricewaterhouseCoopers LLP/s.r.l./s.e.n.c.r.l.
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"PwC" refers to PricewaterhouseCoopers LLP/s.r.l./s.e.n.c.r.l., an Ontario limited liability partnership.

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Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of EXFO Inc. and its subsidiaries as at August 31, 2017 and August 31, 2016 and their financial performance and their cash flows for each of the three years in the period ended August 31, 2017 in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board.

Report on internal control over financial reporting

We have also audited EXFO Inc.'s and its subsidiaries' internal control over financial reporting as at August 31, 2017, based on criteria established in Internal Control – Integrated Framework (2013), issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Management's responsibility for internal control over financial reporting

Management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in "Management's Annual Report on Internal Control over Financial Reporting" included in Item 15b) of the Annual Report on Form 20-F for the fiscal year ended August 31, 2017.

Auditor's responsibility

Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control, based on the assessed risk, and performing such other procedures as we consider necessary in the circumstances.

We believe that our audit provides a reasonable basis for our audit opinion on the company's internal control over financial reporting.

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Definition of internal control over financial reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Inherent limitations

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

As described in the Management's Annual Report on Internal Control over Financial Reporting, management has excluded Ontology Partners Limited from its assessment of internal control over financial reporting as of Augusts 31, 2017, because it was acquired by the company in a purchase business combination during 2017. We have also excluded Ontology Partners Limited from our audit of internal control over financial reporting. Ontology Partners Limited is a wholly-owned subsidiary whose total assets and total revenues represent 6% and 1%, respectively, of the related consolidated financial statement amounts as of and for the year ended August 31, 2017.

Opinion

In our opinion, EXFO Inc. and its subsidiaries maintained, in all material respects, effective internal control over financial reporting as at August 31, 2017, based on criteria established in Internal Control – Integrated Framework (2013) issued by COSO.

Montréal, Quebec
November 24, 2017

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[1] CPA auditor, CA, public accountancy permit No. A119427

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EXFO Inc.
Consolidated Balance Sheets

(in thousands of US dollars)

| | As at August 31, | |
|---|---|---|
| | 2017 | 2016 |
| Assets | | |
| Current assets | | |
| Cash | $38,435 | $43,208 |
| Short-term investments (note 6) | 775 | 4,087 |
| Accounts receivable (note 6) | | |
| Trade | 41,130 | 42,993 |
| Other | 3,907 | 2,474 |
| Income taxes and tax credits recoverable (note 19) | 4,955 | 4,208 |
| Inventories (note 7) | 33,832 | 33,004 |
| Prepaid expenses | 4,202 | 3,099 |
| | 127,236 | 133,073 |
| Tax credits recoverable (note 19) | 38,111 | 34,594 |
| Property, plant and equipment (notes 8 and 21) | 40,132 | 35,978 |
| Intangible assets (notes 9 and 21) | 11,183 | 3,391 |
| Goodwill (notes 9 and 21) | 35,077 | 21,928 |
| Deferred income tax assets (note 19) | 6,555 | 8,240 |
| Other assets | 947 | 589 |
| | $259,241 | $237,793 |
| Liabilities | | |
| Current liabilities | | |
| Accounts payable and accrued liabilities (note 11) | $36,776 | $37,174 |
| Provisions (note 11) | 3,889 | 299 |
| Income taxes payable | 663 | 971 |
| Deferred revenue | 11,554 | 9,486 |
| | 52,882 | 47,930 |
| Deferred revenue | 6,257 | 5,530 |
| Deferred income tax liabilities (note 19) | 3,116 | 2,857 |
| Other liabilities | 196 | 75 |
| | 62,451 | 56,392 |
| Commitments (notes 12 and 22) | | |
| Shareholders' equity | | |
| Share capital (note 13) | 90,411 | 85,516 |

| | | |
|---|---|---|
| Contributed surplus | 18,184 | 18,150 |
| Retained earnings | 127,160 | 126,309 |
| Accumulated other comprehensive loss (note 14) | (38,965 ) | (48,574 ) |
| | 196,790 | 181,401 |
| | $259,241 | $237,793 |

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

On behalf of the Board

| | |
|---|---|
| /s/ Philippe Morin | /s/ Claude Séguin |
| PHILIPPE MORIN | CLAUDE SÉGUIN |
| Chief Executive Officer | Chairman, Audit Committee |

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EXFO Inc.
Consolidated Statements of Earnings

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

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Sales (note 21) | $243,301 | $232,583 | $222,089 |
| Cost of sales [(1)] (note 17) | 94,329 | 87,066 | 85,039 |
| Selling and administrative [(2)] (note 17) | 86,256 | 82,169 | 82,200 |
| Net research and development (note 17) | 47,168 | 42,687 | 44,003 |
| Depreciation of property, plant and equipment (note 17) | 3,902 | 3,814 | 4,835 |
| Amortization of intangible assets (note 17) | 3,289 | 1,172 | 2,883 |
| Change in fair value of cash contingent consideration (note 3) | (383) | – | – |
| Interest and other (income) expense | 303 | (828) | (155) |
| Foreign exchange (gain) loss | 978 | (161) | (7,212) |
| Unusual charge | – | – | 603 |
| Earnings before income taxes | 7,459 | 16,664 | 9,893 |
| Income taxes (note 19) | 6,608 | 7,764 | 5,036 |
| Net earnings for the year | $851 | $8,900 | $4,857 |
| Basic net earnings per share | $0.02 | $0.17 | $0.09 |
| Diluted net earnings per share | $0.02 | $0.16 | $0.08 |
| Basic weighted average number of shares outstanding (000's) | 54,423 | 53,863 | 56,804 |
| Diluted weighted average number of shares outstanding (000's) (note 20) | 55,555 | 54,669 | 57,457 |

(1) The cost of sales is exclusive of depreciation and amortization, shown separately.
(2) Selling and administrative is exclusive of a one-time charge relating to an unusual bad debt expense in fiscal 2015.

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

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EXFO Inc.
Consolidated Statements of Comprehensive Income (Loss)

(in thousands of US dollars)

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Net earnings for the year | $851 | $8,900 | $4,857 |
| Other comprehensive income (loss), net of income taxes | | | |
| Items that will not be reclassified subsequently to net earnings | | | |
| Foreign currency translation adjustment | 8,262 | 707 | (39,175) |
| Items that may be reclassified subsequently to net earnings | | | |
| Unrealized gains/losses on forward exchange contracts | 1,403 | 862 | (5,583) |
| Reclassification of realized gains/losses on forward exchange contracts in net earnings | 423 | 2,797 | 2,107 |
| Deferred income tax effect of gains/losses on forward exchange contracts | (479) | (935) | 905 |
| Other comprehensive income (loss) | 9,609 | 3,431 | (41,746) |
| Comprehensive income (loss) for the year | $10,460 | $12,331 | $(36,889) |

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

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EXFO Inc.
Consolidated Statements of Changes in Shareholders' Equity

(in thousands of US dollars)

| | Year ended August 31, 2015 | | | | |
|---|---|---|---|---|---|
| | Share capital | Contributed surplus | Retained earnings | Accumulated other comprehensive loss | Total shareholders' equity |
| Balance as at September 1, 2014 | $111,491 | $ 16,503 | $112,552 | $ (10,259) | $ 230,287 |
| Redemption of share capital (note 13) | (26,827) | 1,333 | – | – | (25,494) |
| Reclassification of stock-based compensation costs (note 13) | 1,381 | (1,381) | – | – | – |
| Stock-based compensation costs | – | 1,323 | – | – | 1,323 |
| Net earnings for the year | – | – | 4,857 | – | 4,857 |
| Other comprehensive loss | | | | | |
| Foreign currency translation adjustment | – | – | – | (39,175) | (39,175) |
| Changes in unrealized losses on forward exchange contracts, net of deferred income taxes of $905 | – | – | – | (2,571) | (2,571) |
| Total comprehensive loss for the year | | | | | (36,889) |
| Balance as at August 31, 2015 | $86,045 | $ 17,778 | $117,409 | $ (52,005) | $ 169,227 |

| | Year ended August 31, 2016 | | | | |
|---|---|---|---|---|---|
| | 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 13) | (1,768) | 217 | – | – | (1,551) |
| Reclassification of stock-based compensation costs (note 13) | 1,239 | (1,239) | – | – | – |
| Stock-based compensation costs | – | 1,394 | – | – | 1,394 |
| Net earnings for the year | – | – | 8,900 | – | 8,900 |
| Other comprehensive income | | | | | |
| Foreign currency translation adjustment | – | – | – | 707 | 707 |
| Changes in unrealized gains/losses on forward exchange contracts, net of deferred income taxes of $935 | – | – | – | 2,724 | 2,724 |
| Total comprehensive income for the year | | | | | 12,331 |
| Balance as at August 31, 2016 | $85,516 | $ 18,150 | $126,309 | $ (48,574) | $ 181,401 |

| | Year ended August 31, 2017 | | | | |
|---|---|---|---|---|---|
| | 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 (note 13) | 3,490 | – | – | – | 3,490 |
| Reclassification of stock-based compensation costs (note 13) | 1,405 | (1,405 ) | – | – | – |
| Stock-based compensation costs | – | 1,439 | – | – | 1,439 |
| Net earnings for the year | – | – | 851 | – | 851 |
| Other comprehensive income | | | | | |
| Foreign currency translation adjustment | – | – | – | 8,262 | 8,262 |
| Changes in unrealized gains/losses on forward exchange contracts, net of deferred income taxes of $479 | – | – | – | 1,347 | 1,347 |
| Total comprehensive income for the year | | | | | 10,460 |
| Balance as at August 31, 2017 | $90,411 | $ 18,184 | $127,160 | $ (38,965 ) | $ 196,790 |

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

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EXFO Inc.
Consolidated Statements of Cash Flows

(in thousands of US dollars)

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Cash flows from operating activities | | | |
| Net earnings for the year | $851 | $8,900 | $4,857 |
| Add (deduct) items not affecting cash | | | |
| Stock-based compensation costs | 1,477 | 1,378 | 1,295 |
| Depreciation and amortization | 7,191 | 4,986 | 7,718 |
| Change in fair value of cash contingent consideration | (383) | – | – |
| Unusual charge | – | – | 603 |
| Deferred revenue | 1,723 | 4,238 | 396 |
| Deferred income taxes | 1,054 | 1,578 | 403 |
| Changes in foreign exchange gain/loss | 1,096 | (332) | (3,842) |
| | 13,009 | 20,748 | 11,430 |
| Changes in non-cash operating items | | | |
| Accounts receivable | 3,955 | 2,682 | (10,828) |
| Income taxes and tax credits | (2,386) | 939 | (2,062) |
| Inventories | 911 | (4,713) | 820 |
| Prepaid expenses | (918) | (280) | (982) |
| Other assets | (121) | 170 | 61 |
| Accounts payable and accrued liabilities and provisions | (1,745) | 4,882 | 8,132 |
| Other liabilities | 165 | (65) | (87) |
| | 12,870 | 24,363 | 6,484 |
| Cash flows from investing activities | | | |
| Additions to short-term investments | (2,910) | (3,546) | (20,067) |
| Proceeds from disposal and maturity of short-term investments | 6,374 | 873 | 23,685 |
| Purchases of capital assets (notes 8 and 9) | (7,175) | (4,356) | (5,933) |
| Business combinations, net of cash acquired (note 3) | (12,792) | – | – |
| | (16,503) | (7,029) | (2,315) |
| Cash flows from financing activities | | | |
| Repayment of long-term debt (note 3) | (1,480) | | |
| Redemption of share capital (note 13) | – | (1,551) | (25,494) |
| | (1,480) | (1,551) | (25,494) |
| Effect of foreign exchange rate changes on cash | 340 | 1,561 | (6,932) |
| Change in cash | (4,773) | 17,344 | (28,257) |
| Cash – Beginning of year | 43,208 | 25,864 | 54,121 |
| Cash – End of year | $38,435 | $43,208 | $25,864 |
| Supplementary information | | | |
| Income taxes paid | $2,866 | $2,015 | $1,491 |

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

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EXFO Inc.
Notes to Consolidated Financial Statements

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

## 1 Nature of Activities and Incorporation

EXFO Inc. and its subsidiaries (together "EXFO" or the company) develops, manufactures and markets smarter network test, monitoring and analytics solutions for the world's leading communications service providers, network equipment manufacturers and webscale companies.

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 consolidated financial statements were authorized for issue by the Board of Directors on November 24, 2017.

## 2 Basis of Presentation

These consolidated financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS), as issued by the International Accounting Standards Board (IASB). The company has consistently applied the same accounting policies through all periods presented.

These IFRS consolidated financial statements have been prepared based on the following accounting policies:

### Basis of measurement

These consolidated financial statements have been prepared under the historical cost convention, except for the revaluation of derivative financial instruments, available-for-sale investments and the contingent liability.

### Consolidation

These consolidated financial statements include the accounts of the company and its domestic and foreign subsidiaries. Intercompany accounts and transactions have been eliminated.

### Revenue recognition

Revenue comprises the fair value of the consideration received or receivable for the sales of goods and services in the ordinary course of business.

#### Sales of goods

Revenue from sales of goods, which represent the majority of the sales of the company, is recognized when the significant risks and rewards of ownership of the goods have passed to the buyer, usually upon delivery of the goods. Revenue is recorded based on the price specified in the sales arrangements.

#### Maintenance contracts

Maintenance contracts are usually offered to customers for periods of 12 to 36 months. They generally include the right to unspecified software upgrades and enhancements on a when-and-if-available basis as well as customer service. Revenue from these contracts is recognized ratably over the terms of the maintenance contracts on a straight-line basis.



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EXFO Inc.
Notes to Consolidated Financial Statements

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

Extended warranties

Extended warranties are usually offered to customers for periods of 6 to 48 months. Revenue from these extended warranties is recognized ratably over the warranty period on a straight-line basis.

Multiple-component arrangements

When a sales arrangement includes multiple separately identifiable components such as goods, extended warranties, maintenance contracts, installation and training, the revenue recognition criteria are applied to each separately identifiable component. A component is considered separately identifiable if the delivered item has value to the customer on a stand-alone basis and the fair value associated with the component can be measured reliably. The company allocates the selling price of a multiple-component arrangement to each component based on the fair value of each component in relation to the fair value of the arrangement as a whole.

Sales arrangements may include acceptance clauses. When a sales arrangement does include an acceptance provision, acceptance occurs upon the earliest of receipt of a written customer acceptance or expiration of the acceptance period. For these sales arrangements, the sale is recognized when acceptance occurs.

Presentation currency

The functional currency of the company is the Canadian dollar. The company has adopted the US dollar as its presentation currency as it is the most commonly used reporting currency in its industry. The consolidated financial statements are translated into the presentation currency as follows: assets and liabilities are translated at the exchange rate in effect on the date of the balance sheet; revenues and expenses are translated at the monthly average exchange rate. The foreign currency translation adjustment arising from such translation is included in accumulated other comprehensive income in shareholders' equity.

Foreign currency translation

(a) Foreign currency transactions

Transactions denominated in currencies other than the functional currency are translated into the relevant functional currency as follows: Monetary assets and liabilities are translated at the exchange rate in effect on the date of the balance sheet, and revenues and expenses are translated at the exchange rate in effect on the date of the transaction. Non-monetary assets and liabilities measured at historical cost and denominated in a foreign currency are translated using the exchange rate at the date of the transaction, whereas non-monetary items that are measured at fair value and denominated in a foreign currency are translated using the exchange rates at the date when the fair value was determined. Foreign exchange gains and losses arising from such translation are included in the consolidated statements of earnings.

(b) Foreign operations

Each foreign operation determines its own functional currency and items included in the financial statements of each foreign operation are measured using that functional currency. The financial statements of each foreign operation that has a functional currency different from the company are translated into Canadian dollars as follows: assets and liabilities are translated at the exchange rate in effect on the date of the balance sheet; revenues and expenses are translated at the monthly average exchange rate. The foreign currency translation adjustment arising from such translation is included in accumulated other comprehensive income in shareholders' equity.

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EXFO Inc.
Notes to Consolidated Financial Statements

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

Financial instruments

The classification of financial instruments depends on the intended purpose when the financial instruments were acquired or issued, as well as on their characteristics and designation by the company.

Classification

Financial assets

| | |
|---|---|
| Cash | Loans and receivables |
| Short-term investments | Available for sale |
| Accounts receivable | Loans and receivables |
| Other assets | Loans and receivables |
| Forward exchange contracts | Derivatives used for hedging |

Financial liabilities

| | |
|---|---|
| Accounts payable and accrued liabilities | Other financial liabilities |
| Contingent liability | Financial liabilities at fair value through profit or loss |
| Forward exchange contracts | Derivatives used for hedging |

Available-for-sale financial assets

Available-for-sale financial assets are non-derivative financial assets that are designated as available for sale, or are not classified in any of the other categories. They are initially recognized at fair value plus transaction costs and are subsequently measured at fair value. After their initial recognition, any changes in their fair value are reflected in other comprehensive income.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. After their initial measurement at fair value plus transaction costs, they are carried at amortized cost, using the effective interest rate method, which generally corresponds to the nominal amount due to their short-term maturity.

Other financial liabilities

Other financial liabilities are non-derivative financial liabilities initially measured at fair value plus transaction costs, and they are subsequently carried at amortized cost, using the effective interest rate method, which generally corresponds to the nominal amount due to their short-term maturity.

Financial liabilities at fair value through profit or loss

Financial liabilities at fair value through profit or loss are non-derivative financial liabilities initially measured at fair value plus transaction costs and are subsequently measured at fair value. After their initial recognition, any changes in their fair value are reflected in the consolidated statements of earnings.

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EXFO Inc.
Notes to Consolidated Financial Statements

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

Derivative financial instruments and hedging activities

Forward exchange contracts are utilized by the company to manage its foreign currency exposure. Forward exchange contracts are entered into by the company to hedge anticipated US-dollar-denominated sales and the related accounts receivable as well as Indian-rupee-denominated operating expenses and the related accounts payable. The company's policy is not to utilize those derivative financial instruments for trading or speculative purposes.

The company's forward exchange contracts, which are designated as cash flow hedging instruments, qualify for hedge accounting.

They are initially recorded at fair value plus transaction costs and subsequently measured at fair value. The fair value of forward exchange contracts is determined using quoted prices and forward exchange rates at the balance sheet date, with the resulting value discounted back to present value. After initial recognition, the effective portion of changes in their fair value is reflected in other comprehensive income. Any ineffective portion is recognized immediately in the consolidated statements of earnings. Upon recognition of related hedged sales and operating expenses, accumulated changes in fair value of forward exchange contracts are respectively reclassified in sales and net research and development expenses in the consolidated statements of earnings.

At the inception of a hedge relationship, the company formally designates and documents the hedge relationship to which the company wishes to apply hedge accounting, the risk management objectives, the hedging instrument, the hedged item and the method used to test effectiveness. The company assesses effectiveness of the hedge relationship at inception and on an ongoing basis using the dollar-offset method.

Fair value hierarchy

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, forward exchange contracts and contingent liability 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 foreign exchange rates at the balance sheet dates. The company's contingent liability is classified within level 3 of the fair value hierarchy because it is valued using unobservable inputs such as expected future sales of Ontology.

Short-term investments

All investments with original terms to maturity of three months or less and that are not required for the purposes of meeting short-term cash requirements are classified as short-term investments. Short-term investments are classified as available-for-sale financial assets; therefore, they are carried at fair value in the consolidated balance sheet, and any changes in their fair value are reflected in other comprehensive income. Upon the disposal or maturity of these assets, accumulated changes in their fair value are reclassified in the consolidated statements of earnings.

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EXFO Inc.
Notes to Consolidated Financial Statements

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

Inventories

Inventories are valued on an average cost basis, at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs necessary to make the sale.

The cost of work in progress and finished goods includes material, labor and an allocation of manufacturing overhead.

Property, plant and equipment and depreciation

Property, plant and equipment are recorded at cost, net of accumulated depreciation and accumulated impairment losses. Such cost is reduced by related research and development tax credits.

Depreciation is provided on a straight-line basis over the estimated useful lives of the asset as follows:

| | Term |
|---|---|
| Land improvements | 15 years |
| Buildings | 20 to 60 years |
| Equipment | 3 to 15 years |
| Leasehold improvements | The lesser of useful life and remaining lease term |

The assets' residual values and useful lives are reviewed at each financial year-end, and adjusted prospectively, if appropriate.

Intangible assets, goodwill and amortization

Intangible assets

Intangible assets with finite useful lives primarily include the cost of core technology, customer relationships and software. The cost of intangible assets acquired in a business combination is the fair value of the assets at the date of acquisition. Following initial recognition, intangible assets are carried at cost less accumulated amortization and accumulated impairment losses. Amortization is provided on a straight-line basis over the estimated useful lives of one to five years for core technology, five years for customer relationships, and four and eight years for software. None of the company's intangible assets were developed internally.

The amortization method and the useful lives of intangible assets are reviewed at each financial year-end, and adjusted prospectively, if appropriate.

Goodwill

Goodwill represents the excess of the purchase price of acquired businesses over the estimated fair value of net identifiable assets acquired, and is allocated to each cash-generating unit (CGU) or group of CGUs that are expected to benefit from the related business combination. A group of CGUs represents the lowest level within the

company at which the goodwill is monitored for internal management purposes, which is not higher than an operating segment. Goodwill is not amortized but must be tested for impairment on an annual basis or more frequently if events or circumstances indicate that it might be impaired.

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Research and development

All costs related to research are expensed as incurred, net of related tax credits and grants. Development costs are expensed as incurred, net of related tax credits and grants, unless they meet the recognition criteria of IAS 38, "Intangible Assets", in which case they are capitalized, net of related tax credits and grants and amortized on a straight-line basis over the estimated benefit period. Research and development expenses mainly comprise salaries and related expenses, material costs as well as fees paid to third-party consultants. As at August 31, 2016 and 2017, the company had not capitalized any development costs.

The company elected to account for non-refundable research and development tax credits under IAS 20, "Accounting for Governmental Grants and Disclosures of Governmental Assistance", and as such, these tax credits are presented against gross research and development expenses in the consolidated statements of earnings. Non-refundable research and development tax credits are included in earnings or deducted from the related assets, provided there is reasonable assurance that the company has complied and will comply with the conditions related to the tax credits and that the tax credits will be received.

Impairment of non-financial assets

The company assesses at each reporting date whether there is an indication that the carrying value of property, plant and equipment and finite-life intangible assets may not be recoverable. Non-financial assets that are not amortized (such as goodwill) are subject to an annual impairment test. If any indication exists, or when annual impairment testing is required, the company estimates the asset or asset group's recoverable amount. For the purpose of measuring recoverable amounts, assets are grouped at the lowest levels for which there are separately identifiable cash flows (CGUs). The recoverable amount is the higher of an asset or CGU's fair value less costs of disposal and its value in use. Where the carrying value of an asset or CGU exceeds its recoverable amount, the asset or the CGU is considered impaired and is written down to its recoverable amount. The company performs its annual goodwill impairment test in the fourth quarter of each fiscal year.

For property, plant and equipment and finite-life intangible assets, the reversal of impairment is limited so that the carrying value of the asset does not exceed its recoverable amount, nor exceed the carrying value that would have been determined, net of depreciation or amortization, had no impairment loss been recognized for the asset in prior periods. Impairment losses on goodwill are not reversed.

Leases

Operating leases are leases for which the company does not assume substantially all the risks and rewards of ownership of the asset. Operating lease rentals are charged to the consolidated statements of earnings on a straight-line basis over the lease term.

As at August 31, 2016 and 2017, all significant leases of the company were classified as operating leases.

Government grants

Grants related to operating expenses are included in earnings when the related expenses are incurred. Grants related to capital expenditures are deducted from the related assets. Grants are included in the consolidated statements of earnings or deducted from the related assets, provided there is reasonable assurance that the company has complied and will comply with all the conditions related to the grants and that the grants will be received.

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Warranty

The company offers its customers basic warranties of one to three years, depending on the specific products and terms of the purchase agreement. The company's typical warranties require it to repair or replace defective products during the warranty period at no cost to the customer. Costs related to basic warranties are accrued at the time of shipment, based upon estimates of expected rework and warranty costs to be incurred. Costs associated with separately priced extended warranties are expensed as incurred.

Income taxes

Income taxes comprise current and deferred income taxes.

Current income taxes

Current income tax assets and liabilities for the current and prior years are measured at the amount expected to be recovered or paid to the taxation authorities. Income tax rates used to calculate the amount are those that are enacted or substantively enacted at the balance sheet dates in the tax jurisdictions where the company generates taxable income/loss.

Deferred income taxes

The company provides for deferred income taxes using the liability method. Under this method, deferred income tax assets and liabilities are determined based on deductible or taxable temporary differences between financial statement values and tax values of assets and liabilities as well as the carry-forward of unused tax losses and deductions, using enacted or substantively enacted income tax rates at the balance sheet dates, that are expected to be in effect for the years in which the assets are expected to be recovered or the liabilities to be settled.

Deferred income tax assets are recognized only to the extent that it is probable that future taxable income will be available against which the deductible temporary differences as well as unused tax losses and deductions can be utilized.

Deferred tax liabilities are recognized for all taxable temporary differences and for taxable temporary differences arising on investments in subsidiaries, except where the reversal of these temporary differences can be controlled and it is probable that the differences will not reverse in the foreseeable future.

Deferred income tax assets and liabilities are presented as non-current in the consolidated balance sheets.

Uncertain tax positions

The company is subject to income tax laws and regulations in several jurisdictions. There are many transactions and calculations during the course of business for which the ultimate tax determination is uncertain. The company maintains provisions for uncertain tax positions that it believes appropriately reflect its risk. These provisions are

made using the best estimate of the amount expected to be paid based on a qualitative assessment of all relevant factors. The company reviews the adequacy of these provisions at the end of the reporting periods and any changes in the provisions are recognized in the consolidated statements of earnings when they occur. However, it is possible that at some future dates, liabilities in excess of the company's provisions could result from audits by, or litigation with, the relevant taxing authorities. Where the final outcome of these tax-related matters is different from the amounts that were initially recorded, such differences will be recognized in the consolidated statement of earnings in the period in which such determination is made.

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Earnings per share

Basic earnings per share are calculated by dividing net earnings attributable to common equity holders of the company by the weighted average number of common shares outstanding during the year.

Diluted earnings per share are calculated by dividing net earnings attributable to common equity holders of the company by the weighted average number of common shares outstanding during the year, plus the effect of dilutive potential common shares outstanding during the year. This method requires that diluted earnings per share be calculated (using the treasury stock method) as if all dilutive potential common shares had been exercised at the latest at the beginning of the year or on the date of issuance, as the case may be, and that the funds obtained thereby (plus an amount equivalent to the unamortized portion of related stock-based compensation costs) be used to purchase common shares of the company at the average market price of the common shares during the year.

Stock-based compensation

Equity-settled awards

The company's stock options, restricted share units and deferred share units are equity-settled awards. The company accounts for stock-based compensation costs on equity-settled awards using the Black-Scholes option valuation model. The fair value of equity-settled awards is measured at the date of grant. Stock-based compensation costs are amortized to expense over the vesting periods together with a corresponding change in contributed surplus in shareholders' equity. For equity-settled awards with graded vesting, each tranche is considered a separate grant with a different vesting date and fair value, and each tranche is accounted for separately.

Cash-settled awards

The company's stock appreciation rights are cash-settled awards. The company accounts for stock-based compensation costs on cash-settled awards using the Black-Scholes option valuation model. The fair value of the cash-settled awards is remeasured at the end of each reporting period, with any changes in the fair value recognized in the consolidated statements of earnings.

Operating segments

Operating segments are defined as components of an entity engaged in business activities from which it may earn revenues and incur expenses, and whose operating results are regularly reviewed by the chief operating decision maker (CODM) to make decisions about resources to be allocated to segments and assess their performance and for which discrete information is available. The function of the CODM is performed by the Chief Executive Officer who reviews consolidated results for the purposes of allocating resources and evaluating performance. Accordingly, the company determines that it has one operating segment as of, and for the years ended August 31, 2015, 2016 and 2017. Entity-wide disclosures are presented in note 21.

Critical accounting judgments in applying accounting policies and estimates

The preparation of financial statements in accordance with IFRS requires management to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses as well as the disclosures of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those judgments, estimates and assumptions.



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Critical judgments, estimates and assumptions are the following:

Critical judgments in applying accounting policies

(a) Determination of functional currency

The company operates in multiple countries and generates revenue and incurs 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 the company and its subsidiaries may require significant judgment. In determining the functional currency of the company and its subsidiaries, management takes into account primary, secondary and tertiary indicators. When indicators are mixed and the functional currency is not obvious, management uses its 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 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

The company states its inventories at the lower of cost, determined on an average cost basis, and net realizable value, and provides reserves for excess and obsolete inventories. The company determines its 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.

(b) Income taxes

The company is 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 laws and regulations and the amount and timing of future taxable income. The company maintains provisions for uncertain tax positions that it believes appropriately reflect its risk based on its interpretation of laws and regulations. In addition, management has made reasonable estimates and assumptions to determine the amount of deferred tax assets that can be recognized in the consolidated financial statements, based upon the likely timing and level of anticipated future taxable income together with tax planning strategies. The ultimate realization of the company's 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.

(c) Tax credits recoverable

Tax credits are recorded provided that there is reasonable assurance that the company has 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 the company's non-refundable tax credits is dependent upon the generation of sufficient future taxable income during the tax credits carry-forward periods. Management has made reasonable estimates and assumptions to determine the amount of non-refundable tax credits that can be recognized in the consolidated financial statements, based upon the likely timing and level of anticipated future taxable income together with tax planning strategies (note 19).

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(d) Impairment of non-financial assets

Impairment exists when the carrying value of an asset or group of assets (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 the company's CGUs is based on a market approach that relies on unobservable inputs based on valuation multiples and recent transactions for comparable assets or businesses, within the same industry. The company applies judgment in making adjustments to the unobservable inputs for factors such as size, risk profile or profitability. The company also considers the company's value derived from its market capitalization, adjusting for a control premium considered appropriate based on other comparable companies with significant controlling interests. Depending on the market evidence available, the company, from time to time, may further supplement this market approach with an income approach that considers discounted cash flows to determine fair value less costs of disposal. The discounted cash flow model involves significant judgment with respect to estimating cash flows (based on market participant assumptions) and the appropriate discount rate.

(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 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.

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.

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Revenue from contracts with customers

IFRS 15, "Revenue from Contracts with Customers", was issued in May 2014. The objective of this new standard is to provide a single, comprehensive revenue recognition model for all contracts with customers to improve comparability. This new standard contains principles that an entity will apply to determine the measurement of revenue and timing of when it is recognized. The underlying principle is that an entity will recognize revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. This new standard is effective for annual periods beginning on or after January 1, 2018. Early adoption is permitted. The company has performed an assessment to identify significant areas of impact, if any, between the company's current accounting treatment under IAS 18, "Revenue" and the new requirements of IFRS 15. Based on the assessments to date, the company anticipates 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" the company's intellectual property. The company 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. The company 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, 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.

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. The company will adopt this interpretation on September 1, 2018 and is currently assessing the impact that it will have on its consolidated financial statements.

Uncertainty over Income Tax Treatments

IFRIC 23, "Uncertainty over Income Tax Treatment", 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. The company will adopt this interpretation on September 1, 2019 and is currently assessing the impact that it will have on its consolidated financial statements.



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## 3 Business Combinations

### Absolute Analysis Inc.

On October 31, 2016, the company 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 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 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 liability 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 the consolidated financial statements of the company since October 31, 2016, being the date of acquisition.

During the second quarter of fiscal 2017, the company completed the detailed valuation and finalized the allocation of the purchase price.

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

| | |
|---|---|
| Assets acquired | |
| Core technology | $4,130 |
| Other assets | 236 |
| | 4,366 |
| Liability assumed | |
| Deferred income taxes | 279 |
| Net identifiable assets acquired | 4,087 |
| Goodwill | 4,403 |
| Fair value of the total consideration transferred | $8,490 |

Intangible assets are amortized on a straight-line basis over their estimated useful lives of one to five years.

Acquired goodwill mainly represents synergies with the company's products as well as the Absolute acquired workforce. Acquired goodwill is deductible for tax purposes. Goodwill is allocated to the EXFO cash generating unit.

### Ontology Partners Limited

On March 2, 2017, the company acquired all of the 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 transferred amounted

to $9,180,000 and consisted of $7,780,000 in cash, net of Ontology's cash of $2,156,000 at the acquisition date, plus a cash contingent consideration based on certain sales volumes of Ontology products over the 12-month period following the acquisition, with an estimated fair value of $1,400,000 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 have been included in the consolidated financial statements of the company since March 2, 2017, being the date of acquisition.

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During the fourth quarter of fiscal 2017, the company completed the detailed valuation and finalized the allocation of the purchase price; this resulted in an increase of goodwill of $650,000 and a corresponding decrease in intangible assets.

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

| | |
|---|---|
| Assets acquired | |
| Accounts receivable | $ 1,701 |
| Core technology | 3,802 |
| Customer relationships | 1,607 |
| Other assets | 37 |
| | 7,147 |
| Liabilities assumed | |
| Accounts payable and accrued liabilities | 3,343 |
| Deferred revenue | 211 |
| Long-term debt | 1,480 |
| Net identifiable assets acquired | 2,113 |
| Goodwill | 7,067 |
| Fair value of the total consideration transferred, net of cash acquired | $ 9,180 |

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

Acquired goodwill mainly represents synergies with the company's products as well as Ontology acquired workforce. Acquired goodwill is not deductible for tax purposes. Goodwill is allocated to the Ontology cash generating unit.

As at August 31, 2017, the fair value of the cash contingent consideration amounted to $1,092,000 with the change in its fair value being accounted for in the consolidated statement of earnings.

## 4 Restructuring Charges

In May 2017, the company implemented a restructuring plan to streamline its passive monitoring solutions portfolio. This plan resulted in severance expenses of $4,049,000 and inventory writeoffs of $1,030,000, for total restructuring charges of $5,079,000 during the year.

As at August 31, 2017, unpaid severance expenses amounted to $2,477,000, which are expected to be paid in fiscal 2018 (note 11).

## 5 Capital Disclosures

The company is not subject to any external restrictions on its capital.

The company's objectives when managing capital are:

- To maintain a flexible capital structure that optimizes the cost of capital at acceptable risk;
- To sustain future development of the company, including research and development activities, market development and potential acquisitions of complementary businesses or products; and
- To provide the company's shareholders with an appropriate return on their investment.

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No changes were made to the objectives and policies during the years ended August 31, 2016 and 2017.

The company defines its capital as shareholders' equity, excluding accumulated other comprehensive loss. The capital of the company amounted to $229,975,000 and $235,755,000 as at August 31, 2016 and 2017 respectively.

6 Financial Instruments

The following tables summarize financial instruments by category:

| | As at August 31, 2017 | | | | | |
|---|---|---|---|---|---|---|
| | Loans and receivable | Available for sale | Other financial liabilities | Financial liabilities at fair value through profit or loss | Derivatives used for hedging | Total |
| Financial assets | | | | | | |
| Cash | $38,435 | $ | $ | $ | $ | $38,435 |
| Short-term investments | $ | $ 775 | $ | $ | $ | $775 |
| Accounts receivable | $43,340 | $ | $ | $ | $ | $43,340 |
| Other assets | $36 | $ | $ | $ | $ | $36 |
| Forward exchange contracts | $ | $ | $ | $ | $ 2,258 | $2,258 |
| Financial liabilities | | | | | | |
| Accounts payable and accrued liabilities | $ | $ | $ 36,776 | $ | $ | $36,776 |
| Contingent liability | $ | $ | $ | $ 1,092 | $ | $1,092 |

| | As at August 31, 2016 | | | | |
|---|---|---|---|---|---|
| | Loans and receivable | Available for sale | Other financial liabilities | Derivatives used for hedging | Total |
| Financial assets | | | | | |
| Cash | $43,208 | $ | $ | $ | $43,208 |
| Short-term investments | $ | $ 4,087 | $ | $ | $4,087 |
| Accounts receivable | $45,467 | $ | $ | $ | $45,467 |
| Other assets | $35 | $ | $ | $ | $35 |

| | | | | | |
|---|---|---|---|---|---|
| Forward exchange contracts | $ | $ | $ | $ 980 | $980 |
| Financial liabilities | | | | | |
| Accounts payable and accrued liabilities | $ | $ | $ 36,099 | $ | $36,099 |
| Forward exchange contracts | $ | $ | $ | $ 1,120 | $1,120 |

Fair value

Cash, accounts receivable and accounts payable and accrued liabilities are financial instruments whose carrying values approximate their fair values due to their short-term maturities. The fair value of other assets approximates their carrying value due to their relatively short-term maturities.

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

| | As at August 31, 2017 | | | As at August 31, 2016 | |
|---|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Level 1 | Level 2 |
| Financial assets | | | | | |
| Short-term investments | $775 | $ | | $4,087 | $ |
| Forward exchange contracts | $ | $2,258 | | $ | $980 |
| Financial liabilities | | | | | |
| Forward exchange contracts | $ | $ | | $ | $1,120 |
| Contingent liability | $ | $ | 1,092 | $ | $ |

Market risk

Currency risk

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. Forward exchange contracts, which are designated as cash flow hedging instruments, qualify for hedge accounting.

As at August 31, 2016 and 2017, 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 |
|---|---|---|
| As at August 31, 2016 | | |
| September 2016 to August 2017 | $ 22,200 | 1.2784 |
| September 2017 to August 2018 | 9,900 | 1.3367 |
| September 2018 to December 2018 | 1,900 | 1.3639 |

| | | |
|---|---|---|
| Total | $ 34,000 | 1.3002 |
| | | |
| As at August 31, 2017 | | |
| September 2017 to August 2018 | $ 18,300 | 1.3407 |
| September 2018 to August 2019 | 10,900 | 1.3426 |
| Total | $ 29,200 | 1.3414 |

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US dollars – Indian rupees

| Expiry dates | Contractual amounts | Weighted average contractual forward rates |
|---|---|---|
| As at August 31, 2016 | | |
| September 2016 to August 2017 | $ 3,800 | 70.92 |
| As at August 31, 2017 | | |
| September 2017 to August 2018 | $ 3,400 | 69.49 |
| September 2018 to February 2019 | 1,600 | 67.26 |
| Total | $ 5,000 | 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 $140,000 and net gains of $2,258,000 as at August 31, 2016 and 2017 respectively.

As at August 31, 2017, forward exchange contracts in the amount of $1,697,000 are presented as current assets in other accounts receivable and forward exchange contracts in the amount of $561,000 are presented as long-term assets in other long-term assets in the balance sheet. Forward exchange contracts of $261,000, included in other accounts receivable, 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.

As at August 31, 2016, forward exchange contracts in the amount of $635,000 were presented as current assets in other accounts receivable; forward exchange contracts in the amount of $345,000 were presented as long-term assets in other long-term assets; forward exchange contracts in the amount of $1,075,000 were presented as current liabilities in accounts payable and accrued liabilities; and forward exchange contracts in the amount of $45,000 were presented as long-term liabilities in other long-term liabilities in the consolidated balance sheet.

Based on the portfolio of forward exchange contracts as at August 31, 2017, the company estimates that the portion of net unrealized gains 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 $1,436,000.

For the years ended August 31, 2015, 2016 and 2017, the company recorded within its sales the following foreign exchange losses on forward exchange contracts:

Years ended August 31,

| | 2017 | 2016 | 2015 |
|---|---|---|---|
| Losses on forward exchange contracts | $468 | $2,651 | $2,562 |

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The following table summarizes significant derivative and non-derivative financial assets and liabilities that are subject to currency risk as at August 31, 2016 and 2017 and for which such risk is charged to earnings:

| | As at August 31, 2017 | | 2016 | |
|---|---|---|---|---|
| | Carrying/nominal amount (in thousands of US dollars) | Carrying/nominal amount (in thousands of euros) | Carrying/nominal amount (in thousands of US dollars) | Carrying/nominal amount (in thousands of euros) |
| Financial assets | | | | |
| Cash | $ 20,120 | € 6,235 | $ 13,090 | € 2,927 |
| Accounts receivable | 28,420 | 6,164 | 30,141 | 5,963 |
| | 48,540 | 12,399 | 43,231 | 8,890 |
| Financial liabilities | | | | |
| Accounts payable and accrued liabilities | 12,447 | 2,725 | 14,251 | 1,081 |
| Forward exchange contracts (nominal value) | 3,600 | | 4,000 | – |
| | 16,047 | 2,725 | 18,251 | 1,081 |
| Net exposure | $ 32,493 | € 9,674 | $ 24,980 | € 7,809 |

In addition to these assets and liabilities, the company has derivative financial liabilities for its outstanding forward exchange contracts in the amount (nominal value) of $33,800,000 and $29,200,000 as at August 31, 2016 and 2017 respectively for which the currency risk is charged to other comprehensive income.

The value of the Canadian dollar compared to the US dollar was CA$1.3116 = US$1.00 and CA$1.2536 = US$1.00 as at August 31, 2016 and 2017 respectively.

The value of the Canadian dollar compared to the euro was CA$1.4601 = €1.00 and CA$1.4825 = €1.00 as at August 31, 2016 and 2017 respectively.

The following sensitivity analysis summarizes the effect that a change in the value of the Canadian dollar (compared to the US dollar and euro) on derivative and non-derivative financial assets and liabilities denominated in US dollars and euros would have on net earnings, net earnings per diluted share and comprehensive income, based on the foreign exchange rates as at August 31, 2016 and 2017:

- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the US dollar would decrease (increase) net earnings by $2,342,000, or $0.04 per diluted share, and $2,726,000, or $0.05 per diluted share, as at August 31, 2016 and 2017 respectively.

- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the euro would decrease (increase) net earnings by $830,000, or $0.02 per diluted share, and $1,025,000 or $0.02 per diluted share, as at August 31, 2016 and 2017 respectively.

- An increase (decrease) of 10% in the period-end value of the Canadian dollar compared to the US dollar would increase (decrease) other comprehensive income by $2,176,000 and $2,744,000 as at August 31, 2016 and 2017 respectively.

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The impact of the change in the value of the Canadian dollar compared to the US dollar and the euro on these derivative and non-derivative financial assets and liabilities is recorded in the foreign exchange gain or loss line item in the consolidated statements of earnings, except for outstanding forward contracts, whose impact is recorded in other comprehensive income. The change in the value of the Canadian dollar compared to the US dollar and the euro also affects the company's balances of income tax recoverable or payable, as well as deferred income tax assets and liabilities denominated in US dollars and euros; this may result in additional and significant foreign exchange gains or losses. However, these tax-related assets and liabilities are not considered financial instruments and are therefore excluded from the sensitivity analysis above. The foreign exchange rate fluctuations also flow through the consolidated statements of earnings line items, as a significant portion of the company's cost of sales and operating expenses are denominated in Canadian dollars, euros, British pounds and Indian rupees, and the company reports its results in US dollars; that effect is not reflected in the sensitivity analysis above.

Interest rate risk

The company has limited exposure to interest rate risk. The company is mainly exposed to interest rate risks through its cash and short-term investments.

Cash

As at August 31, 2016 and 2017, the company's cash balances included an amount of $23,277,000 and $6,681,000 respectively that bears interest at an annual rate of 1.2%.

Short-term investments

Short-term investments consist of the following:

| | As at August 31, | |
|---|---|---|
| | 2017 | 2016 |
| Term deposits denominated in Indian rupees, bearing interest at annual rates of 4.3% to 6.9% in 2017 and 6.0% to 7.3% in 2016, maturing on different dates between October 2017 and October 2018 in 2017 and November 2016 and October 2018 in 2016 | $775 | $1,419 |
| Term deposit denominated in Canadian dollars, bearing interest at an annual rate of 1.5%, matured in May 2017 | | 2,668 |
| | $775 | $4,087 |

Due to their short-term maturity, the company's short-term investments are not subject to a significant fair value interest rate risk. Accordingly, changes in fair value have been nominal to the degree that amortized cost approximates the fair value. Any change in the fair value of the company's short-term investments, all of which are classified as available for sale, is recorded in other comprehensive income.

Other financial instruments

Accounts receivable, other assets, accounts payable and accrued liabilities and the contingent liability are non-interest-bearing financial assets and liabilities.

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Credit risk

Financial instruments that potentially subject the company to credit risk consist of cash, short-term investments, accounts receivable, other assets and forward exchange contracts (with a positive fair value). As at August 31, 2017, the company's short-term investments consist of debt instruments issued by high-credit quality corporations. These debt instruments are not expected to be affected by a significant credit risk. The company's cash and forward exchange contracts are held with or issued by high-credit quality financial institutions; therefore, the company considers the risk of non-performance on these instruments to be limited.

Generally, the company does not require collateral or other security from customers for trade accounts receivable; however, credit is extended to customers following an evaluation of creditworthiness. In addition, the company performs ongoing credit reviews of all its customers and establishes an allowance for doubtful accounts receivable when accounts are determined to be uncollectible. Allowance for doubtful accounts amounted to $3,752,000 and $2,960,000 as at August 31, 2016 and 2017 respectively.

For the year ended August 31, 2017, the company's top customer represented 10.1% of sales. For the years ended August 31, 2015 and 2016, no customer represented more than 10% of sales.

The following table summarizes the age of trade accounts receivable:

| | As at August 31, | |
|---|---|---|
| | 2017 | 2016 |
| Current | $35,100 | $38,411 |
| Past due, 0 to 30 days | 3,049 | 1,286 |
| Past due, 31 to 60 days | 1,289 | 868 |
| Past due, more than 60 days, net of allowance for doubtful accounts of $3,752 and $2,960 as at August 31, 2016 and 2017, respectively | 1,692 | 2,428 |
| | $41,130 | $42,993 |

Changes in the allowance for doubtful accounts are as follows:

| | Years ended August 31, | |
|---|---|---|
| | 2017 | 2016 |
| Balance – Beginning of year | $3,752 | $2,935 |
| Addition charged to earnings | 654 | 817 |
| Writeoff of uncollectible accounts | (1,446) | |
| Balance – End of year | $2,960 | $3,752 |

Liquidity risk

Liquidity risk is defined as the potential that the company cannot meet its obligations as they become due.

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The following tables summarize the contractual maturity of the company's derivative and non-derivative financial liabilities:

| | As at August 31, 2017 | |
|---|---|---|
| | 0-12 months | 13-24 months |
| Accounts payable and accrued liabilities | $36,776 | $ |
| Contingent liability | 1,092 | |
| Forward exchange contracts | | |
| Outflow | 21,700 | 12,500 |
| Inflow | (23,265) | (13,357) |
| Total | $36,303 | $(857) |

| | As at August 31, 2016 | | |
|---|---|---|---|
| | 0-12 months | 13-24 months | 25-36 months |
| Accounts payable and accrued liabilities | $36,099 | $ | $ |
| Forward exchange contracts | | | |
| Outflow | 26,000 | 9,900 | 1,900 |
| Inflow | (25,653) | (10,089) | (1,976) |
| Total | $36,446 | $(189) | $(76) |

As at August 31, 2017, the company had $39,210,000 in cash and short-term investments and $45,037,000 in accounts receivable. In addition to these financial assets, the company has unused available lines of credit totaling $15,424,000 for working capital and other general corporate purposes, including potential acquisitions as well as unused lines of credit totaling $25,676,000 for foreign currency exposure related to its forward exchange contracts (notes 10 and 22).

## 7 Inventories

| | As at August 31, 2017 | 2016 |
|---|---|---|
| Raw materials | $18,899 | $18,692 |
| Work in progress | 886 | 1,067 |
| Finished goods | 14,047 | 13,245 |
| | $33,832 | $33,004 |

The cost of sales comprised almost exclusively the amount of inventory recognized as an expense during the reporting years, and amounts to $88,098,000, $89,058,000 and $98,503,000 for the years ended August 31, 2015, 2016 and 2017 respectively, including related depreciation and amortization, which are shown separately in operating expenses (note 17).

Inventory writedown amounted to $4,066,000, $3,678,000 and $3,259,000 for the years ended August 31, 2015, 2016 and 2017 respectively.

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8 Property, Plant and Equipment

| | Land and land improvements | Buildings | Equipment | Leasehold improvements | Total |
|---|---|---|---|---|---|
| Cost as at September 1, 2015 | $ 4,309 | $ 29,472 | $ 31,209 | $ 2,794 | $ 67,784 |
| Additions | | 201 | 3,626 | 226 | 4,053 |
| Disposals | | (11) | (4,280) | (121) | (4,412) |
| Foreign currency translation adjustment | 13 | 93 | 162 | 19 | 287 |
| Cost as at August 31, 2016 | 4,322 | 29,755 | 30,717 | 2,918 | 67,712 |
| Additions | | 794 | 5,562 | 319 | 6,675 |
| Business combinations (note 3) | | | 130 | | 130 |
| Disposals | | | (2,568) | (339) | (2,907) |
| Foreign currency translation adjustment | 200 | 1,402 | 1,733 | 150 | 3,485 |
| Cost as at August 31, 2017 | $ 4,522 | $ 31,951 | $ 35,574 | $ 3,048 | $ 75,095 |
| | | | | | |
| Accumulated depreciation as at September 1, 2015 | $ 1,142 | $ 5,943 | $ 24,213 | $ 791 | $ 32,089 |
| Depreciation for the year | 45 | 639 | 2,811 | 319 | 3,814 |
| Disposals | | (11) | (4,258) | (121) | (4,390) |
| Foreign currency translation adjustment | 5 | 31 | 136 | 49 | 221 |
| Accumulated depreciation as at August 31, 2016 | 1,192 | 6,602 | 22,902 | 1,038 | 31,734 |
| Depreciation for the year | 45 | 403 | 3,162 | 292 | 3,902 |
| Disposals | | | (2,210) | (339) | (2,549) |
| Foreign currency translation adjustment | 58 | 328 | 1,353 | 137 | 1,876 |
| Accumulated depreciation as at August 31, 2017 | $ 1,295 | $ 7,333 | $ 25,207 | $ 1,128 | $ 34,963 |
| | | | | | |
| Net carrying value as at: | | | | | |
| August 31, 2016 | $ 3,130 | $ 23,153 | $ 7,815 | $ 1,880 | $ 35,978 |
| August 31, 2017 | $ 3,227 | $ 24,618 | $ 10,367 | $ 1,920 | $ 40,132 |

As at August 31, 2016 and 2017, unpaid additions to property, plant and equipment amounted to $499,000 and $522,000 respectively.

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## 9 Intangible Assets and Goodwill

Intangible assets

| | Core technology | Customer relationships | Brand name | Software | Total |
|---|---|---|---|---|---|
| Cost as at September 1, 2015 | $ 10,521 | $ 4,935 | $ 492 | $ 10,728 | $ 26,676 |
| Additions | 147 | | | 313 | 460 |
| Disposals | (6,414) | (4,935) | (492) | (310) | (12,151) |
| Foreign currency translation adjustment | 48 | | | 112 | 160 |
| Cost as at August 31, 2016 | 4,302 | | | 10,843 | 15,145 |
| Additions | | | | 912 | 912 |
| Business combinations (note 3) | 7,932 | 1,607 | | | 9,539 |
| Disposals | (76) | | | (407) | (483) |
| Foreign currency translation adjustment | 735 | 82 | | 553 | 1,370 |
| Cost as at August 31, 2017 | $ 12,893 | $ 1,689 | $ | $ 11,901 | $ 26,483 |
| | | | | | |
| Accumulated amortization as at September 1, 2015 | $ 7,912 | $ 4,935 | $ 492 | $ 9,241 | $ 22,580 |
| Amortization for the year | 700 | | | 472 | 1,172 |
| Disposals | (6,414) | (4,935) | (492) | (297) | (12,138) |
| Foreign currency translation adjustment | 109 | | | 31 | 140 |
| Accumulated amortization as at August 31, 2016 | 2,307 | | | 9,447 | 11,754 |
| Amortization for the year | 2,617 | 167 | | 505 | 3,289 |
| Disposals | (54) | | | (398) | (452) |
| Foreign currency translation adjustment | 260 | 2 | | 447 | 709 |
| Accumulated amortization as at August 31, 2017 | $ 5,130 | $ 169 | $ | $ 10,001 | $ 15,300 |
| | | | | | |
| Net carrying value as at: | | | | | |
| August 31, 2016 | $ 1,995 | $ | $ | $ 1,396 | $ 3,391 |
| August 31, 2017 | $ 7,763 | $ 1,520 | $ | $ 1,900 | $ 11,183 |
| | | | | | |
| Remaining amortization period as at August 31, 2017 | 4 years | 5 years | | 5 years | |

Goodwill

| | Years ended August 31, | |
|---|---|---|
| | 2017 | 2016 |
| Balance – Beginning of year | $ 21,928 | $ 21,860 |

| | | |
|---|---|---|
| Business combinations (note 3) | 11,470 | |
| Foreign currency translation adjustment | 1,679 | 68 |
| Balance – End of year | $35,077 | $21,928 |

In the fourth quarter of fiscal 2016 and 2017, the company performed its annual goodwill impairment test for all CGUs.

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:

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| | As at August 31, | |
|---|---|---|
| | 2017 | 2016 |
| EXFO CGU | $13,772 | $8,663 |
| Brix CGU | 13,878 | 13,265 |
| Ontology CGU (note 3) | 7,427 | |
| Total | $35,077 | $21,928 |

In performing the goodwill impairment review of its CGUs, the company determined the recoverable amount of goodwill based on fair value less costs of disposal. In estimating the recoverable amount of its CGUs, the company 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. The company applied judgment in making certain adjustments for factors such as size, risk profile or profitability of the comparable businesses, when compared to the company's CGU.

Furthermore, as the sales and operations of the EXFO CGU constitutes the significant majority of the company's sales and operations, the company also compared the carrying amount of the EXFO CGU to the company's 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, management 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 the company's market approach described above.

As the valuation techniques used by the company require the use of unobservable inputs, the recoverable amount of the company's CGUs is classified within Level 3 of the fair value hierarchy.

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 if we assume sales multiples of 0.7, 0.6 and 2.2 times sales respectively.

10 Credit Facilities

The company has lines of credit that provide for advances of up to CA$5,800,000 (US$4,627,000) and up to US$6,000,000. The line of credit in Canadian dollars bears interest at the Canadian prime rate and the line of credit in US dollars bears interest at the US prime rate. As at August 31, 2017, an amount of CA$736,000 (US$587,000) was drawn from these lines of credit for letters of guarantee in the normal course of the company's operations for its own selling and purchasing requirements. The company also has a line of credit that provides for advances of up to CA$6,750,000 (US$5,384,000). This line of credit bears interest at the Canadian prime rate (note 22).

In addition, the company has lines of credit totaling $26,731,000 for the foreign currency risk exposure related to its US dollar – Canadian dollar forward exchange contracts (note 6). As at August 31, 2017, an amount of $1,955,000 was reserved from these lines of credit.

Finally, the company has a line of credit of INR 115,385,000 (US$1,800,000) for the foreign currency risk exposure related to its US dollar – Indian rupee forward exchange contracts (note 6). As at August 31, 2017, an amount of INR 57,692,000 (US$900,000) was reserved from this line of credit.

Accounts receivable were pledged as collateral against all these lines of credit, which are also subject to a negative pledge whereby the company has agreed with the banks not to pledge its assets to any other party without its consent.

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## 11 Accounts Payable and Accrued Liabilities and Provisions

Accounts payable and accrued liabilities

| | As at August 31, | |
|---|---|---|
| | 2017 | 2016 |
| Trade | $19,002 | $16,940 |
| Salaries and social benefits | 15,176 | 16,188 |
| Forward exchange contracts (note 6) | | 1,075 |
| Other | 2,598 | 2,971 |
| | $36,776 | $37,174 |

Provisions

| | As at August 31, | |
|---|---|---|
| | 2017 | 2016 |
| Warranty | $320 | $299 |
| Contingent liability (note 3) | 1,092 | |
| Restructuring charges (note 4) | 2,477 | |
| | $3,889 | $299 |

## 12 Commitments

The company entered into operating leases for certain of its premises and equipment, which expire at various dates through 2023. Minimum rentals payable under operating leases are as follows:

| | As at August 31, | |
|---|---|---|
| | 2017 | 2016 |
| No later than 1 year | $2,176 | $2,213 |
| Later than 1 year and no later than 5 years | 6,238 | 3,050 |
| Later than 5 years | 1,681 | 1,037 |
| | $10,095 | $6,300 |

For the years ended August 31, 2015, 2016 and 2017, rental expenses under operating leases amounted to $2,845,000, $2,728,000 and $2,945,000 respectively.

The company also entered into license agreements for certain intellectual property which expire at various dates through 2022:

| | As at August 31, | |
| --- | --- | --- |
| | 2017 | 2016 |
| No later than 1 year | $1,264 | $1,124 |
| Later than 1 year and no later than 5 years | 1,450 | 826 |
| | $2,714 | $1,950 |

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13 Share Capital

Authorized – unlimited as to number, without par value
Subordinate voting and participating, bearing a non-cumulative dividend to be determined by the Board of Directors, ranking pari passu with multiple voting shares
Multiple voting and participating, entitling to 10 votes each, bearing a non-cumulative dividend to be determined by the Board of Directors, convertible at the holder's option into subordinate voting shares on a one-for-one basis, ranking pari passu with subordinate voting shares

The following table summarizes the share capital activity:

| | Multiple Voting Shares | | Subordinate Voting Shares | | |
|---|---|---|---|---|---|
| | Number | Amount | Number | Amount | Total amount |
| Balance as at September 1, 2014 | 31,643,000 | $ 1 | 28,703,750 | $111,490 | $111,491 |
| Redemption of restricted share units (note 15) | | – | 229,559 | – | – |
| Redemption of deferred share units (note 15) | | – | 48,697 | – | – |
| Redemption of share capital | | – | (6,889,972 ) | (26,827 ) | (26,827 ) |
| Reclassification of stock-based compensation costs to share capital upon exercise of stock awards | – | – | – | 1,381 | 1,381 |
| Balance as at August 31, 2015 | 31,643,000 | 1 | 22,092,034 | 86,044 | 86,045 |
| Redemption of restricted share units (note 15) | – | – | 277,805 | – | – |
| Redemption of deferred share units (note 15) | – | – | 653 | – | – |
| Redemption of share capital | – | – | (452,550 ) | (1,768 ) | (1,768 ) |
| Reclassification of stock-based compensation costs to share capital upon exercise of stock awards | – | – | – | 1,239 | 1,239 |
| Balance as at August 31, 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 (note 15) | – | – | 327,859 | – | – |
| Redemption of deferred share units (note 15) | – | – | 29,906 | – | – |
| Reclassification of stock-based compensation costs to share capital upon exercise of stock awards | – | – | – | 1,405 | 1,405 |
| Balance as at August 31, 2017 | 31,643,000 | $ 1 | 23,068,777 | $90,410 | $90,411 |

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a) On January 7, 2015, the company announced that its Board of Directors had authorized a substantial issuer bid (the "Offer") to purchase for cancellation up to 7,142,857 subordinate voting shares for an aggregate purchase price not to exceed CA$30,000,000. On February 20, 2015, pursuant to the Offer, the company purchased for cancellation 6,521,739 subordinate voting shares for an aggregate purchase price of CA$30,000,000 (US$24,027,000), plus related fees of $223,000. The company used cash to fund the purchase of shares.

b) On March 25, 2015, the company announced that its Board of Directors had approved the renewal of its share repurchase program, by way of a normal course issuer bid on the open market of up to 10% of the issued and outstanding subordinate voting shares, representing 1,397,598 subordinate voting shares at the prevailing market price. The normal course issuer bid started on March 27, 2015, and ended on March 26, 2016. All shares repurchased under the bid were cancelled.

c) On March 29, 2016, the company announced that its Board of Directors had approved the renewal of its share repurchase program, by way of a normal course issuer bid on the open market of up to 6.6% of the issued and outstanding subordinate voting shares, representing 900,000 subordinate voting shares at the prevailing market price. The normal course issuer bid started on April 1, 2016, and ended on March 31, 2017. All share repurchased under that bid were cancelled.

## 14 Accumulated Other Comprehensive Loss

Changes in accumulated other comprehensive loss are as follows:

| | Foreign currency translation adjustment | Cash-flow hedge | Accumulated other comprehensive loss |
|---|---|---|---|
| Balance as at September 1, 2014 | $ (10,668) | $ 409 | $ (10,259) |
| Foreign currency translation adjustment | (39,175) | – | (39,175) |
| Changes in unrealized losses on forward exchange contracts, net of deferred income taxes | – | (2,571) | (2,571) |
| Balance as at August 31, 2015 | (49,843) | (2,162) | (52,005) |
| Foreign currency translation adjustment | 707 | | 707 |
| Changes in unrealized gains/losses on forward exchange contracts, net of deferred income taxes | | 2,724 | 2,724 |
| Balance as at August 31, 2016 | (49,136) | 562 | (48,574) |
| Foreign currency translation adjustment | 8,262 | | 8,262 |
| Changes in unrealized gains/losses on forward exchange contracts, net of deferred income taxes | | 1,347 | 1,347 |

| | | | |
|---|---|---|---|
| Balance as at August 31, 2017 | $ (40,874 ) | $ 1,909 | $ (38,965 ) |

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## 15 Stock-Based Compensation Plans

The following table summarizes the stock-based compensation costs recognized for employee services received during the years ended August 31, 2015, 2016 and 2017:

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Stock-based compensation costs arising from equity-settled awards | $1,439 | $1,394 | $1,323 |
| Stock-based compensation costs arising from cash-settled awards | 38 | (16 ) | (28 ) |
| | $1,477 | $1,378 | $1,295 |

The maximum number of additional subordinate voting shares issuable under the Long-Term Incentive Plan and the Deferred Share Unit Plan cannot exceed 6,306,153 shares. The maximum number of subordinate voting shares that may be granted to any individual on an annual basis cannot exceed 5% of the number of outstanding subordinate voting shares. The company settles equity-settled awards through the issuance of common shares from treasury.

### Long-Term Incentive Plan

The company established the Long-Term Incentive Plan for its directors, executive officers and employees and those of its subsidiaries, as determined by the Board of Directors. The plan, which includes stock options and restricted share units, was approved by the shareholders of the company.

### Stock Options

The exercise price of stock options granted under the Long-Term Incentive Plan is the market price of the common shares on the date of grant. Stock options granted under the plan expire 10 years from the date of grant and generally vest over a four-year period, being the required period of service from employees, generally with 25% vesting on an annual basis commencing on the first anniversary of the date of grant. As at August 31, 2017, the company had no outstanding or exercisable stock options.

The following table summarizes stock option activity for the years ended August 31, 2015 and 2016 (no activities in 2017):

| Years ended August 31, | | | |
|---|---|---|---|
| 2016 | | 2015 | |
| Number | Weighted average exercise | Number | Weighted average exercise |

| | | price (CA$) | | price (CA$) |
|---|---|---|---|---|
| Outstanding – Beginning of year | 17,099 | $ 6 | 87,454 | $ 6 |
| Forfeited | – | – | (2,000 ) | 6 |
| Expired | (17,099) | 6 | (68,355) | 6 |
| Outstanding – End of year | – | $ – | 17,099 | $ 6 |
| Exercisable – End of year | – | $ – | 17,099 | $ 6 |

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Restricted Share Units (RSUs)

RSUs are stock awards that rise and fall in value based on the market price of the company's subordinate voting shares and are redeemable for actual subordinate voting shares. Vesting dates are also established by the Board of Directors on the date of grant. The vesting dates are subject to a minimum term of three years and a maximum term of 10 years from the award date, being the required period of service from employees. Fair value of RSUs equals the market price of the common shares on the date of grant.

The following table summarizes RSU activity for the years ended August 31, 2015, 2016 and 2017:

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Outstanding – Beginning of year | 1,551,555 | 1,299,958 | 1,225,135 |
| Granted | 527,143 | 572,008 | 409,521 |
| Redeemed | (327,859 ) | (277,805 ) | (229,559 ) |
| Forfeited | (139,509 ) | (42,606 ) | (105,139 ) |
| Outstanding – End of year | 1,611,330 | 1,551,555 | 1,299,958 |

None of the RSUs outstanding as at August 31, 2016 and 2017 were redeemable. The weighted average grant-date fair value of RSUs granted during the years ended August 31, 2015, 2016 and 2017 amounted to $3.63, $3.23 and $4.54 respectively.

The weighted-average market price of the shares at the date of redemption of RSUs redeemed during the years ended August 31, 2015, 2016 and 2017, was $3.60, $3.03 and $4.55 respectively.

Deferred Share Unit Plan

The company established a Deferred Share Unit (DSU) Plan for the members of the Board of Directors as part of their annual retainer fees. Each DSU entitles the Board members to receive one subordinate voting share. DSUs are acquired on the date of grant and are redeemed in subordinate voting shares when the Board member ceases to be Director of the company. This plan was approved by the shareholders of the company.

The following table summarizes DSU activity for the years ended August 31, 2015, 2016 and 2017:

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Outstanding – Beginning of year | 159,127 | 114,810 | 117,701 |
| Granted | 45,058 | 44,970 | 45,806 |
| Redeemed | (29,906 ) | (653 ) | (48,697 ) |
| Outstanding – End of year | 174,279 | 159,127 | 114,810 |

As at August 31, 2016 and 2017, none of the DSUs outstanding were redeemable. The weighted average grant-date fair value of DSUs granted during the years ended August 31, 2015, 2016 and 2017, amounted to $3.38, $3.33 and $4.53 respectively.

The weighted-average market price of the shares at the date of redemption of DSUs redeemed during the years ended August 31, 2015, 2016 and 2017, was $3.49, $3.04 and $5.02 respectively.

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

Stock Appreciation Rights Plan

The company established the Stock Appreciation Rights Plan for certain employees. Under that plan, eligible employees are entitled to receive a cash amount equivalent to the difference between the market price of the common shares on the date of exercise and the exercise price determined on the date of grant. Stock appreciation rights granted under the plan expire 10 years from the date of grant and generally vest over a four-year period, being the required period of service from employees. This plan was approved by the shareholders of the company.

The following table summarizes stock appreciation rights activity for the years ended August 31, 2015, 2016 and 2017:

| | Years ended August 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2017 | | 2016 | | 2015 | |
| | Number | Weighted average exercise price | Number | Weighted average exercise price | Number | Weighted average exercise price |
| Outstanding – Beginning of year | 33,500 | $ 1 | 42,324 | $ 1 | 39,874 | $ 2 |
| Granted | 7,900 | – | 7,800 | – | 6,150 | – |
| Exercised | (14,104) | 2 | (12,927) | 5 | (500) | 6 |
| Expired | – | – | (1,500) | 7 | (2,000) | 5 |
| Forfeited | – | – | (2,197) | – | (1,200) | 6 |
| Outstanding – End of year | 27,296 | $ 1 | 33,500 | $ 1 | 42,324 | $ 1 |
| Exercisable – End of year | 4,721 | $ 3 | 14,000 | $ 3 | 22,924 | $ 3 |

The liability arising from stock appreciation rights as at August 31, 2016 and 2017 amounted to $76,000 and $115,000 respectively and is recorded in accounts payable and accrued liabilities in the consolidated balance sheets.

The following table summarizes information about outstanding stock appreciation rights as at August 31, 2017:

| | Stock appreciation rights outstanding | | Stock appreciation rights exercisable |
|---|---|---|---|
| Exercise price | Number | Weighted average remaining contractual life | Number |
| $ – | 22,575 | 8 years | – |

| | | | |
|---|---|---|---|
| $ 2.36 | 2,721 | 1 year | 2,721 |
| $ 3.74 | 1,500 | 2 years | 1,500 |
| $ 6.28 | 500 | – | 500 |
| | 27,296 | 7 years | 4,721 |

16 Related-Party Disclosures

Ultimate controlling shareholder

Mr. Germain Lamonde, the company's Executive Chairman, is the company's ultimate controlling shareholder.

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

Related party transaction

During the year ended August 31, 2015, following the merger of one subsidiary with the parent company, the subsidiary redeemed one share owned by G. Lamonde Investissements financiers, a company controlled by Mr. Germain Lamonde, for a cash consideration of $1, representing its paid-up capital.

Compensation of key management personnel

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Salaries and short-term employee benefits | $3,715 | $3,701 | $3,025 |
| Stock-based compensation costs | 775 | 826 | 617 |
| | $4,490 | $4,527 | $3,642 |

Key management personnel includes senior management and directors.

17 Statements of Earnings

Net research and development

Net research and development expenses comprise the following:

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Gross research and development expenses | $53,124 | $47,875 | $50,148 |
| Research and development tax credits and grants | (5,956 ) | (5,188 ) | (6,145 ) |
| Net research and development expenses for the year | $47,168 | $42,687 | $44,003 |

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Depreciation and amortization

Depreciation and amortization expenses by functional area are as follows:

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Cost of sales | | | |
| Depreciation of property, plant and equipment | $1,522 | $1,290 | $1,519 |
| Amortization of intangible assets | 2,652 | 702 | 1,540 |
| | 4,174 | 1,992 | 3,059 |
| Selling and administrative expenses | | | |
| Depreciation of property, plant and equipment | 530 | 501 | 524 |
| Amortization of intangible assets | 251 | 75 | 790 |
| | 781 | 576 | 1,314 |
| Net research and development expenses | | | |
| Depreciation of property, plant and equipment | 1,850 | 2,023 | 2,792 |
| Amortization of intangible assets | 386 | 395 | 553 |
| | 2,236 | 2,418 | 3,345 |
| | $7,191 | $4,986 | $7,718 |
| Depreciation of property, plant and equipment | $3,902 | $3,814 | $4,835 |
| Amortization of intangible assets | 3,289 | 1,172 | 2,883 |
| Total depreciation and amortization expenses for the year | $7,191 | $4,986 | $7,718 |

Employee compensation

Employee compensation comprises the following:

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Salaries and benefits | $115,832 | $112,569 | $114,868 |
| Restructuring charges | 3,509 | | 1,637 |
| Stock-based compensation costs | 1,414 | 1,378 | 1,295 |
| Total employee compensation for the year | $120,755 | $113,947 | $117,800 |

Restructuring charges by functional area are as follows:

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Cost of sales | $1,697 | $ | $290 |
| Selling and administrative expenses | 1,150 | | 586 |
| Net research and development costs | 2,232 | | 761 |
| Total restructuring charges for the year | $5,079 | $ | $1,637 |

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

Stock-based compensation costs by functional area are as follows:

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Cost of sales | $121 | $107 | $159 |
| Selling and administrative expenses | 1,052 | 972 | 791 |
| Net research and development expenses | 304 | 299 | 345 |
| Total stock-based compensation costs for the year | $1,477 | $1,378 | $1,295 |

18 Other Disclosures

Government grants

The company is entitled to receive grants on certain eligible research and development projects conducted in Finland from TEKES, a Finnish technology organization, which funds Finnish companies' high technology research and innovations. The company's eligible research and development projects must be pre-approved by TEKES, and the grant is subject to certain conditions. In the event that a condition is not met, TEKES can require reimbursement of a portion or the entire amount of the grant received. A liability to repay the funding is recognized in the period in which conditions arise that will cause the funding to be repayable. As at August 31, 2017, the company was in compliance with the conditions of the funding. This funding is accounted for as a reduction of gross research and development expenses in the consolidated statements of earnings. For the years ended August 31, 2015, 2016 and 2017, the company recorded $919,000, $299,000 and $146,000 respectively, under that program in the consolidated statements of earnings.

Defined contribution pension plans

The company maintains separate defined contribution pension plans for certain eligible employees. These plans, which are accounted for on an accrual basis, are summarized as follows:

· Canadian defined contribution pension plan

The company maintains a plan for certain eligible employees residing in Canada, under which the company may elect to match the employees' contributions up to a maximum of 4% of an employee's gross salary. Cash contributions to this plan and expenses for the years ended August 31, 2015, 2016 and 2017, amounted to $1,492,000, $1,374,000 and $1,571,000 respectively.

· US defined contribution pension plan (401K plan)

The company maintains a 401K plan for eligible employees residing in the U.S. Under this plan, the company must contribute an amount equal to 3% of an employee's current compensation. In addition, eligible employees

may contribute up to the lesser of 1% of eligible compensation or the statutorily prescribed annual limit to the 401K plan. The 401K plan permits but does not require the company to make additional matching contributions to the 401K plan on behalf of the eligible participants, subject to a maximum of 50% of the first 6% of the participant's current compensation subject to certain legislated maximum contribution limits. During the years ended August 31, 2015, 2016 and 2017, the company recorded cash contributions and expenses totaling $628,000, $622,000 and $630,000 respectively.

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

19 Income Taxes

The reconciliation of the income tax provision calculated using the combined Canadian federal and provincial statutory income tax rate with the income tax provision in the financial statements is as follows:

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Income tax provision at combined Canadian federal and provincial statutory tax rate (27%) | $2,014 | $4,499 | $2,671 |
| Increase (decrease) due to: | | | |
| Foreign income/loss taxed at different rates | (900) | (1,025) | 482 |
| Non-deductible loss (non-taxable income) | (245) | 5 | 2,540 |
| Non-deductible expenses | 981 | 411 | 664 |
| Change in tax rates | (10) | | |
| Foreign exchange effect of translation of foreign subsidiaries in the functional currency | 176 | 566 | (3,641) |
| Utilization of previously unrecognized deferred income tax assets | (46) | | |
| Unrecognized deferred income tax assets on temporary deductible differences and unused tax losses | 4,659 | 3,702 | 2,556 |
| Other | (21) | (394) | (236) |
| Income tax provision for the year | $6,608 | $7,764 | $5,036 |

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| The income tax provision consists of the following: | | | |
| Current | | | |
| Current income taxes | $5,554 | $6,186 | $4,633 |
| Deferred | | | |
| Deferred income taxes relating to the origination and reversal of temporary differences | (3,605) | (2,124) | (2,153) |
| Unrecognized deferred income tax assets on temporary deductible differences and unused tax losses | 4,659 | 3,702 | 2,556 |
| | 1,054 | 1,578 | 403 |
| Income tax provision for the year | $6,608 | $7,764 | $5,036 |

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EXFO Inc.
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Deferred taxes

| | As at August 31, 2017 | 2016 |
|---|---|---|
| Deferred income tax assets | | |
| Deferred income tax assets recoverable within 12 months | $3,361 | $4,224 |
| Deferred income tax assets recoverable after 12 months | 3,194 | 4,016 |
| | 6,555 | 8,240 |
| Deferred income tax liabilities | | |
| Deferred income tax liabilities payable within 12 months | 499 | 645 |
| Deferred income tax liabilities payable after 12 months | 2,617 | 2,212 |
| | 3,116 | 2,857 |
| Deferred income tax assets net | $3,439 | $5,383 |

The changes in deferred income tax assets and liabilities for the year ended August 31, 2016 are as follows:

| | Balance as at September 1, 2015 | Credited (charged) to the statement of earnings | Credited (charged) to shareholders' equity | Foreign currency translation adjustment | Balance as at August 31, 2016 |
|---|---|---|---|---|---|
| Deferred income tax assets | | | | | |
| Long-lived assets | $ 2,849 | $ (595) | $ | $ 1 | $2,255 |
| Provisions and accruals | 5,024 | 177 | (935) | (20) | 4,246 |
| Deferred revenue | 1,308 | 1,015 | | 7 | 2,330 |
| Research and development expenses | 2,240 | 112 | | 9 | 2,361 |
| Losses carried forward | 6,551 | (1,951) | | (2) | 4,598 |
| Deferred income tax liabilities | | | | | |
| Research and development tax credits | (10,037) | (336) | | (34) | (10,407) |
| Total | $ 7,935 | $ (1,578) | $ (935) | $ (39) | $5,383 |
| Classified as follows: | | | | | |
| Deferred income tax assets | $ 9,459 | | | | $8,240 |
| Deferred income tax liabilities | (1,524) | | | | (2,857) |
| | $ 7,935 | | | | $5,383 |

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The changes in deferred income tax assets and liabilities for the year ended August 31, 2017 are as follows:

| | Balance as at September 1, 2016 | Credited (charged) to the statement of earnings | Credited (charged) to shareholders' equity | Business combinations | Foreign currency translation adjustment | Balance as at August 31, 2017 |
|---|---|---|---|---|---|---|
| Deferred income tax assets | | | | | | |
| Long-lived assets | $ 2,255 | $ (240 ) | $ | $ (279 ) | $ 66 | $ 1,802 |
| Provisions and accruals | 4,246 | (89 ) | (479 ) | | 94 | 3,772 |
| Deferred revenue | 2,330 | 486 | | | 74 | 2,890 |
| Research and development expenses | 2,361 | 248 | | | 122 | 2,731 |
| Losses carried forward | 4,598 | (1,470 ) | | 1,059 | 54 | 4,241 |
| Deferred income tax liabilities | | | | | | |
| Long-lived assets | | 111 | | (1,059 ) | (54 ) | (1,002 ) |
| Research and development tax credits | (10,407 ) | (100 ) | | | (488 ) | (10,995) |
| Total | $ 5,383 | $ (1,054 ) | $ (479 ) | $ (279 ) | $ (132 ) | $ 3,439 |
| Classified as follows: | | | | | | |
| Deferred income tax assets | $ 8,240 | | | | | $ 6,555 |
| Deferred income tax liabilities | (2,857 ) | | | | | (3,116 ) |
| | $ 5,383 | | | | | $ 3,439 |

Unrecognized deferred income tax assets on temporary deductible differences and unused tax losses are as follows:

| | As at August 31, 2017 | 2016 |
|---|---|---|
| Temporary deductible differences | $ 2,271 | $ 1,676 |
| Losses carried forward | 43,670 | 38,287 |
| | $ 45,941 | $ 39,963 |

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

As at August 31, 2017, the year of expiry of operating losses for which no deferred income tax assets were recognized in the consolidated balance sheet are as follows, presented by tax jurisdiction:

| Year of expiry | Finland | United States | United Kingdom |
|---|---|---|---|
| 2018 | $444 | $741 | $ |
| 2019 | | 3,470 | |
| 2020 | 7,848 | 7,991 | |
| 2021 | 6,799 | 2,211 | |
| 2022 | 11,788 | 7,435 | |
| 2023 | 7,637 | 1,972 | |
| 2024 | 5,896 | 1,351 | |
| 2025 | 7,350 | 1,351 | |
| 2026 | 251 | 1,351 | |
| 2027 | 2,035 | 1,351 | |
| 2028 | | 2,447 | |
| 2030 | | 2,713 | |
| 2031 | | 109 | |
| 2033 | | 4,681 | |
| 2034 | | 4,851 | |
| 2035 | | 2,616 | |
| 2036 | | 8,501 | |
| 2037 | | 8,988 | |
| Indefinite | | | 3,737 |
| | $50,048 | $64,130 | $ 3,737 |

Furthermore, as at August 31, 2017, the company had available capital losses in Canada amounting to $53,396,000 (CA$66,937,000) at the federal level and $56,696,000 (CA$71,074,000) at the provincial level for which no deferred income tax assets were recognized. These losses can be carried forward indefinitely against capital gains.

As at August 31, 2017, non-refundable research and development tax credits recognized in the consolidated balance sheet amounted to $40,501,000. In order to recover these non-refundable research and development tax credits, the company needs to generate approximately $262,000,000 (CA$328,000,000) in pre-tax earnings at the Canadian federal level and approximately $12,000,000 at the Canadian provincial level. In order to generate $262,000,000 in pre-tax earnings at the Canadian Federal level over the estimated recovery period of 15 years, the company must generate a pre-tax earnings compound annual growth rate (CAGR) of 2%, which the company believes is probable. The company's non-refundable research and development tax credits can be carried forward over a twenty-year period.

In addition, as at August 31, 2017, the company had deferred income tax assets in the consolidated balance sheet in the amount of $3,239,000 for operating losses in the United States. In order to recover these deferred income tax assets, the company needs to generate approximately $9,500,000 in pre-tax earnings at the United States level, and in order to do so over the estimated recovery period of three years, the company must generate a pre-tax earnings CAGR of 2%, which the company believes is probable. The company's operating losses in the United States can be carried forward over a twenty-year period.

As at August 31, 2017, no income taxes were recognized on taxable temporary differences of $17,006,000; such taxes would be payable on the unremitted earnings of certain of the company's subsidiaries, as the company has determined that:

(1) Undistributed profits of its foreign subsidiaries will not be distributed in the foreseeable future; and
(2) Undistributed profits of its domestic subsidiaries will not be taxable when distributed.

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## 20 Earnings per Share

The following table summarizes the reconciliation of the basic weighted average number of shares outstanding and the diluted weighted average number of shares outstanding:

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Basic weighted average number of shares outstanding (000's) | 54,423 | 53,863 | 56,804 |
| Plus dilutive effect of (000's): | | | |
| Restricted share units | 979 | 675 | 549 |
| Deferred share units | 153 | 131 | 104 |
| Diluted weighted average number of shares outstanding (000's) | 55,555 | 54,669 | 57,457 |
| Stock awards excluded from the calculation of the diluted weighted average number of shares outstanding because their exercise price was greater than the average market price of the common shares (000's) | | 75 | 57 |

## 21 Segment Information

Sales for products and services are detailed as follows:

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Products | $213,653 | $205,371 | $193,427 |
| Services | 29,648 | 27,212 | 28,662 |
| | $243,301 | $232,583 | $222,089 |

Sales to external customers by geographic region are detailed as follows:

| | Years ended August 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| United States | $97,186 | $95,388 | $82,227 |
| Canada | 22,586 | 18,027 | 19,722 |
| Other | 14,951 | 14,129 | 17,547 |
| Americas | 134,723 | 127,544 | 119,496 |
| Europe, Middle-East and Africa | 62,101 | 57,172 | 57,274 |

| | | | |
|---|---|---|---|
| China | 22,312 | 25,281 | 21,526 |
| Other | 24,165 | 22,586 | 23,793 |
| Asia-Pacific | 46,477 | 47,867 | 45,319 |
| | $243,301 | $232,583 | $222,089 |

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Sales were allocated to geographic regions based on the country of residence of the related customers.

Long-lived assets by geographic region are detailed as follows:

| | As at August 31, 2017 | | | As at August 31, 2016 | | |
|---|---|---|---|---|---|---|
| | Property, plant and equipment | Intangible assets | Goodwill | Property, plant and equipment | Intangible assets | Goodwill |
| Canada | $29,417 | $ 4,643 | $ 3,890 | $27,048 | $ 1,330 | $ – |
| United States | 2,031 | 1,072 | 14,696 | 1,174 | 1,637 | 13,265 |
| Finland | 441 | 316 | 9,064 | 572 | 354 | 8,663 |
| United Kingdom | 915 | 5,093 | 7,427 | 797 | – | – |
| India | 4,000 | 27 | – | 3,602 | 37 | – |
| China | 3,227 | 32 | – | 2,657 | 33 | – |
| Other | 101 | – | – | 128 | – | – |
| | $40,132 | $ 11,183 | $ 35,077 | $35,978 | $ 3,391 | $ 21,928 |

22 Subsequent Events

Business combinations

Astellia SA

On September 8, 2017, the company acquired a 33.1% interest in 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 cost of this investment amounted to €8,568,000 (US$10,311,000), which was settled in cash on September 8, 2017.

On October 10, 2017, the company reached an agreement with Astellia to acquire Astellia's remaining shares at a share price of €10, for total consideration of €17,312,010 (approximately US$20,000,000) 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.

Yenista Optics S.A.S.

On October 2, 2017, the company 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. The acquisition-date fair value of the total consideration amounted to €9,400,000 (US$11,100,000) and consisted of €8,300,000 (US$9,700,000) in cash, net of Yenista's cash of €1,100,000 (US$1,400,000) at the acquisition date. This acquisition will be 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 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 the consolidated financial statements of the company starting October 2, 2017, being the acquisition date.

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Other

Credit facilities

On October 25, 2017, the company modified certain credit facilities whereby existing lines of credits, that provided advances up to CA$4,800,000 (US$3,829,000) and up to US$6,000,000 for operating purposes, were cancelled and replaced by a credit facility of CA$28,929,000 (US$23,077,000) mainly for the acquisition of the remaining shares of Astellia under the public tender offer. This credit facility bears interest at the Canadian prime rate and is secured by a movable mortgage of CA$65,000,000 (US$51,851,000) over the universality of the company's Canadian movable assets, present and future (note 10).

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## 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.

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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.

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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 73 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.

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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 Combinations", 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 a 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.



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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.

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

| | Years ended August 31, | | | | | |
|---|---|---|---|---|---|---|
| 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 73 for non-IFRS measures.

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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