UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2006

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission File Number 0-23081

FARO TECHNOLOGIES, INC.

(Exact name of Registrant as specified in its charter)

Florida	**59-3157093**
(State or other jurisdiction	*(I.R.S. Employer Identification Number)*
of incorporation or organization)	
125 Technology Park, Lake Mary, FL	**32746**
(Address of principal executive offices)	*(Zip code)*

(Registrant s telephone number, including area code): (407) 333-9911

Securities registered pursuant to Section 12(b) of the Act: Common Stock, par value $.001

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ¨ No þ

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definite proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes þ No ¨

Indicate by check mark whether the registrant is large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨   Accelerated filer þ   Non-accelerated filer ¨

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No þ

The aggregate market value of the Registrant s common stock held by non-affiliates of the Registrant on July 1, 2006, the last business day of the Registrant s most recently completed second fiscal quarter, was $362 million (based on the last sale on such date on the NASDAQ Global Market).

As of March 1, 2007, there were outstanding 14,706,969 shares of the Registrant s common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s proxy statement for the 2007 Annual Meeting of Shareholders are incorporated by reference in Part II.

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PART I

CAUTIONARY STATEMENTS FOR FORWARD-LOOKING INFORMATION

FARO Technologies, Inc. (FARO , the Company , us , we , or our) has made forward-looking statements in this report (within the meaning Private Securities Litigation Reform Act of 1995). Statements that are not historical facts or that describe our plans, beliefs, goals, intentions, objectives, projections, expectations, assumptions, strategies, or future events are forward-looking statements. In addition, words such as may, will, believe, plan, should, could, seek, expect, anticipate, intend, estimate, goal, objective, project, forecast, tar discussions of our strategy or other intentions identify forward-looking statements. Other written or oral statements that constitute forward-looking statements also may be made by the Company from time to time.

Forward-looking statements are not guarantees of future performance and are subject to a number of known and unknown risks, uncertainties, and other factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements. Consequently, undue reliance should not be placed on these forward-looking statements. We do not intend to update any forward-looking statements, whether as a result of new information, future events, or otherwise, unless otherwise required by law. Important factors that could cause a material difference in the actual results from those contemplated in such forward-looking statements include among others those under Cautionary Statements and elsewhere in this report and the following:

- our inability to further penetrate our customer base;
- development by others of new or improved products, processes or technologies that make our products obsolete or less competitive;
- our inability to maintain our technological advantage by developing new products and enhancing our existing products;
- our inability to successfully identify and acquire target companies or achieve expected benefits from acquisitions that are consummated;
- the cyclical nature of the industries of our customers and the financial condition of our customers;
- the fact that the market potential for the CAM2 market and the potential adoption rate for our products are difficult to quantify and predict;
- the inability to protect our patents and other proprietary rights in the United States and foreign countries and the assertion and ultimate outcome of infringement claims against us; including the existing suit by Hexagon s Romer-Cimcore subsidiary against us;
- fluctuations in our annual and quarterly operating results and the inability to achieve our financial operating targets as a result of a number of factors including, without limitation (i) litigation and regulatory action brought against us, (ii) quality issues with our products, (iii) excess or obsolete inventory, (iv) raw material price fluctuations, (v) expansion of our manufacturing capability and other inflationary pressures, (vi) the size and timing of customer orders, (vii) the amount of time that it takes to fulfill orders and ship our products, (viii) the length of our sales cycle to new customers and the time and expense incurred in further penetrating our existing customer base, (ix) increases in operating expenses required for product development and new product, marketing, (x) costs associated with new product introductions, such as product development, marketing, assembly line start-up costs and low introductory period production volumes, (xi) the timing and market acceptance of new products and product enhancements, (xii) customer order deferrals in anticipation of new products and product enhancements, (xiii) our success in expanding our sales and marketing programs, (xiii) costs associated with opening new sales offices outside of the United States, (xiv) start-up costs

associated with opening new sales offices outside of the United States, (xv) fluctuations in revenue without proportionate

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adjustments in fixed costs, (xvi) the efficiencies achieved in managing inventories and fixed assets, (xvii) investments in potential acquisitions or strategic sales, product or other initiatives, (xviii) shrinkage or other inventory losses due to product obsolescence, scrap or material price changes, (xiv) adverse changes in the manufacturing industry and general economic conditions, and (xx) other factors noted herein;

changes in gross margins due to changing product mix of products sold and the different gross margins on different products;

the outcome of the purported class action lawsuit;

our inability to successfully implement the requirements of Restriction of use of Hazardous Substances (RoHS) and Waste Electrical and Electronic Equipment (WEEE) compliance into our products;

the inability of our products to displace traditional measurement devices and attain broad market acceptance;

the impact of competitive products and pricing in the CAM2 market and the broader market for measurement and inspection devices;

the effects of increased competition as a result of recent consolidation in the CAM2 market;

risks associated with expanding international operations, such as fluctuations in currency exchange rates, difficulties in staffing and managing foreign operations, political and economic instability, and the burdens and potential exposure of complying with a wide variety of U.S. and foreign laws and labor practices;

unforeseen developments in our Foreign Corrupt Practices Act matter or in complying with the FCPA in the future;

higher than expected increases in expenses relating to our Asia Pacific expansion or our Singapore manufacturing facility;

the loss of our Chief Executive Officer, our Chief Technology Officer, our Chief Financial Officer, or other key personnel;

our inability to find less expensive alternatives to stock options to attract and retain employees;

difficulties in recruiting research and development engineers, and application engineers;

the failure to effectively manage our growth;

variations in the effective income tax rate and the difficulty in predicting the tax rate on a quarterly and annual basis;

- the loss of key suppliers and the inability to find sufficient alternative suppliers in a reasonable period or on commercially reasonable terms; and

- the matters set forth under Cautionary Statements in Management s Discussion and Analysis of Financial Condition and Results of Operations below.

ITEM 1. BUSINESS.

The Company designs, develops, manufactures, markets and supports portable, software driven, 3-D measurement systems that are used in a broad range of manufacturing, industrial, building construction and forensic applications. The Company s Faro Arm, Faro Scan Arm and Faro Gage articulated measuring devices, the Faro Laser Scanner LS, the Faro Laser Tracker, and their companion CAM2 software, provide for Computer-Aided Design (CAD)-based inspection and/or factory-level statistical process control and high-density surveying. Together, these products integrate the measurement, quality inspection, and reverse engineering functions with CAD software to improve productivity, enhance product quality and decrease rework and scrap in the manufacturing process. The Company uses the acronym CAM2 for this process, which stands for computer-aided manufacturing

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measurement. As of February 2007, the Company s products have been purchased by approximately 6,100 customers worldwide, ranging from small machine shops to such large manufacturing and industrial companies as Audi, Bell Helicopter, Boeing, British Aerospace, Caterpillar, Daimler Chrysler, General Electric, General Motors, Honda, Johnson Controls, Komatsu Dresser, Lockheed Martin, Nissan, Siemens and Volkswagen, among many others.

We were founded in 1982 and we re-incorporated in Florida in 1992. Our worldwide headquarters are located at 125 Technology Park, Lake Mary, Florida 32746, and our telephone number is (407) 333-9911.

Industry Background

The Company believes that there are four principal forces driving the need for its products and services: 1) the widespread use by manufacturers of CAD in product development which shortens product cycles; 2) the adoption by manufacturers of quality standards such as Six Sigma and ISO-9000 (and its offshoot QS-9000), which stress the measurement of every step in a manufacturing process to reduce or eliminate defects, 3) the inability of traditional measurement devices to address many manufacturing problems, especially those related to large components for products such as automobiles, aircraft, heavy duty construction equipment, and factory retrofits, and 4) the growing demand to capture large volumes of three-dimensional data for modeling and analysis.

CAD changes the manufacturing process. The creation of physical products involves the processes of design, engineering, production and measurement and quality inspection. These basic processes have been profoundly affected by the computer hardware and software revolution that began in the 1980s. CAD software was developed to automate the design process, providing manufacturers with computerized 3-D design capability. Today, most manufacturers use some form of CAD software to create designs and engineering specifications for new products and to quantify and modify designs and specifications for existing products. The use of CAD can shorten the time between design changes. While manufacturers previously designed their products to be in production for longer periods of time, current manufacturing practices must accommodate more frequent product introductions and modifications, while satisfying more stringent quality and safety standards. Assembly fixtures and measurement tools must be figuratively linked to the CAD design to enable production to keep up with the rate of design change.

Quality standards dictate measurement to reduce defects. QS-9000 is the name given to the Quality System Requirements of the automotive industry that were developed by Chrysler, Ford, General Motors and major truck manufacturers and issued in late 1994. Companies that become registered under QS-9000 are considered to have higher standards and better quality products. Six Sigma embodies the principles of total quality management that focus on measuring results and reducing product or service failure rates to 3.4 per million. All aspects of a Six Sigma company s infrastructure must be analyzed, and if necessary, restructured to increase revenues and raise customer satisfaction levels. The all-encompassing nature of these and other quality standards has resulted in manufacturers measuring every aspect of their process, including stages of product assembly that may have never been measured before, in part because of the lack of suitable measurement equipment.

Traditional products don t measure up. A significant aspect of the manufacturing process, which traditionally has not benefited from computer-aided technology, is measurement and quality inspection. Historically, manufacturers have measured and inspected products using hand-measurement tools such as scales, calipers, micrometers and plumb lines for simple measuring tasks, test (or check) fixtures for certain large manufactured products and traditional coordinate measurement machines (CMM) for objects that require higher precision measurement. However, the broader utility of each of these measurement methods is limited.

Although hand-measurement tools are often appropriate for simple geometric measurements, including hole diameters or length and width of a rectangular component, their use for complex part measurements, such as the

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fender of a car, is limited. Also these devices do not allow for the measurements to be directly compared to the CAD model of the part. Test fixtures (customized fixed tools used to make comparative measurements of complex production parts to master parts) are relatively expensive and must be reworked or discarded each time a dimensional change is made in the part being measured. In addition, these manual measuring devices do not permit the manufacturer to compare the dimensions of an object with its CAD model.

Conventional CMMs are generally large, fixed-base machines that provide very high levels of precision and provide a link to the CAD model of the object being measured. However, fixed-base CMMs require the object being measured be brought to the CMM and the object fit within the CMMs measurement grid. As manufactured subassemblies increase in size and become integrated into even larger assemblies, they become less transportable, thus diminishing the utility of a conventional CMM. Consequently, manufacturers must continue to use hand-measuring tools, or expensive customized test fixtures, in order to measure large or unconventionally shaped objects. Some parts or assemblies are not easily accessible and cannot be measured at all using traditional devices.

Conventional surveying equipment is limited to single-point measurements and doesn t have the capacity to capture and analyze large volumes of three-dimensional data. As data requirements for construction, civil engineering and forensic inspection projects become more complex, single-point measurement devices will become increasingly more difficult to utilize in those applications.

Escalating global competition has created a demand for higher quality products with shorter life cycles. Customers require more rapid design, greater control of the manufacturing process, tools to compare components to their CAD specifications and the ability to precisely measure components that cannot be measured or inspected by conventional devices, and the ability to capture and analyze large volumes of three-dimensional data. Moreover, they increasingly require measurement capabilities to be integrated into manufacturing processes and to be available on the factory floor.

FARO Products

The Faro Arm. The Faro Arm is a combination of a portable, six or seven-axis, instrumented articulated measurement arm, a computer, and software programs under the acronym CAM2.

Articulated Arm Each articulated arm is comprised of three major joints, each of which may consist of one, two or three axes of motion. The articulated arm is available in a variety of sizes, configurations and precision levels that are suitable for a broad range of applications. To take a measurement, the operator simply touches the object to be measured with a probe at the end of the arm and presses a button. Data can be captured at either individual points or a series of points. Digital rotational transducers located at each of the joints of the arm measure the angles at those joints. This rotational measurement data is transmitted to an on-board controller that converts the arm angles to precise locations in 3-D space using xyz position coordinates and ijk orientation coordinates.

Computer The Company pre-installs its CAM2 software on either a notebook or desktop style computer, depending on the customer s need, and the measuring device, computer and installed software are sold as a system. The computers are not manufactured by the Company, but are purchased from various suppliers.

CAM2 Software See separate section on CAM2 Software below.

The Faro Scan Arm. The Faro Scan Arm is a Faro Arm equipped with a combination of a hard probe (like that in the Faro Arm) *and* a non-contact line laser probe. This product provides our customers the ability to measure their products without touching them and offers a seven-axis contact/non-contact measurement device with a fully integrated laser scanner. The Scan Arm is used for non-contact measurement applications, including inspection, cloud-to-CAD comparison, rapid prototyping, reverse engineering and 3-D modeling.

The Faro Gage. Sold as a combination of an articulated arm device with a computer and software, the Faro Gage is a smaller, higher accuracy version of the Faro Arm product. What distinguishes the Faro Gage from the Faro Arm are the special mounting features and the basic software which are unique to the Faro Gage. The Faro

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Gage is targeted at machine tools, and bench tops around machine tools, where basic measurements of smaller machined parts must be measured. As such, the CAM2 software developed for this device features basic 2-D and 3-D measurements common to these applications. (See also Faro Gage Software below.)

The Faro Laser Tracker. A combination of a portable, large-volume laser measurement tool, a computer, and CAM2 software programs.

Laser Tracker The Faro Laser Tracker utilizes an ultra-precise laser beam to measure objects of up to 230 feet. It enables manufacturing, engineering, and quality control professionals to measure and inspect large parts, machine tools and other large objects on-site and/or in-process. With its greater angular resolution, repeatability, and accuracy, the Faro Laser Tracker advances already-proven tracker technology. Among its many enhanced features is SuperADM, which improves upon existing Absolute Distance Measurement technology by providing the time-saving ability to reacquire the laser beam without the need to return to a known reference point or the need to hold the target stationary.

Computer See description under Faro Arm above.

CAM2 Software See separate section on CAM2 software below.

The Faro Laser Scanner LS. The FARO Laser Scanner LS utilizes laser technology to measure and collect a cloud of data points, allowing for the detailed and precise three-dimensional rendering of an object or an area as large as a factory. This technology is currently used for factory planning, facility life-cycle management, quality control, forensic analysis and in general, capturing large volumes of three-dimensional data. Laser scanning technology simplifies modeling, reduces project time and maintains or increases the accuracy of the image. The resulting data is used with major CAD systems or FARO s own proprietary software for the applications listed above.

CAM2 Software. CAM2 is the Company s family of proprietary CAD-based measurement and statistical process control software. The CAM2 product line includes the following software programs, many of which are translated into multiple languages:

CAM2 Measure X allows users to compare measurements of manufactured components or assemblies with the corresponding CAD data for the components or assemblies. CAM2 Measure X is offered with the Faro Arm and the Faro Laser Tracker.

CAM2 SPC Process allows for the collection, organization, and presentation of measurement data factory-wide. Not limited to measurements from the Faro Arm or Faro Laser Tracker, CAM2 SPC Process accepts data from CMM and other computer-based measurement devices from many different measurement applications along the production line.

Soft Check Tool is a custom software program designed to lead an operator through a measurement process on the Faro Arm or Faro Laser Tracker with minimal training. These programs are created by the Company from specifications provided by the customer.

Faro Gage Software includes a dedicated graphical interface designed for the ease of use of the operator. Capable of producing graphical and tabular reports, the software runs a library of gauging and Soft Check tools.

Laser Scanner LS Software. The Company has a number of programs available for its Laser Scanner LS product, as follows:

Faro Scout is a powerful software tool for displaying 3-D measurements and navigation in huge pointclouds.

Faro Scene is software for displaying, analyzing, administration and editing of 3-D measurements in huge pointclouds including registration of multiple pointclouds.

Farocloud for AutoCAD supports the visualization and analysis of millions of 3-D points in the well known AutoCAD software environment. As-built documentation of industrial structures, historic buildings or many more applications are possible.

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Faroworks is a web-based tool for the administration of complex projects and navigation from floorplan to scan with links to measurements.

Walkinside is a high performance 3-D viewer with full room measurement and other features.

Customers

As of February 2007, the Company s products have been purchased by approximately 6,100 customers worldwide, including small machine shops, large manufacturing and industrial companies, universities and law enforcement agencies. The Company s ten largest customers by revenue represented an aggregate of 7.2% of the Company s total revenues in 2006. No customer represented more than 2.0% of the Company s sales in 2006.

Sales and Marketing

The Company directs its sales and marketing efforts on a decentralized basis in three main regions around the world: Americas, Europe/Africa and Asia/Pacific. The regional headquarters for the Americas is in the Company s headquarters in Lake Mary, Florida and the Europe/Africa regional headquarters is in Stuttgart, Germany. The Company opened a regional headquarters for the Asia/Pacific region in Singapore in 2005. At December 31, 2006 the Company employed 83, 118, and 64 sales and marketing specialists in the Americas, Europe/Africa, and Asia/Pacific regions, respectively. The Company has direct sales representation in the United States, Canada, Brazil, Germany, United Kingdom, France, Spain, Italy, Poland, Netherlands, India, China, Singapore, Malaysia, Vietnam, and Japan. See Footnote 19 to the Notes to Consolidated Financial Statements, incorporated herein by reference to Item 8 hereof, for financial information about the Company s foreign and domestic operations and export sales required by this Item.

The Company uses a process of integrated lead qualification and sales demonstration. Once a customer opportunity is identified, the Company employs a team-based sales approach involving inside and outside sales personnel who are supported by application engineers. Each product has a separate sales force who report to regional sales managers for all products. The Company employs a variety of marketing techniques to promote brand awareness and customer identification.

Research and Development

The Company believes that its future success depends on its ability to maintain technological leadership, which will require ongoing enhancements of its products and the development of new applications and products that provide 3-D measurement solutions. Accordingly, the Company intends to continue to make substantial investments in the development of new technologies, the commercialization of new products that build on the Company s existing technological base, and the enhancement and development of additional applications for its products.

The Company s research and development efforts are directed primarily at enhancing the functional adaptability of its current products and developing new and innovative products that respond to specific requirements of the emerging market for 3-D measurement systems. The Company s research and development efforts have been devoted primarily to mechanical hardware, electronics and software. The Company s engineering development efforts will continue to focus on enhancing our existing products and developing new products for the CAM2 market.

At December 31, 2006, the Company employed 50 scientists and technicians in its research and development efforts. Research and development expenses were approximately $7.2 million in 2006 as compared to $6.4 million in 2005 and $5.4 million in 2004. We believe that the continual development or acquisition of innovative new products is critical to our future success. The field of CAM2 and more broadly, 3-D measurement, continues to expand and new technologies and applications will be essential to competing in this market. Research and development activities, especially with respect to new products and technologies, are

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subject to significant risks, and there can be no assurance that any of the Company s research and development activities will be completed successfully or on schedule, or, if so completed, will be commercially accepted.

Intellectual Property

The Company holds or has pending 65 patents in the United States and related patents worldwide. The Company also has 26 registered or pending trademarks in the United States and worldwide.

The Company relies on a combination of contractual provisions and trade secret laws to protect its proprietary information. There can be no assurance that the steps taken by the Company to protect its trade secrets and proprietary information will be sufficient to prevent misappropriation of its proprietary information or preclude third-party development of similar intellectual property.

Despite the Company s efforts to protect its proprietary rights, unauthorized parties may attempt to copy aspects of the Company s products or to obtain and use information that the Company regards as proprietary. The Company intends to vigorously defend its proprietary rights against infringement by third parties. However, policing unauthorized use of the Company s products is difficult, particularly overseas, and the Company is unable to determine the extent to which piracy of its software products exists. In addition, the laws of some foreign countries do not protect the Company s proprietary rights to the same extent as the laws of the United States.

The Company does not believe that any of its products infringe on the proprietary rights of third parties. There can be no assurance, however, that third parties will not claim infringement by the Company with respect to current or future products. Any such claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays or require the Company to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to the Company or at all, which could have a material adverse effect upon the Company s business, operating results and financial condition. The Company has been defending itself in a patent infringement suit brought against the Company by Romer-Cimcore (a subsidiary of Hexagon) on November 25, 2003. (See Item 3 Legal Proceedings)

Manufacturing and Assembly

The Company manufactures its products at its headquarters in Lake Mary, Florida, and at its plants in Kennett Square, Pennsylvania, Schaffhausen, Switzerland, Stuttgart, Germany, and Singapore. Manufacturing consists primarily of assembling components and subassemblies, purchased from suppliers, into finished products. The primary components, which include machined parts and electronic circuit boards, are produced by subcontractors according to the Company s specifications. All products are assembled, calibrated and tested for accuracy and functionality before shipment. In limited circumstances, the Company performs in-house circuit board assembly and part machining.

The Company s manufacturing, engineering, and design headquarters have been registered to the ISO-9001 standard since July 1998. Semi-annual surveillance audits have documented continuous improvement to this multinational standard. The Company continues to examine its scope of registration as the business evolves and has chosen English as the standard business language for its operations. This decision is expected to significantly influence the Company s operations and documentation globally. This has been done in concert with the ISO Standard Registrar, and is expected to increase customer confidence in the Company s products and services worldwide.

The Company takes a global approach to ISO registration, seeking to have all locations registered with identical scope of accreditation and capabilities for the products generated and serviced. In 2004 FARO took this to the highest level possible. Our manufacturing sites in Lake Mary, Kennett Square, Stuttgart, and Schaffhausen are now jointly registered to ISO-9001:2000. In addition, our service sites in the United States, Germany, Switzerland, Japan, China, and Brazil have been jointly accredited to ISO-17025 for Calibration and Certification Laboratories by the Laboratory Accreditation Bureau.

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Competition

Our portable measurement systems compete in the broad market for measurement devices for manufacturing and industrial applications which, in addition to portable articulated arms, laser tracker and laser scanner products, consist of fixed-base CMMs, templates and go/no-go gages, check fixtures, handheld measurement tools and various categories of surveying equipment. The broad market for measurement devices is highly competitive. In the Faro Gage product line, we compete with manufacturers of handheld measurement tools and fixed-base CMMs, including some large, well-established companies. In the Faro Arm, Faro Scan Arm, Faro Laser Tracker, and Faro Laser Scanner LS product lines, we compete primarily with Hexagon Metrology, a division of Hexagon. We also compete in these product lines with a number of other smaller competitors.

We will be required to make continued investments in technology and product development to maintain the technological advantage that we believe we currently have over our competition. Some of our competitors, including some manufacturers of fixed based CMMs and Hexagon, possess substantially greater financial, technical, and marketing resources than we possess. Moreover, we cannot be certain that our technology or our product development efforts will allow us to successfully compete as the industry evolves. As the market for our portable measurement systems expands, additional competition may emerge and the Company s existing and future competitors may commit more resources to the markets in which the Company participates.

Government Regulation

Our operations are subject to numerous governmental laws and regulations, including those governing antitrust and competition, the environment, securities transactions and disclosures, import and export of products, currency conversions and repatriation, taxation of foreign earnings and earnings of expatriate personnel and use of local employees and suppliers. Our foreign operations are subject to the U.S. Foreign Corrupt Practices Act (FCPA), which makes illegal any payments to foreign officials or employees of foreign governments that are intended to induce them to use their influence to assist us or to gain any improper advantage for us. The Company operates in certain regions that are more highly prone to risk under the FCPA.

Manufacturers of electrical goods have become subject to the European Union s Restrictions of Hazardous Substances, (RoHS) and Waste Electrical and Electronic Equipment (WEEE) directives, which took effect during 2006. Parallel initiatives are being proposed in other jurisdictions, including several states in the United States and China. RoHS prohibits the use of lead, mercury and certain other specified substances in electronics products, and WEEE makes producers of electrical goods financially responsible for specified collection, recycling, treatment, and disposal of covered electronic products and components.

We expect that we will have our products in compliance with the RoHS directive in time. However, if we are unable to do so, we would be unable to sell our products in European Union countries, as well as possible several states in the United States and China, which would have a material adverse effect on our sales and results of operation.

Backlog

At December 31, 2006, the Company had orders representing approximately $10.3 million in product sales outstanding. The majority of these specific orders were shipped by February 29, 2007, and, as of February 29, 2007, the Company had orders representing approximately $12.0 million in product sales outstanding. At December 31, 2005 and 2004, the Company had orders representing approximately $7.3 million and $5.1 million in product sales outstanding, respectively.

The Company s increase in backlog at December 31, 2006 is consistent with the Company s overall sales growth and includes planned customer delivery dates in early 2007. The Company believes that substantially all of the outstanding sales orders as of February 29, 2007 will be shipped during 2007.

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Employees

At December 31, 2006, the Company had 641 full-time employees, consisting of 265 sales and marketing professionals, 128 production staff, 50 research and development staff, 82 administrative staff, and 116 customer service/application engineering specialists. The Company is not a party to any collective bargaining agreements and believes its employee relations are good. Management believes that its future growth and success will depend in part on its ability to retain and continue to attract highly skilled personnel. The Company anticipates that it will be able to obtain the additional personnel required to satisfy its staffing requirements over the foreseeable future.

Geographic Information

The information regarding net sales, operating income, and long-lived assets set forth in Note 19 Segment Reporting to the Consolidated Financial Statements is hereby incorporated by reference into this Part I, Item 1.

Available Information

We maintain a web site with the address www.faro.com. Information contained on our web site is not a part of, or incorporated by reference into, this Annual Report on Form 10-K. We make available free of charge through our web site our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, proxy statements and amendments to these reports, as soon as reasonably practicable after we electronically file these reports with, or furnish these reports to, the Securities and Exchange Commission.

ITEM 1A. RISK FACTORS.

We discuss expectations regarding our future performance and make other forward-looking statements in our annual and quarterly reports, press releases and other written and oral statements. These forward-looking statements are based on currently available competitive, financial and economic data and our operating plans. They are inherently uncertain, and investors must recognize that events could turn out to be significantly different from our expectations. The following discussion of risks and uncertainties which is not exclusive, highlights some important factors to consider when evaluating our trends and future results.

Our customers buying process for our products is highly decentralized, and therefore, it typically requires significant time and expense for us to further penetrate the potential market of a specific customer, which may delay our ability to generate additional revenue.

Our success will depend, in part, on our ability to further penetrate our customer base. During 2006, 45.1% of our revenue was attributable to sales to our existing customers, compared to 40.6% in 2005. If we are not able to continue to penetrate our existing customer base, our sales growth will be impaired. Most of our customers have a decentralized buying process for measurement devices. Thus, we must spend significant time and resources to increase revenues from a specific customer. For example, we may provide products to only one of our customer s manufacturing facilities or for a specific product line within a manufacturing facility. We cannot be certain that we will be able to maintain or increase the amount of sales to our existing customers.

Others may develop products that make our products obsolete or less competitive.

The CAM2 market is emerging and could be characterized by rapid technological change. Others may develop new or improved products, processes or technologies that may make our products obsolete or less competitive. We cannot assure you that we will be able to adapt to evolving markets and technologies or maintain our technological advantage.

Our success will depend, in part, on our ability to maintain our technological advantage by developing new products and applications and enhancing our existing products. Developing new products and applications and

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enhancing our existing products can be complex and time-consuming and will require substantial investment by us. Significant delays in new product releases or difficulties in developing new products could adversely affect our revenues and results of operations. Because our customers are concentrated in a few industries, a reduction in sales to any one of these industries could cause a significant decline in our revenues.

An economic slowdown in manufacturing will affect our growth and profitability.

A significant portion of our sales are to manufacturers in the automotive, aerospace and heavy equipment industries. We are dependent upon the continued growth, viability and financial stability of our customers in these industries, which are highly cyclical and dependent upon the general health of the economy and consumer spending. The cyclical nature of these industries may exert significant influence on our revenues and results of operations. In addition, the volume of orders from our customers and the prices of our products may be adversely impacted by decreases in capital spending by a significant portion of our customers during recessionary periods. If one or more of our significant customers were to become insolvent or otherwise were unable to pay for the products provided by us, our operating results and financial condition would be adversely affected.

Our inability to protect our patents and proprietary rights in the United States and foreign countries could adversely affect our revenues.

Our success depends in large part on our ability to obtain and maintain patent and other proprietary right protection for our processes and products in the United States and other countries. We also rely upon trade secrets, technical know-how and continuing inventions to maintain our competitive position. We seek to protect our technology and trade secrets, in part, by confidentiality agreements with our employees and contractors. Our employees may breach these agreements or our trade secrets may otherwise become known or be independently discovered by inventors. If we are unable to obtain or maintain protection of our patents, trade secrets and other proprietary rights, we may not be able to prevent third parties from using our proprietary rights.

Our patent protection involves complex legal and technical questions. Our patents may be challenged, narrowed, invalidated or circumvented. We may be able to protect our proprietary rights from infringement by third parties only to the extent that our proprietary processes and products are covered by valid and enforceable patents or are effectively maintained as trade secrets. Furthermore, others may independently develop similar or alternative technologies or design around our patented technologies. Litigation or other proceedings to defend or enforce our intellectual property rights could require us to spend significant time and money and could otherwise adversely affect our business.

Claims from others that we infringe their intellectual property rights may adversely affect our operations.

From time to time we receive notices from others claiming we infringe their intellectual property rights. The number of these claims may grow. Responding to these claims may require us to enter into royalty or licensing agreements on unfavorable terms, require us to stop selling or to redesign affected products or require us to pay damages. Any litigation or interference proceedings, regardless of their outcome, may be costly and may require significant time and attention of our management and technical personnel.

On November 25, 2003, Romer-Cimcore (now a division of Hexagon) filed a patent infringement suit against us in the Federal District Court for the Southern District of California alleging that certain of our products sold in the United States, including the FARO Arm, infringe U.S. Patent 5,829,148 (148 patent). A summary of this litigation is set forth in Item 3 (Legal Proceedings) of this report.

In the event of an adverse ruling in the Romer-Cimcore litigation, we could be required to pay substantial damages, cease the manufacturing, use and sale of any infringing products, discontinue the use of certain processes or obtain a license, if available, from Romer-Cimcore with royalty payment obligations by us. At this time, however, the Company cannot estimate the potential impact, if any, that might result from this suit, and therefore, no provision has been made to cover such expense.

Potential product failures or product quality and performance issues could result in lost sales, loss of customers and possible delays in new product introductions and enhancements and increased warranty costs.

The Company has a history of new product introductions and enhancements to existing products. Potential product failures in new or existing products of the Company could result in delays in new product introductions, which could lead to a loss of sales, and increased warranty costs.

We may not be able to achieve financial results within our target goals, and our operating results may fluctuate due to a number of factors, many of which are beyond our control.

Our ability to achieve financial results that are within our goals is subject to a number of factors, some of which our beyond our control. Moreover, our annual and quarterly operating results have varied significantly in the past and likely will vary significantly in the future. Factors that cause our financial results to fluctuate include those set forth elsewhere in this report and the following:

- the size and timing of customer orders, many of which are received towards the end of the quarter;
- the effectiveness of sales promotions and sales of demonstration equipment;
- geographic expansion in the Asia/Pacific region and other regions;
- unforeseen developments in our Foreign Corrupt Practices Act matter or in complying with the FCPA in the future;
- training and ramp-up time for new sales people;
- investments in technologies and new products;
- our effective tax rate;
- the outcomes of the patent infringement lawsuit filed by Romer-Cimcore and the purported class action lawsuit;
- the amount of time that it takes to fulfill orders and ship our products;
- the length of our sales cycle to new customers and the time and expense incurred in further penetrating our existing customer base;
- increases in operating expenses for product development and new product marketing;
- costs associated with new product introductions, such as assembly line start-up costs and low introductory period production volumes;

- the timing and market acceptance of new products and product enhancements;
- customer order deferrals in anticipation of new products and product enhancements;
- our success in expanding our sales and marketing programs;
- start-up costs and ramp-up time associated with opening new sales offices outside of the United States;
- potential decreases in revenue without proportionate adjustments in fixed costs;
- the efficiencies achieved in managing inventories and fixed assets;
- investments in potential acquisitions or strategic sales, product or other initiatives;
- shrinkage or other inventory losses due to product obsolescence, scrap or material price changes; and
- adverse changes in the manufacturing industry and general economic conditions.

Any one or a combination of these factors could adversely affect our annual and quarterly operating results in the future and could cause us to fail to achieve our target financial results.

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The CAM2 market is an emerging market and our growth depends on the ability of our products to attain broad market acceptance.

The market for traditional fixed-base CMMs, check fixtures, handheld measurement tools, and surveying equipment is mature. Part of our strategy is to continue to displace these traditional measurement devices. Displacing traditional measurement devices and achieving broad market acceptance of our products requires significant effort to convince manufacturers to reevaluate their historical measurement procedures and methodologies.

Because the CAM2 market is emerging, the potential size and growth rate of the CAM2 market is uncertain and difficult to quantify. If the CAM2 market does not continue to expand or does not expand at least as quickly as we anticipate, we may not be able to continue our sales growth, which also may affect our profitability.

We market six closely interdependent products (Faro Arm, Scan Arm, Faro Laser Scanner LS, Faro Laser Tracker and Faro Gage) and related software for use in measurement, inspection and high-density surveying applications. Substantially all our revenues are currently derived from sales of these products and software and we plan to continue our business strategy of focusing on the portable software-driven, 3-D measurement and inspection market. Consequently, our financial performance will depend in large part on portable, computer-based measurement, inspection and high-density surveying products achieving broad market acceptance. If our products cannot attain broad market acceptance, we will not grow as anticipated and may be required to make increased expenditures on research and development for new applications or new products.

We compete with manufacturers of portable measurement systems and traditional measurement devices, many of which have more resources than us and may develop new products and technologies.

The broad market for measurement devices is highly competitive. In the Faro Gage product line, we compete with manufacturers of handheld measurement tools and fixed-base CMMs, including some large, well-established companies. In the Faro Arm, Faro Scan Arm, Faro Laser Tracker, and Faro Laser Scanner LS product lines, we compete primarily with Hexagon Metrology, a division of Hexagon. We also compete in these product lines with a number of other smaller competitors.

We will be required to make continued investments in technology and product development to maintain the technological advantage that we believe we currently have over our competition. Some of our competitors, including some manufacturers of fixed based CMMs and Hexagon, possess substantially greater financial, technical, and marketing resources than we possess. Moreover, we cannot be certain that our technology or our product development efforts will allow us to successfully compete as the industry evolves. As the market for our portable measurement systems expands, additional competition may emerge and the Company s existing and future competitors may commit more resources to the markets in which the Company participates.

We derive a substantial part of our revenues from our international operations, which are subject to greater volatility and often require more management time and expense to achieve profitability than our domestic operations.

Since 2000, we have derived approximately half of our sales from international operations. In our experience, entry into new international markets requires considerable management time as well as start-up expenses for market development, hiring and establishing office facilities before any significant revenues are generated. As a result, initial operations in a new market may operate at low margins or may be unprofitable.

Our international operations are subject to various risks, including:

- difficulties in staffing and managing foreign operations;
- political and economic instability;
- unexpected changes in regulatory requirements and laws;
- longer customer payment cycles and difficulty collecting accounts receivable;

export duties, import controls and trade restrictions;

governmental restrictions on the transfer of funds to us from our operations outside the United States;

burdens of complying with a wide variety of foreign laws and labor practices; and

fluctuations in currency exchange rates.

Because our foreign subsidiaries maintain their financial records and statements in their respective local currencies, our consolidated financial results are affected by foreign currency translation adjustments. Moreover, several of the countries where we operate have emerging or developing economies, which may be subject to greater currency volatility, negative growth, high inflation, limited availability of foreign exchange and other risks. These factors may harm our results of operations and any measures that we may implement to reduce the effect of volatile currencies and other risks of our international operations may not be effective.

In addition, our foreign operations are subject to the Foreign Corrupt Practices Act, which makes illegal any payments to foreign officials or employees of foreign governments that are intended to induce them to use their influence to assist us or to gain any improper advantage for us. As previously reported on the Company s Form 8-K dated March 15, 2006, the Company learned that its China subsidiary had made payments to certain customers in China that may have violated the Foreign Corrupt Practices Act and other applicable laws. We voluntarily notified the United States Securities and Exchange Commission (SEC) and the United States Department of Justice (DOJ) of this matter. If the SEC or the DOJ determines that violations of the FCPA have occurred, they could seek civil and criminal sanctions, including monetary penalties, against the Company and/or certain of its employees, as well as additional changes to the Company s business practices and compliance programs, any of which could have a material adverse effect on the Company business and financial condition. In addition, such actions, whether actual or alleged, could damage our reputation and ability to do business. Further, detecting, investigating, and resolving such actions is expensive and could consume significant time and attention of our senior management.

We may not be able to identify, consummate or achieve expected benefits from acquisitions.

We have completed three significant acquisitions since our initial public offering in 1997. We may pursue access to additional technologies, complementary product lines and sales channels through selective acquisitions and strategic investments. We may not be able to identify and successfully negotiate suitable acquisitions, obtain financing for future acquisitions on satisfactory terms or otherwise complete acquisitions in the future. In the past we have used our stock as consideration for acquisitions. Our common stock may not remain at a price at which it can be used as consideration for acquisitions without diluting our existing shareholders, and potential acquisition candidates may not view our stock attractively.

Realization of the benefits of acquisitions often requires integration of some or all of the sales and marketing, distribution, manufacturing, engineering, finance and administrative organizations of the acquired companies. The integration of acquisitions demands substantial attention from senior management and the management of the acquired companies. Any acquisition may be subject to a variety of risks and uncertainties including:

the inability to assimilate effectively the operations, products, technologies and personnel of the acquired companies (some of which may be located in diverse geographic regions);

the inability to maintain uniform standards, controls, procedures and policies;

the need or obligation to divest portions of the acquired companies; and

the potential impairment of relationships with customers.

We cannot assure you that we will be able to integrate successfully any acquisitions, that any acquired companies will operate profitably or that we will realize the expected benefits from any acquisition.

We may face difficulties managing growth.

If our business continues to grow rapidly in the future, we expect it to result in:

increased complexity

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- increased responsibility for existing and new management personnel; and

- incremental strain on our operations and financial and management systems.

If we are not able to manage future growth, our business, financial condition and operating results may be harmed.

Our dependence on suppliers for materials could impair our ability to manufacture our products.

Outside vendors provide key components used by us in the manufacture of our products. Although we believe that alternative sources for these components are available, any supply interruption in a limited source component would harm our ability to manufacture our products until a new source of supply is identified. In addition, an uncorrected defect or supplier s variation in a component, either known or unknown to us, or incompatible with our manufacturing processes, could harm our ability to manufacture our products. We may not be able to find a sufficient alternative supplier in a reasonable period, or on commercially reasonable terms, if at all. If we fail to obtain a supplier for the manufacture of components of our potential products, we may experience delays or interruptions in our operations, which would adversely affect our results of operations and financial condition.

Our failure to attract and retain qualified personnel could lead to a loss of sales or decreased profitability or growth. Required compensation levels including equity based compensation to attract and retain personnel could result in increased compensation expense.

We may not be able to attract and retain enough qualified personnel to support our growth. In addition, the loss of our Chief Executive Officer, Chief Technology Officer, or Chief Financial Officer, or other key personnel could adversely effect our sales, profitability, or growth. Moreover, we continue to rely in part on equity awards to attract and retain qualified personnel. Because of new accounting regulations requiring the expensing of stock options, if we continue to rely or equity compensation to attract and retain qualified personnel, our compensation expenses may increase.

We may experience volatility in our stock price.

The price of our common stock has been, and may continue to be, highly volatile in response to various factors, many of which are beyond our control, including:

- developments in the industries in which we operate;

- actual or anticipated variations in quarterly or annual operating results;

- speculation in the press or investment community; and

- announcements of technological innovations or new products by us or our competitors.

The market price of our common stock may also be affected by our inability to meet analyst and investor expectations and failure to achieve projected financial results. Any failure to meet such expectations or projected financial results, even if minor, could cause the market price of our common stock to decline. Volatility in our stock price may result in your inability to sell your shares at or above the price at which you purchased them.

In addition, stock markets have generally experienced a high level of price and volume volatility, and the market prices of equity securities of many companies have experienced wide price fluctuations not necessarily related to the operating performance of such companies. These broad market fluctuations may adversely affect the market price of our common stock. In the past, securities class action lawsuits frequently have been instituted against such companies following periods of volatility in the market price of such companies securities. If any such litigation is instigated against us, it could result in substantial costs and a diversion of management s attention and resources, which could have a material adverse effect on our business, results of operations and financial condition.

We are a defendant in a shareholder class-action lawsuit.

We and certain of our officers were named as defendants in purported class action complaints filed in the United States District Court for the Middle District of Florida, Orlando Division. The lead plaintiff in the securities litigation seeks an unspecified amount of damages, premised on allegations that each defendant made misrepresentations and omissions of material fact during the class period in violation of the Securities Exchange Act of 1934. A summary of the securities litigation is set forth in Item 3 (Legal Proceedings) of this report. Although the Company believes that the material allegations made in the amended complaint are without merit and intends to vigorously defend the securities litigation, no assurances can be given with respect to the outcome of the securities litigation.

Anti-takeover provisions in our articles of incorporation, our bylaws and provisions of Florida law could delay or prevent a change of control that you may favor.

Our articles of incorporation, our bylaws and provisions of Florida law could make it more difficult for a third party to acquire us, even if doing so would be beneficial to you. These provisions could discourage potential takeover attempts and could adversely affect the market price of our shares. Because of these provisions, you might not be able to receive a premium on your investment. These provisions include:

- a limitation on shareholders ability to call a special meeting of our shareholders;
- advance notice requirements to nominate directors for election to our board of directors or to propose matters that can be acted on by shareholders at shareholder meetings;
- our classified board of directors, which means that approximately one-third of our directors are elected each year; and
- the authority of the board of directors to issue, without shareholder approval, preferred stock with such terms as the board of directors may determine.

The provisions described above could delay or make more difficult transactions involving a change in control of us, or our management.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

We had no comments from the Securities and Exchange Commission staff regarding the Company s periodic or current reports under the Securities Exchange Act of 1934 that were unresolved as of the date of filing of this report.

ITEM 2. PROPERTIES.

The Americas

The Company s headquarters are located in a leased building in Lake Mary, Florida containing approximately 35,000 square feet. This facility houses the Company s U.S. production, research and development, administrative staff and customer service/application operations. The Company s U.S. sales and marketing headquarters is in a leased building in Lake Mary, Florida consisting approximately 8,200 square feet. Additionally, the Company has a leased facility consisting of two buildings totaling approximately 37,000 square feet located in Kennett Square, Pennsylvania containing research and development, manufacturing and service operations of the laser tracker product lines.

Europe/Africa

The Company s European headquarters are located in a leased building in Stuttgart, Germany containing approximately 62,000 square feet. This facility houses the manufacturing, administration, sales, marketing and service management personnel for the Company s European operations. Additionally the Company has a leased facility consisting of approximately 16,000 square feet located in Schaffhausen, Switzerland containing manufacturing operations for the Company s products, which are shipped to customers in Europe, Africa and Asia.

Asia/Pacific

The Company s Asian headquarters are located in a leased building in Singapore containing approximately 22,000 square feet. This facility houses the administration, sales, marketing, production and service management personnel for the Company s Asian operations. The Company s Japan headquarters are located in a leased building in Nagoya, Japan containing approximately 5,000 square feet. This facility houses the Company s Japan sales, marketing and service operations. The Company s China headquarters are located in a leased building in Shanghai, China containing approximately 11,000 square feet for sales, marketing and service operations.

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The Company believes that its current facilities will be adequate for its foreseeable needs and that it will be able to locate suitable space for additional regional offices or enhanced production needs as necessary.

The information required by the remainder of this item is incorporated herein by reference to Exhibit 99.1 attached hereto.

ITEM 3. LEGAL PROCEEDINGS.

Patent Litigation On November 25, 2003, Cimcore-Romer (now a division of Hexagon) filed a patent infringement suit against us in the Federal District Court for the Southern District of California alleging that certain of our products sold in the United States, including the FARO Arm, infringe U.S. Patent 5,829,148 (148 patent). The Company believes, and has contended in this litigation, that the Company does not infringe the 148 patent and that the 148 patent is invalid.

On July 12, 2005, the court issued an order granting Cimcore-Romer s motion for summary judgment of infringement of three claims of the 148 patent. On July 22, 2005, the Company announced its decision to limit the capability of its U.S.-based FARO Arm products (the FARO Arm, the FARO Gage and the Digital Template) by removing what we call the infinite rotation feature by reducing this capability to 50 rotations or fewer. FARO believes that by limiting the range of the joint rotation to 50 rotations, it has removed from its U.S. products the ability to sweep through an unlimited arc, which is a feature of the 148 patent claims addressed by the court s ruling required to infringe the 148 patent. The revised products have not, however, been considered by the courts. Accordingly, we cannot give assurance that the revised products will not be deemed to infringe the 148 patent.

On September 20, 2005, the Court vacated its order of summary judgment of infringement and agreed to reconsider its conclusions from the patent claim construction (Markman) ruling, which is a pretrial hearing often used in patent infringement cases. The new Markman hearing occurred on October 3, 2005 and the hearing-on-summary judgments of infringement occurred on November 14, 2005. On October 18, 2005, the Court issued a revised claim construction that the Company believes materially alters the Court s previous Markman ruling by substantially narrowing what FARO believes to be key aspects of the claim construction. The Company believes that this narrower claim construction will ultimately lead to a finding that it does not infringe any claim of the 148 patent.

The trial began in November 2006, and on December 6, 2006, the judge presiding over the case declared a mistrial trial. A new trial date has been set for April 3, 2007.

In addition, the Company filed two separate requests for reexamination in the U.S. Patent and Trademark Office (PTO) of the 148 Patent, both of which requests were granted. The PTO ruled in the first reexamination in September 2005. The Company believes that the PTO ruling bolsters the Company s previous position that it does not infringe the 148 patent. More specifically, in the first reexamination, the PTO construed critical claim terms in a relatively narrow manner, which the Company believes is consistent with its stated positions in the patent litigation. The Company s second reexamination request was granted by the PTO in November 2005 and is based on new prior art (that is, earlier issued patent publications) submitted to the PTO which FARO believes will ultimately invalidate the 148 patent. This prior art reference was not at issue in the first reexamination proceeding.

On December 7, 2006, the PTO rejected key claims in Hexagon s 148 patent. Hexagon has appealed the PTO s rejection of the claims. The rejected claims include all the claims involved in the ongoing 148 patent infringement. If the PTO rejection is ultimately made final, the patent claims asserted against the Company in the Hexagon litigation will be invalidated, and FARO will then prevail in its litigation. The Hexagon 148 patent claims cover a four-jointed arm construction with a mechanically unlimited rotation of certain joints. The PTO, in its rejection, determined that this feature was already found in a number of prior patents and so determined that the 148 claims were obvious in view of these prior patents. Hexagon will have the right to respond to, and eventually appeal, the rejection of the claims.

In the event of an adverse ruling in the Romer-Cimcore litigation, we could be required to pay substantial damages, cease the manufacturing, use and sale of any infringing products, discontinue the use of certain processes or obtain a license, if available, from Romer-Cimcore with royalty payment obligations by us. An adverse decision in the Romer-Cimcore case could materially and adversely affect our financial condition and results of operations. At this time, however, the Company cannot estimate the potential impact, if any, that might result from this suit, and therefore, no provision has been made to cover such expense.

Securities Litigation On December 6, 2005, the first of four essentially identical class action securities fraud lawsuits were filed against the Company and certain officers of the Company. On April 19, 2006, the four lawsuits were consolidated, and Kornitzer Capital Management, Inc. was appointed as the lead plaintiff. On May 16, 2006, Kornitzer filed its Consolidated Amended Class Action Complaint against the Company and the individual defendants. The Amended Complaint also named Grant Thornton LLP, the Company s independent registered public accounting firm, as an additional defendant.

On July 31, 2006, the Company filed a Motion to Dismiss the Amended Complaint. On February 3, 2007, the Court dismissed the Amended Complaint, as against all defendants, with leave to re-plead.

On February 22, 2007, Kornitzer filed its Consolidated Second Amended Class Action Complaint. The Second Amended Complaint principally asserts the same claims set forth in the Amended Complaint, but adds various allegations in an attempt to comply with certain standards stated in the Court s order. As in the Amended Complaint, Kornitzer seeks to represent a class consisting of all persons who purchased or otherwise acquired the Company s publicly traded securities between April 15, 2004 and March 15, 2006. On behalf of the alleged class, Kornitzer seeks an unspecified amount of damages, premised on allegations that each defendant made misrepresentations and omissions of material fact during the class period in violation of the Securities Exchange Act of 1934. Among other things, Kornitzer alleges that the defendants misrepresented matters during the class period related to: (i) the value of the Company s inventory, and the amount of the Company s gross margins and profits, as a result of the inventory valuation; (ii) the amount of the 2005 selling expenses that the Company had accrued and expected; and (iii) the effectiveness of the Company s systems of internals controls, including in connection with the Company s determination of its inventory valuation and selling expenses, and the fact that certain reported sales in Asia were obtained in violation of the Foreign Corrupt Practices Act.

The Company s deadline for responding to the Second Amended Complaint is April 26, 2007. The Company intends to file a motion to dismiss the Second Amended Complaint. The Company has timely notified the issuer of its Executive Liability and Entity Securities Liability insurance policy of the Securities Litigation. Although the Company believes that the material allegations made in the Second Amended Complaint are without merit and intends to vigorously defend the Securities Litigation, no assurances can be given with respect to the outcome of the Securities Litigation.

Voluntary Disclosure of Foreign Corrupt Practices Act Matter to the Securities and Exchange Commissions and Department of Justice As previously reported by the Company, the Company learned that its China subsidiary had made payments to certain customers in China that may have violated the FCPA and other applicable laws. The Company s Audit Committee instituted an internal investigation into this matter in February 2006, and the Company voluntarily notified the SEC and the DOJ of this matter in March 2006. The internal investigation into this matter has been completed. The Company has provided to the SEC and the DOJ information obtained during the course of this investigation and is cooperating with both agencies.

The Company s internal investigation has identified certain improper payments made in China and deficiencies in its controls with respect to its operations in China in possible violation of the FCPA. If the SEC or

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the DOJ determines that violations of the FCPA have occurred, they could seek civil and criminal sanctions, including monetary penalties, against the Company and/or certain of its employees, as well as additional changes to the Company s business practices and compliance programs. Based on current information, it is not possible to predict at this time when the SEC or DOJ investigations will be resolved, what the outcome will be, what sanctions, if any, will be imposed, or the effect that such matters may ultimately have on the Company or its consolidated financial statements.

Results of the investigation revealed that referral fee payments in possible violation of the FCPA were $165,000 and $265,000 in 2004 and 2005, respectively, which were recorded in selling expenses in the Company s statement of income. The related sales to customers to which payment of these referral fees had been made totaled approximately $1.3 million and $3.24 million in 2004 and 2005, respectively. Additional improper referral fee payments of $122,000 were made in January and February 2006 related to sales contracts in 2005. The Company had sales in China of $9.0 million in 2005 and $4.2 million in 2004, approximately 7% and 4% of total sales, respectively. The Company incurred expenses of $3.8 million in 2006 relating to its internal investigation of the FCPA matter.

The Company has terminated certain personnel in the Asia-Pacific Region and has re-assigned the duties of other personnel in both the Asia-Pacific Region and the U.S. as a result of the internal investigation. The Company is instituting the following remedial measures:

- Contracted with a third party forensics accounting team to conduct an in-depth audit of the operations in China and in other countries in the Asia-Pacific region and to make recommendations for improvement to the internal control systems.

- Reviewing third party distributor arrangements in an effort to assure that all contracts include adherence to the FCPA.

- Performing due diligence on all third party distributors and implementing a process to assess potential new distributors.

- Established an in-house internal audit function including hiring a Director of Internal Audit.

- Consolidating the human resources, financial accounting and reporting functions for the Asia region into the Singapore Operations.

- Implemented an internal certification process to ascertain whether similar issues may exist elsewhere in the Company.

- Implemented a quarterly internal certification process to confirm adherence to company policy and all applicable laws and regulations that will include all regional leadership, country management and other sales management.

- Implementing additional training on FCPA and other matters for employees and a confidential compliance reporting system.

During the Company s internal investigation of its business practices in China, it became aware that income taxes related to certain commissions and bonus payments to its employees had not been properly reported. The Company has filed the appropriate payroll tax returns and remitted the deficiency.

Other than the litigation mentioned above, the Company is not involved in any other legal proceedings other than routine litigation arising in the normal course of business. The Company does not believe the results of such litigation, even if the outcome were unfavorable to the Company, would have a material adverse effect on the Company s business, financial condition or results of operations.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

No matters were submitted to a vote of security holders during the fourth quarter of 2006.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

The Company s common stock is listed and traded on the NASDAQ Global Market.

The following table sets forth, for the calendar points indicated, the high and low sales prices of the Company s common stock as reported by the NASDAQ Global Market:

	2006		2005	
	High	**Low**	**High**	**Low**
First Quarter	20.74	13.00	30.33	22.85
Second Quarter	17.00	11.85	30.31	24.11
Third Quarter	19.72	14.76	28.37	19.14
Fourth Quarter	24.29	16.93	22.47	16.50

The Company has not paid any cash dividends on its common stock to date. The Company expects to retain future earnings for use in operating and expanding its business and does not anticipate paying any cash dividends in the reasonably foreseeable future.

As of March 1, 2007, the last sale price of the Company s common stock was $24.60, and there were 80 holders of record of common stock.

During the year ended December 31, 2006, no equity securities of the Company were sold by the Company that were not registered under the Securities Act of 1933, as amended.

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PERFORMANCE GRAPH

The following line graph compares the cumulative five-year Common Stock returns with the cumulative returns return of the Dow Jones U.S. Total Market Index and the Dow Jones U.S. Electronic Equipment Index.

COMPARISON OF THE FIVE YEAR CUMULATIVE TOTAL RETURN*

AMONG FARO TECHNOLOGIES, INC., THE DOW JONES U.S. TOTAL MARKET

INDEX AND THE DOW JONES U.S. ELECTRONIC EQUIPMENT INDEX

ASSUMES $100 INVESTED ON JAN. 1, 2002

ASSUMES DIVIDEND REINVESTED

FISCAL YEAR ENDING DEC. 31, 2006

Date	FARO	Dow	Dow Elec Eqmt
31-Dec-2001	$ 100.00	$ 100.00	$ 100.00
31-Dec-2002	$ 84.38	$ 77.92	$ 68.94
31-Dec-2003	$ 1,115.88	$ 101.87	$ 103.61
31-Dec-2004	$ 1,391.96	$ 114.11	$ 112.41
31-Dec-2005	$ 892.86	$ 121.34	$ 121.01
31-Dec-2006	$ 1,073.21	$ 140.23	$ 139.58

* Assumes $100 invested on December 31, 2001

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The information under the heading EQUITY COMPENSATION PLAN INFORMATION in the Company s definitive Proxy Statement for its 2007 Annual Meeting of Shareholders, to be filed with the SEC is incorporated herein by reference.

ITEM 6. SELECTED FINANCIAL DATA.

in thousands, except share and per-share data	Historical Year ended December 31, 2006	2005	2004	2003	2002
Statement of Operations Data:					
Sales	$ 152,405	$ 125,590	$ 97,020	$ 71,786	$ 46,246
Gross profit	89,458	72,932	59,996	42,266	25,137
Income (loss) from operations	8,259	10,226	14,584	7,440	(2,939)
Income (loss) before income taxes	9,776	9,898	15,289	9,436(1)	(1,805)
Net income (loss)	8,196	8,179	14,931	8,278	(2,016)
Net income (loss) per common share:					
Basic	$ 0.57	$ 0.58	$ 1.08	$ 0.68	$ (0.17)
Diluted	$ 0.56	$ 0.57	$ 1.06	$ 0.64	$ (0.17)
Weighted average common shares outstanding:					
Basic	14,397,050	14,169,140	13,833,590	12,181,221	11,853,732
Diluted	14,560,331	14,442,248	14,023,159	12,845,992	11,853,732

	Historical as at December 31, 2006	2005	2004	2003	2002
Consolidated Balance Sheet Data:					
Working capital	$ 73,692	$ 86,624	$ 65,686	$ 51,368	$ 18,339
Total assets	144,276	122,648	105,078	81,914	45,195
Total debt	205	340	250	107	1,556
Total shareholders equity	111,055	98,860	89,158	68,921	33,384

(1) Includes a favorable legal settlement of $1.1 million in other income.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following information should be read in conjunction with the Consolidated Financial Statements of the Company, including the notes thereto, included elsewhere in this document.

Overview

The Company designs, develops, manufacturers, markets and supports portable, software driven, 3-D measurement systems that are used in a broad range of manufacturing, industrial, building construction and forensic applications. The Company s Faro Arm, Faro Scan Arm and Faro Gage articulated measuring devices, the Faro Laser Scanner LS, the Faro Laser Tracker, and their companion CAM2 software, provide for Computer-Aided Design (CAD)-based inspection and/or factory-level statistical process control, and high-density surveying. Together, these products integrate the measurement, quality inspection, and reverse engineering functions with CAD software to improve productivity, enhance product quality and decrease rework and scrap in the manufacturing process. The Company uses the acronym CAM2 for this process, which stands for computer-aided measurement.

As of February 2007, the Company s products have been purchased by approximately 6,100 customers worldwide, ranging from small machine shops to such large manufacturing and industrial companies as Audi, Bell Helicopter, Boeing, British Aerospace, Caterpillar, Daimler Chrysler, General Electric, General Motors, Honda, Johnson Controls, Komatsu Dresser, Lockheed Martin, Nissan, Siemens and Volkswagen, among many others.

We continue to pursue international markets. We established sales offices in France and Germany in 1996, Great Britain in 1997, Japan and Spain in 2000, Italy in 2001, and China in 2003. We opened sales offices in South Korea and India in 2004. We established sales offices in Poland, Netherlands, Malaysia, Vietnam, and Singapore in 2005 and added a new regional headquarters in Singapore in the third quarter of 2005 along with a new manufacturing and service facility there in the fourth quarter of 2005. In 2003 we began to manage and report our global sales in three regions: the Americas, Europe/Africa and Asia/Pacific. In 2006 we closed our South Korean office and established a third party distributor relationship for serving that market. In 2006, 41.3% of our sales were in the Americas compared to 44.5% in 2005, 40.0% were in the Europe/Africa region compared to 35.7% in 2005 and 18.7% were in the Asia/Pacific region, compared to 19.7% in 2005 (see also Note 19 Geographic Data to the financial statements below).

We derive revenues primarily from the sale of our Faro Arm, Faro Scan Arm, Faro Gage, Faro Laser Tracker and Faro Laser Scanner LS 3-D measurement equipment, and their related multi-faceted software. Revenue related to these products is generally recognized upon shipment. In addition, we sell one and three-year extended warranties and training and technology consulting services relating to our products. We recognize the revenue from extended warranties on a straight-line basis. We also receive royalties from licensing agreements for our historical medical technology and recognize the revenue from these royalties as licensees use the technology.

In 2003, we began to manufacture our Faro Arm products in Switzerland for customer orders from the Europe/Africa and Asia/Pacific regions. We began to manufacture our Faro Gage product, and parts of our Faro Laser Tracker product in our Swiss plant in the third quarter of 2004. We began complete production of the Faro Laser Tracker product in our Swiss plant in 2005. We began to manufacture our Faro Arm products in our Singapore plant in the fourth quarter of 2005, the Faro Laser Tracker in the first half of 2006, and the Faro Gage in the second half of 2006. We expect our Singapore plant will take over from our Swiss plant in supplying our Asia/Pacific region s needs for these products. The manufacture of these products for customer orders from the Americas will be done in our manufacturing facilities located in Florida and Pennsylvania. Our Faro Laser Scanner LS product is currently manufactured in our new facility located in Stuttgart, Germany. We expect all of our existing plants to have the production capacity necessary to support our growth through 2007.

As previously reported on the Company s Form 8-K dated March 15, 2006, the Company learned that its China subsidiary had made payments to certain customers in China that may have violated the FCPA and other applicable laws. The Company s Audit Committee instituted an internal investigation into this matter in February 2006, and the Company voluntarily notified the SEC and the DOJ of this matter in March 2006. The internal investigation into this matter has been completed. The Company has provided to the SEC and the DOJ information obtained during the course of this investigation and is cooperating with both agencies.

The Company s internal investigation has identified certain improper payments made in China and deficiencies in its controls with respect to its operations in China in possible violation of the FCPA. If the SEC or the DOJ determines that violations of the FCPA have occurred, they could seek civil and criminal sanctions, including monetary penalties, against the Company and/or certain of its employees, as well as additional changes to the Company s business practices and compliance programs. Based on current information, it is not possible to predict at this time when the SEC or DOJ investigations will be resolved, what the outcome will be, what sanctions, if any, will be imposed, or the effect that such matters may ultimately have on the Company or its consolidated financial statements. Results of the investigation revealed that referral fee payments in possible violation of the FCPA were $165,000 and $265,000 in 2004 and 2005, respectively, which were recorded in selling expenses in the Company s statement of income. The related sales to customers to which payment of

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these referral fees had been made totaled $1.3 million and $3.24 million in 2004 and 2005, respectively. Additional improper referral fee payments of $122,000 were made in January and February 2006 related to sales contracts in 2005. The Company had sales in China of $9.0 million in 2005 and $4.2 million in 2004, approximately 7% and 4% of total sales, respectively. The Company incurred expenses of $3.8 million in 2006 relating to the FCPA matter.

The Company has terminated certain personnel in the Asia-Pacific Region and has re-assigned the duties of other personnel in both the Asia-Pacific Region and the U.S. as a result of the internal investigation. The Company is instituting the following remedial measures:

- Contracted with a third party forensics accounting team to conduct an in-depth audit of the operations in China and in other countries in the Asia-Pacific region and to make recommendations for improvement to the internal control systems.
- Reviewing third party distributor arrangements in an effort to assure that all contracts include adherence to the FCPA.
- Performing due diligence on all third party distributors and implementing a process to assess potential new distributors.
- Established an in-house internal audit function including hiring a Director of Internal Audit.
- Consolidating the human resources, financial accounting and reporting functions for the Asia region into the Singapore Operations.
- Implemented an internal certification process to ascertain whether similar issues may exist elsewhere in the Company.
- Implemented a quarterly internal certification process to confirm adherence to company policy and all applicable laws and regulations that will include all regional leadership, country management and other sales management.
- Implementing additional training on FCPA and other matters for employees and a confidential compliance reporting system.

During the Company s internal investigation of its business practices in China, it became aware that income taxes related to certain commissions and bonus payments to its employees had not been properly reported. The Company has filed the appropriate payroll tax returns and remitted the deficiency.

The Company is currently involved in a patent infringement lawsuit and a class action securities fraud lawsuit. (See Item 3. LEGAL PROCEEDINGS). Neither the ultimate outcome of any of these actions, nor their potential impact on the Company s business, financial condition, or reported results of operations in any future period can be predicted.

With respect to the financial performance in 2006, cost of sales consists primarily of material, labor and production overhead. Since our IPO in 1997, annual gross margins have been in the range of 54%-64% of sales. Gross margin for fiscal 2006 was within that range at 58.7%.

Selling expenses as a percentage of sales remained at 29.7% in 2006 and 2005. This percentage has decreased to 28.4% in the second half of 2006 from 31.2% in the first half of 2006 as the new sales personnel hired at the end of 2005 became more productive.

General and administrative expenses consist primarily of salaries for administrative personnel, rent, utilities and professional and legal expenses. General and administrative expenses were higher in 2006 primarily as a result of an increase in professional and legal expenses of approximately $3.8 million related to the FCPA investigation and $1.4 million related to increased patent litigation costs.

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Research and development expenses represent salaries, equipment and third-party services. We have a commitment to support ongoing research and development and intend to continue to fund these efforts at the level of 5%-7% of sales going forward.

We incurred minimal expenses in 2006 as calculated under the Black-Scholes method of SFAS 123, related to our adoption of SFAS 123(R) for the expensing of stock options as we vested substantially all of our unvested options in the fourth quarter of 2005. The reduction in pre-tax charges estimated by the Company as a result of the acceleration amounts to approximately $7.7 million over the course of the original vesting periods. Options to purchase approximately 704,310 shares of the Company s stock or 52.5% of the Company s outstanding options were accelerated. The weighted average exercise price of the options subject to acceleration were $21.30. The aggregate pretax expense for the shares subject to acceleration that would have been reflected in the Company s consolidated financial statements beginning in 2006 is approximately $7.7 million, including $4.3 million in 2006, $2.7 million in 2007, and $0.7 million in 2008. The fair value for any future grants will be included in expense over the vesting periods. These expenses will be apportioned according to the classification of the employees who have received stock options into cost of sales, selling, general and administrative or research and development costs.

In 2006, our worldwide effective tax rate was 16.2%. We have received a favorable income tax rate commitment from the Swiss government as an incentive to establish a manufacturing plant in Switzerland, and in 2006 received approval from the Singapore Economic Development Board for a favorable multi-year income tax holiday for our Singapore headquarters and manufacturing operations subject to certain terms and conditions including employment, spending, and capital investment. (See Critical Accounting Policies Income Taxes below).

Accounting for wholly owned foreign subsidiaries is maintained in the currency of the respective foreign jurisdiction and, therefore, fluctuations in exchange rates may have an impact on inter-company accounts reflected in our consolidated financial statements. We are aware of the availability of off- balance sheet financial instruments to hedge exposure to foreign currency exchange rates, including cross-currency swaps, forward contracts and foreign currency options (see Foreign Exchange Exposure below). However, we do not regularly use such instruments, and none were utilized in 2006, 2005, or 2004.

We have had eighteen consecutive profitable quarters through December 31, 2006. Our sales growth and profitability has been a result of a number of factors, including: the acquisition of SMX, which manufactured the predecessor to the Faro Laser Tracker, the introduction in October 2002 of the latest generation of our traditional Faro Arm product, the introduction of the Faro Gage in September 2003, the introduction of our Faro Scan Arm product in 2004, continuing market demand for and acceptance of our products, and an increase in the number of sales people worldwide. Our worldwide sales and marketing headcount in 2006, 2005 and 2004 was 265, 289, and 167, respectively.

On January 10, 2005, the Company filed a Registration Statement on Form S-3 with the Securities and Exchange Commission allowing it to raise proceeds of up to $125 million. The proceeds from any offerings with respect to this registration statement, if any, would be used for either repayment or refinancing of debt, acquisition of additional businesses or technologies or for working capital and general corporate purposes. To date, we have not raised any capital under this Form S-3 Registration Statement. The Company must file in a timely manner all reports under the Securities and Exchange Act of 1934 (with certain exceptions) with the SEC for a period of 12 months in order to be able to use its S-3 registration statement. (See also Liquidity and Capital Resources below).

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Results of Operations

The following table sets forth, for the periods presented, the percentage of sales represented by certain items in the Company s consolidated statements of income:

	Years ended December 31,		
	2006	**2005**	**2004**
Statement of Operations Data:			
Sales	100.0%	100.0%	100.0%
Cost of sales	41.3%	41.9%	38.2%
Gross margin	58.7%	58.1%	61.8%
Operating expenses:			
Selling	29.7%	29.7%	26.7%
General and administrative	16.1%	12.4%	12.1%
Depreciation and amortization	2.7%	2.7%	2.4%
Research and development	4.7%	5.1%	5.6%
Total operating expenses	53.2%	49.9%	46.8%
Income from operations	5.5%	8.2%	15.0%
Interest income	0.5%	0.6%	0.4%
Other (expense) income, net	0.5%	(0.6%)	0.4%
Interest expense	(0.0%)	(0.1%)	(0.0%)
Income before income taxes	6.5%	8.1%	15.8%
Income tax expense	1.0%	1.5%	0.4%
Net income	5.5%	6.6%	15.4%

2006 Compared to 2005

Sales. Sales increased $26.8 million, or 21.3%, to $152.4 million in the year ended December 31, 2006, from $125.6 million for the year ended December 31, 2005. This increase resulted primarily from an increase in unit sales. Our sales growth is driven by increased product sales resulting from continuing market demand for and acceptance of our products. Sales in the Americas region increased $7.0 million or 12.5%, to $62.9 million in the year ended December 31, 2006 from $55.9 million in the year ended December 31, 2005. Sales in the Europe/Africa region increased $16.0 million, or 35.6%, to $60.9 million in the year ended December 31, 2006 from $44.9 million in the year ended December 31, 2005. Sales in the Asia/Pacific region increased $3.8 million, or 15.3% to $28.6 million in the year ended December 31, 2006 from $24.8 million in the year ended December 31, 2005. In 2006 our sales and marketing headcount decreased to 83 from 88 in the Americas, increased to 118 from 117 in Europe/Africa, and decreased to 64 from 84 in the Asia/Pacific region.

Gross profit. Gross profit increased $16.6 million, or 22.8%, to $89.5 million for the year ended December 31, 2006 from $72.9 million for the year ended December 31, 2005. Gross margin increased to 58.7% in the year ended December 31, 2006, from 58.1% for the year ended December 31, 2005 primarily due to a change in the sales mix resulting in an increase in unit sales of product lines with a lower than average cost of sales. We expect the trend of changes in the sales mix to result in gross margins in the range of approximately 57% to 60% in 2007.

Selling expenses. Selling expenses increased by $8.0 million or 21.4%, to $45.3 million for the year ended December 31, 2006 from $37.3 million for the year ended December 31, 2005. This increase was primarily due to higher compensation and commission expense of $4.5 million related to the increase in sales, higher marketing costs of $2.9 million and higher product demonstration costs of $0.6 million. As a percentage of sales, selling expenses were unchanged at 29.7% in 2006 and 2005.

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General and administrative expenses. General and administrative expenses increased by $9.1 million or 58.7%, to $24.6 million for the year ended December 31, 2006 from $15.5 million for the year ended December 31, 2005. This increase was primarily due to increased professional and legal fees of $5.4 million, of which $3.8 million was related to the Company s investigation of possible violations of the Foreign Corrupt Practices Act by its Chinese subsidiary, and $1.4 million for ongoing patent litigation. In addition, compensation costs increased $1.7 million and expenses related to the Singapore facility, which opened in September 2005, increased by $0.3 million. General and administrative expenses as percentage of sales increased to 16.1% of sales in 2006 from 12.4% of sales in 2005.

Depreciation and amortization expenses. Depreciation and amortization expenses increased by $0.6 million or 17.1%, to $4.1 million for the year ended December 31, 2006 from $3.5 million in 2005, primarily due to an increase in depreciation of new equipment from our Asia/Pacific expansion and additions to our leased space in the U.S.

Research and development expenses. Research and development expenses increased by $0.8 million or 12.5%, to $7.2 million for the year ended December 31, 2006 from $6.4 million for the year ended December 31, 2005. This resulted primarily from an increase in salaries and subcontractors expense of $0.7 million related to the addition of the Laser Scanner product line. Research and development expenses as a percentage of sales were 4.7% in 2006 compared to 5.1% in 2005.

Interest income / expense. Interest income increased by $0.1 million or 16.7%, to $0.7 million for the year ended December 31, 2006 from $0.6 million for the year ended December 31, 2005, primarily due to an increase in interest rates and short term investments. Interest expense decreased slightly due to the purchase of iQvolution in 2005 and subsequent retirement of their debt obligations.

Other income (expense), net. Other income (expense), net increased by $1.6 million, to income of $0.8 million for the year ended December 31, 2006 from an expense of $0.8 million for the year ended December 31, 2005. Other income includes foreign exchange gains of $0.8 million in 2006.

Income tax expense. Income tax expense decreased to $1.6 million in the year ended December 31, 2006, from $1.7 million for the year ended December 31, 2005. The effective tax rate in 2006 was 16.2% compared to 17.4% in 2005. The primary reason for the lower tax rate was the effect of the receipt of approval of the tax holiday for our operations in Singapore effective January 1, 2006 for a period of four years and an additional six year extension at a favorable tax rate subject to certain terms and conditions including employment, spending, and capital investment. The Company has $4.6 million in net deferred tax assets remaining, which will, more likely than not, be realized in 2007 and thereafter if the Company remains consistently profitable (See also Note 14-Income Taxes). Separate from income tax expenses, the Company recorded an addition to shareholders equity of $0.01 million in 2006 for the income tax benefit received from the exercise of unqualified stock options by employees.

Net income. Net income was $8.2 million for the year ended December 31, 2006 and for the year ended December 31, 2005 as a result of the factors described above.

2005 Compared to 2004

Sales. Sales increased $28.6 million or 29.5% from $97.0 million for the year ended December 31, 2004 to $125.6 million for the year ended December 31, 2005. This increase resulted from higher unit sales of the Faro Arm, Faro Laser Tracker and Faro Gage products, the introduction of the Faro Laser Scanner LS and the effect of an overall increase in headcount in sales and marketing of 122, or 73.1% from 167 in 2004 to 289 in 2005. Geographically, sales increased $14.1 million or 33.8% in the Americas, $1.8 million or 4.2% in Europe/Africa, and $12.6 million or 103.3% in the Asia/Pacific region. In 2005 our sales and marketing headcount increased 63.0% from 54 to 88 in the Americas, 53.9% from 76 to 117 in Europe/Africa, and 127.0% from 37 to 84 in the Asia/Pacific region.

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Gross profit. Gross profit increased $12.9 million or 21.5% from $60.0 million for the year ended December 31, 2004 to $72.9 million for the year ended December 31, 2005. Gross margin decreased from 61.8% for the year ended December 31, 2004 to 58.1% for the year ended December 31, 2005 due primarily to product mix, higher service costs and price discounts.

Selling expenses. Selling expenses increased by $11.4 million or 44.0%, from $25.9 million for the year ended December 31, 2004 to $37.3 million for the year ended December 31, 2005. This increase was a result of higher commissions related to increased volume of $3.1 million, higher salaries of $4.6 million related to the increase in sales and marketing personnel, higher product demonstration costs of $0.6 million and higher marketing costs of $3.1 million. As a percentage of sales, selling expenses increased to 29.7% of sales in 2005 from 26.7% in 2004.

General and administrative expenses. General and administrative expenses increased by $3.8 million or 32.5% from $11.7 million for the year ended December 31, 2004 to $15.5 million for the year ended December 31, 2005. This increase was due to higher salaries and bonuses of $1.1 million, higher professional and legal fees of $2.7 million, of which $1.3 million was related to patent litigation, and higher facilities and rent of $0.6 million, partially offset by reduced stock option expense of $0.4 million. General and administrative expenses as percentage of sales rose slightly to 12.4% of sales in 2005 from 12.1% of sales in 2004.

Depreciation and amortization expenses. Depreciation and amortization expenses increased by $1.2 million or 52.2% from $2.3 million for the year ended December 31, 2004 to $3.5 million in 2005, due to an increase in depreciation of new equipment from our Asia/Pacific expansion and from additions to our leased space in the U.S., and an increase in amortization from our purchase of iQvolution.

Research and development expenses. Research and development expenses increased by $1.0 million or 18.5% from $5.4 million for the year ended December 31, 2004 to $6.4 million for the year ended December 31, 2005. This was due to an increase in salaries and bonuses of $0.6 million stemming from the hiring of personnel to support the new Laser Scanner LS and an increase in external services and other project expenses of $0.2 million. Research and development expenses as a percentage of sales were 5.1% in 2005 compared to 5.6% in 2004.

Interest income / expense. Interest income increased by $0.2 million or 50% from $0.4 million for the year ended December 31, 2004 to $0.6 million for the year ended December 31, 2005 primarily from an increase in interest rates in 2005 which was partially offset by reduced investment balances. Interest expense increased slightly due to our purchase of iQvolution and subsequent retirement of their debt obligations.

Other (expense) income, net. Other (expense) income, net decreased by $1.2 million from income of $0.4 million for the year ended December 31, 2004 to expense of $0.8 million for the year ended December 31, 2005. This decrease was primarily due to foreign exchange losses of $0.8 million in 2005.

Income tax expense. Income tax expense increased $1.3 million from $0.4 million for the year ended December 31, 2004 to $1.7 million for the year ended December 31, 2005. The effective tax rate in 2005 was 17.4% of income before income tax compared to 2.3% in 2004. The primary reason for the higher tax rate was the prior year tax benefit attributable to a reduction in the valuation allowance of approximately $3.2 million. Of that reduction, $1.5 million related to usage of net operating losses in foreign jurisdictions and $1.7 million of the reduction in the valuation allowance related to the partial release of the valuation allowance taken in the fourth quarter of 2004 on foreign deferred tax assets which the Company believed were more likely than not to be realized. The Company has $6.0 million in net deferred tax assets remaining, which will more likely than not be realized in 2006 and thereafter if the Company remains consistently profitable (See also Note 14-Income Taxes). Separate from income tax expenses, the Company recorded an addition to shareholders equity of $0.4 million in 2005 for the income tax benefit received from the exercise of unqualified stock options by employees.

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Net income. Net income decreased $6.7 million or 45.0% from $14.9 million for the year ended December 31, 2004 to $8.2 million for the year ended December 31, 2005 as a result of the factors described above.

Liquidity and Capital Resources

The Company has financed its operations primarily from cash provided by operating activities and from the proceeds of its 1997 initial public offering of common stock (approximately $31.7 million), and its 2003 private placement of its common stock with various institutional investors (approximately $24.9 million).

On January 10, 2005, the Company filed a Registration Statement on Form S-3 with the Securities and Exchange Commission allowing it to raise proceeds of up to $125 million. The proceeds from any offerings with respect to this registration statement, if any, would be used for either repayment or refinancing of debt, acquisition of additional businesses or technologies or for working capital and general corporate purposes. To date, we have not raised any capital under this Form S-3 Registration Statement. The Company must file in a timely manner all reports under the Securities and Exchange Act of 1934 (with certain exceptions) with the SEC for a period of 12 months in order to be able to use its S-3 registration statement. Because the Company s Form 10-K for the year ended December 31, 2005 and Form 10-Q for the first quarter ended April 1, 2006 were not timely filed, the Company is not eligible to use its Form S-3 registration statement. As a result, the Company would be required to use a Form S-1 registration statement if it were to raise equity or debt in the public markets.

On July 11, 2006, the Company entered into an loan agreement providing for an available line of credit of $30.0 million. Loans under the loan agreement bear interest at the rate of LIBOR plus 1.75% and require the Company to maintain certain ratios with respect to a debt covenant agreement, including current ratio, consolidated EBITDA, and senior funded debt to EBITDA. As of December 31, 2006, the Company is in compliance with all of the covenants under the Amended Loan Agreement. The term of the Amended Loan Agreement extends to April 30, 2009. The Company has not drawn on this line of credit.

Cash and cash equivalents increased by $6.4 million to $15.7 million at December 31, 2006 from $9.3 million at December 31, 2005. This increase was primarily attributable to net cash provided by operating activities of $10.2 million; less: cash used in investing activities to purchase equipment, intangible and other assets of $4.2 million, offset by proceeds from sales of investments of $0.7 million; cash used in financing activities to make payments of capital leases of $0.2 million, and a decrease of $0.1 million related to the exchange rate effects on cash. In addition, the Company had short term investments of $15.8 million and $16.5 million at December 31, 2006 and December 31, 2005, respectively.

We believe that our working capital, together with anticipated cash flow from our operations, our credit facility and previously announced shelf registration will be sufficient to fund our liquidity requirements through 2007.

Off Balance Sheet Items

The Company is not party to any off-balance sheet items that have not already been appropriately disclosed in these financial statements.

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Contractual Obligations and Commercial Commitments

The Company is party to capital leases on automotive and other equipment with an initial term of 36 to 60 months and other non-cancelable operating leases, including leases with related parties that expire on or before 2011. These obligations are presented below as of December 31, 2006:

	Payments Due by Period				
	Total	**< 1 Year**	**1-3 Years**	**3-5 Years**	**> 5 Years**
Contractual Obligations					
Capital lease obligations	$ 167	$ 86	$ 79	$ 2	$
Operating lease obligations	9,344	3,022	4,366	1,480	476
Purchase obligations	10,549	10,549			
Total	$ 20,060	$ 13,657	$ 4,445	$ 1,482	$ 476

The Company enters into purchase commitments for products and services in the ordinary course of business. These purchases generally cover production requirements for 60 to 90 days. On August 11, 2005, the Company entered into an agreement with DELCAM plc under which the Company agreed to purchase approximately $1.4 million in products over a 12-month term. At December 31, 2006, the Company had completed the purchase of $1.4 million in products under this agreement. Effective November 1, 2005, the Company entered into an agreement with Metrologic Group S.A. under which the Company agreed to purchase approximately $0.4 million in products over a 12-month term. At December 31, 2006, $0.3 million had been purchased under this agreement and the agreement was not renewed. Other than the agreements listed above, the Company does not have any long-term commitments for purchases.

Critical Accounting Policies

In response to the SEC s financial reporting release, FR-60,

Cautionary Advice Regarding Disclosure About Critical Accounting Policies, we have selected our critical accounting policies for purposes of explaining the methodology used in the calculation in addition to any inherent uncertainties pertaining to the possible effects on our financial condition. The critical policies discussed below are our processes of recognizing revenue, the reserve for excess and obsolete inventory, income taxes, and the reserve for warranties. These policies affect current assets and operating results and are therefore critical in assessing our financial and operating status. These policies involve certain assumptions that, if incorrect, could create an adverse impact on our operations and financial position.

The preparation of these consolidated financial statements requires the Company s management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses, as well as disclosure of contingent assets and liabilities. The Company bases its estimates on historical experience along with various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Some of these judgments can be subjective and complex and, consequently, actual results may differ from these estimates under different assumptions or conditions. While for any given estimate or assumption made by the Company s management there may be other estimates or assumptions that are reasonable, the Company believes that, given the current facts and circumstances, it is unlikely that applying any such other reasonable estimate or assumption would materially impact the financial statements.

Revenue Recognition

Revenue related to the Company s measurement equipment and related software is generally recognized upon shipment as the Company considers the earnings process substantially complete as of the shipping date. Revenue from sales of software only is recognized when no further significant production, modification or customization of the software is required and where the following criteria are met: persuasive evidence of a sales agreement exists, delivery has occurred, and the sales price is fixed or determinable and deemed collectible. Revenues resulting from sales of comprehensive support, training and technology consulting services are recognized as such services are performed. Extended maintenance plan revenues are recognized on a straight-line basis over the life of the plan. The Company warrants its products against defects in design, materials and workmanship for one year. A provision for estimated future costs relating to warranty expenses is recorded when products are shipped. Costs relating to extended maintenance plans are recognized as incurred. Revenue from the licensing agreements for the use of the Company s technology for medical applications is recognized on an accrual basis based on historical data.

The Reserve for Excess and Obsolete Inventory

Since the value of inventory that will ultimately be realized cannot be known with exact certainty, we rely upon both past sales history and future sales forecasts to provide a basis for the determination of the reserve. Inventory is considered obsolete if we have withdrawn those products from the market or had no sales of the product for the past 12 months, and have no sales forecasted for the next 12 months. Inventory is considered excess if the quantity on hand exceeds 12 months of remaining usage. The resulting obsolete and excess parts are then reviewed to determine if a substitute usage or a future need exists. Items without an identified current or future usage will be reserved in an amount equal to 100% of the FIFO cost of such inventory. Our products are subject to changes in technologies that may make certain of our products or their components obsolete or less competitive, which may increase our historical provisions to the reserve.

Income Taxes

We review our deferred tax assets on a regular basis to evaluate their recoverability based upon expected future reversals of deferred tax liabilities, projections of future taxable income over a two year period, and tax planning strategies that we might employ to utilize such assets, including net operating loss carryforwards. Based on the positive and negative evidence described in Financial Accounting Standards Board Statement No. 109, Accounting for Income Taxes , we establish a valuation allowance against the net deferred assets of a taxing jurisdiction in which we operate unless it is more likely than not that we will recover such assets through the above means. In the future, our evaluation of the need for the valuation allowance will be significantly influenced by our ability to achieve profitability and our ability to predict and achieve future projections of taxable income.

The Company operates in a number of different countries around the world and considers the statutory rates within each jurisdiction to determine the overall effective tax rate. In 2003, the Company began to manufacture its products in Switzerland, where it has received a favorable income tax rate commitment from the Swiss government as an incentive to establish a manufacturing plant there. The aggregate dollar effect of this favorable tax rate was approximately $1.7 million, or $0.12 per share, in the year ended December 31, 2006, and $3.0 million, or $0.21 per share, in the year ended December 31, 2005.

In 2005, the Company opened a regional headquarters and began to manufacture its products in Singapore, where it has recently received approval for a four year tax holiday from the Singapore Economic Development Board as an incentive to establish a manufacturing plant and regional headquarters. The aggregate dollar effect of this favorable tax rate was approximately $0.9 million, or $.06 per share, during the year ended December 31, 2006.

The Company is subject to certain terms and conditions including employment, spending, and capital investment in each of these countries in order to receive these favorable tax rates or be subject to the statutory rates. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of global business, there are many transactions for which the ultimate tax outcome is uncertain. We have appropriately reserved for our tax uncertainties based on the criteria established by SFAS 5, Accounting for Loss Contingencies .

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The Reserve For Warranties

The Company establishes at the time of sale a liability for the one year warranty included with the initial purchase price of the equipment based upon an estimate of the repair expenses likely to be incurred for the warranty period. The warranty period is measured in installation-months for each major product group. Warranty reserve is reflected in accrued liabilities in the accompanying consolidated balance sheets. The warranty expense is estimated by applying the actual total repair expenses for each product group in the prior period and determining a rate of repair expense per installation month. This repair rate is multiplied by the number of installation-months of warranty for each product group to determine the provision for warranty expenses for the period. The Company evaluates its exposure to warranty costs at the end of each period using the estimated expense per installation-month for each major product group, the number of units remaining under warranty and the remaining number of months each unit will be under warranty. The Company has a history of new product introductions and enhancements to existing products which may result in unforeseen issues that may increase our warranty costs. While such expenses have historically been within expectations, we cannot guarantee this will continue in the future.

Transactions with Related and Other Parties

The Company leases its headquarters in Lake Mary, Florida from Xenon Research, Inc., a company owned by Simon Raab, the Company s Chairman, and Diana Raab, his spouse. The prior lease expired on February 28, 2006, and the Company executed a new Lease Agreement on August 8, 2006 with Xenon Research. The initial term of the Lease commenced as of July 1, 2006 and expires on July 1, 2011. The Lease will be automatically renewed for one successive five-year term unless the Company provides Xenon Research with written notice of non-renewal at least 90 days prior to the end of the then-applicable term. The Company also has a one-time right to terminate the Lease after three years (from July 1, 2006) upon written notice delivered to the Landlord one year prior to the date upon which the Company wishes to terminate the Lease. The Company s independent directors negotiated and approved the lease on behalf of the Company. In that process, the independent directors consulted with a real estate broker to verify that the lease rate and terms were competitive and at market.

During the first year of the initial term, the fixed rent will be $302,750 per annum payable monthly. Each year thereafter (on July 1), the fixed rent will be increased by three percent over the fixed rent for the preceding year. The lease is a net lease, meaning that the Company also is responsible for real estate taxes and insurance expenses covering the leased premises. The real estate taxes and insurance expenses are paid by Xenon Research, and the Company reimburses Xenon Research in equal monthly payments for such real estate taxes and insurance expenses with the reimbursement amount to be computed annually based on the real estate taxes and insurance expenses actually paid by Xenon Research. All payments of fixed rent and additional rent will include all applicable sales and use taxes.

Foreign Exchange Exposure

We conduct a significant portion of our business outside the United States. At present, approximately 59% of our revenues are invoiced, and a significant portion of our operating expenses paid, in foreign currencies. Fluctuations in exchange rates between the U.S. dollar and such foreign currencies may have a material adverse effect on our business, results of operations and financial condition, and could specifically result in foreign exchange gains and losses. The impact of future exchange rate fluctuations on the results of our operations cannot be accurately predicted. To the extent that the percentage of our non-U.S. dollar revenues derived from international sales increases (or decreases) in the future, our exposure to risks associated with fluctuations in foreign exchange rates may increase (or decrease) in response to the SEC s financial reporting release, FR-60, Cautionary Advice Regarding Disclosure About Critical Accounting Policies, we have selected our critical accounting policies for purposes of explaining the methodology used in the calculation in addition to any inherent uncertainties pertaining to the possible effects on our financial condition. The critical policies discussed below are our processes of recognizing revenue, the reserve for obsolescence, income taxes, and the reserve for warranties. These policies affect current assets and operating results and are therefore critical in assessing our financial and operating status. These policies involve certain assumptions that, if incorrect, could create an adverse impact on our operations and financial position.

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Inflation

The Company believes that inflation has not had a material impact on its results of operations in recent years and does not expect inflation to have a material impact on its operations in 2007.

Impact of Recently Issued Accounting Standards

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs, an Amendment of ARB No. 43, Chapter 4.* SFAS No. 151 retains the general principle of ARB No. 43, Chapter 4, *Inventory Pricing,* that inventories are presumed to be stated at cost; however, it amends ARB No. 43 to clarify that abnormal amounts of idle facilities, freight, handling costs and spoilage should be recognized as current period expenses. Also, SFAS No. 151 requires fixed overhead costs be allocated to inventories based on normal production capacity. The guidance in SAFS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 did not have a material impact on its financial position or results of operations.

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment.* SFAS No. 123R requires employee stock options and rights to purchase shares under stock participation plans to be accounted for under the fair value method, and eliminates the ability to account for these instruments under the intrinsic value method prescribed by APB Opinion No. 25, as allowed under the original provisions of SFAS No. 123. SFAS No. 123R requires the use of an option pricing model for estimating fair value, which is amortized to expense over the service periods. SFAS No. 123R allows for two alternative transition methods. The first method is the modified prospective application whereby compensation cost for the portion of awards for which the requisite service has not yet been rendered that are outstanding as of the adoption date will be recognized over the remaining service period. The compensation cost for that portion of awards will be based on the grant date fair value of those awards as calculated for pro forma disclosures under SFAS No. 123, as originally issued. All new awards and awards that are modified, repurchased, or cancelled after the adoption date will be accounted for under the provisions of SFAS No. 123R. The second method is the modified retrospective application, which requires that the Company restates prior period financial statements. The modified retrospective application may be applied either to all periods or only to prior interim periods in the year of adoption of this statement. The Company has adopted the provisions of SFAS No. 123R effective January 1, 2006 using the modified prospective application transition method. The Company accelerated the vesting for substantially all of its outstanding options prior to December 31, 2005, and expects to record minimal expenses for its remaining unvested stock options during 2006. The reduction in pre-tax charges estimated by the Company as a result of the acceleration amounts to approximately $7.7 million over the course of the original vesting periods. The fair value for any future grants will be included in expense over the vesting periods.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 was issued to provide consistency between how registrants quantify financial statement misstatements.

Historically, there have been two widely-used methods for quantifying the effects of financial statement misstatements. These methods are referred to as the roll-over and iron curtain method. The roll-over method quantifies the amount by which the current year income statement is misstated. Exclusive reliance on an income statement approach can result in the accumulation of errors on the balance sheet that may not have been material to any individual income statement, but which may misstate one or more balance sheet accounts. The iron curtain method quantifies the error as the cumulative amount by which the current year balance sheet is misstated. Exclusive reliance on a balance sheet approach can result in disregarding the effects of errors in the current year income statement that results from the correction of an error existing in previously issued financial statements. We previously used the roll-over method for quantifying identified financial statement misstatements.

SAB 108 established an approach that requires quantification of financial statement misstatements based on the effects of the misstatement on each of the Company s financial statements and the related financial statement disclosures. This approach is commonly referred to as the dual approach because it requires quantification of errors under both the roll-over and iron curtain methods.

SAB 108 allows registrants to initially apply the dual approach either by (1) retroactively adjusting prior financial statements as if the dual approach had always been used or by (2) recording the cumulative effect of initially applying the dual approach as adjustments to the carrying values of assets and liabilities as of January 1, 2006 with an offsetting adjustment recorded to the opening balance of retained earnings. Use of this cumulative effect transition method requires detailed disclosure of the nature and amount of each individual error being corrected through the cumulative adjustment and how and when it arose.

The Company has evaluated SAB 108 and it did not have a material impact on the Company s financial condition or results of operations.

In July 2006, the FASB issued FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes an interpretation of SFAS No. 109* (FIN 48). The intent of FIN 48 is to clarify the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with SFAS 109. This interpretation imposes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the requirements of FIN 48 and has not yet determined the impact this adoption will have on its consolidated financial statements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Foreign Exchange Exposure

The Company conducts a significant portion of its business outside the United States. At present, a slight majority of the Company s revenues are invoiced, and a significant portion of its operating expenses paid, in foreign currencies. Fluctuations in exchange rates between the U.S. dollar and such foreign currencies may have a material adverse effect on the Company s business, results of operations and financial condition, and could specifically result in foreign exchange gains and losses. The impact of future exchange rate fluctuations on the results of the Company s operations cannot be accurately predicted. To the extent that the percentage of the Company s non-U.S. dollar revenues derived from international sales increases in the future, the Company s exposure to risks associated with fluctuations in foreign exchange rates will increase further.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of FARO Technologies, Inc.:

We have audited the accompanying consolidated balance sheets of FARO Technologies, Inc. (a Florida Corporation) and subsidiaries (collectively, the Company) as of December 31, 2006 and 2005, and the related consolidated statements of income, shareholders equity and cash flows for each of the years in the three year period ended December 31, 2006. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits 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 the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of FARO Technologies, Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three year period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The Schedule II Valuation and Qualifying Accounts is presented for purposes of additional analysis and is not a required part of the basic financial statements. This schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects to the basic financial statements taken as a whole.

As discussed in Note 1 to the consolidated financial statements, the Company adopted Statement No 123 (revised 2004), *Share-Based Payment*, effective for interim or annual reporting periods beginning after December 15, 2005.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of FARO Technologies, Inc. and subsidiaries internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 14, 2007 expressed an unqualified opinion on management s assessment of internal controls over financial reporting and an adverse opinion on the Company s internal controls over financial reporting.

Orlando, Florida

March 14, 2007

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of FARO Technologies, Inc.:

We have audited management s assessment, included in the accompanying Management s Report on Internal Control Over Financial Reporting, that FARO Technologies, Inc. (a Florida Corporation) and subsidiaries did not maintain effective internal control over financial reporting as of December 31, 2006, because of the effect of the lack of controls in place to prevent premature revenue recognition on sales with certain shipping terms, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). FARO Technologies, Inc. and subsidiaries management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the company s internal control over financial reporting based on our audit.

We conducted our audit 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. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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 (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) 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 (3) 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.

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.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management s assessment. The controls were not in place to provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, which resulted in premature revenue recognition on sales with certain shipping terms. This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2006 financial statements, and this report does not affect our report dated March 14, 2007, which expressed an unqualified opinion (and contained an explanatory paragraph on the Company s adoption of Statement No. 123 (revised 2004)) on those financial statements.

In our opinion, management s assessment that FARO Technologies, Inc. and subsidiaries did not maintain effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material

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respects, based on criteria established in Internal Control Integrated Framework issued by COSO. Also in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, FARO Technologies, Inc. and subsidiaries has not maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by COSO.

Orlando, Florida

March 14, 2007

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FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)	December 31, 2006	December 31, 2005
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 15,689	$ 9,278
Short-term investments	15,790	16,490
Accounts receivable, net	42,706	28,654
Inventories	23,429	28,650
Deferred income taxes, net	1,845	2,155
Prepaid expenses and other current assets	3,222	2,200
Total current assets	102,681	87,427
Property and Equipment:		
Machinery and equipment	9,131	6,940
Furniture and fixtures	3,988	3,334
Leasehold improvements	2,615	1,710
Property and equipment at cost	15,734	11,984
Less: accumulated depreciation and amortization	(8,889)	(5,920)
Property and equipment, net	6,845	6,064
Goodwill	17,266	14,574
Intangible assets, net	6,221	6,395
Service Inventory	7,278	4,333
Deferred income taxes, net	3,985	3,855
Total Assets	$ 144,276	$ 122,648
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 11,182	$ 12,301
Accrued liabilities	10,379	5,569
Income taxes payable	2,151	1,406
Current portion of unearned service revenues	4,569	3,168
Customer deposits	618	201
Current portion of long-term debt and obligations under capital leases	90	163
Total current liabilities	28,989	22,808
Unearned service revenues less current portion	2,917	803
Deferred tax liability, net	1,200	
Long-term debt and obligations under capital leases less current portion	115	177
Total Liabilities	33,221	23,788
Commitments and contingencies See notes 2, 11 and 15		
Shareholders Equity:		
	14	14

Common stock par value $.001, 50,000,000 shares authorized; 14,586,402 and 14,481,178 issued; 14,464,715 and 14,290,917 outstanding, respectively		
Additional paid-in-capital	85,160	83,940
Retained earnings	25,452	17,256
Accumulated other comprehensive income (loss)	580	(2,199)
Common stock in treasury, at cost 40,000 shares	(151)	(151)
Total Shareholders Equity	111,055	98,860
Total Liabilities and Shareholders Equity	$ 144,276	$ 122,648

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

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FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

	Years ended December 31,		
(in thousands, except share and per share data)	**2006**	**2005**	**2004**
SALES	$ 152,405	$ 125,590	$ 97,020
COST OF SALES (exclusive of depreciation and amortization, shown separately below)	62,947	52,658	37,025
GROSS PROFIT	89,458	72,932	59,995
OPERATING EXPENSES:			
Selling	45,282	37,274	25,887
General and administrative	24,554	15,539	11,745
Depreciation and amortization	4,135	3,453	2,339
Research and development	7,228	6,440	5,441
Total operating expenses	81,199	62,706	45,412
INCOME FROM OPERATIONS	8,259	10,226	14,583
OTHER INCOME (EXPENSE)			
Interest income	743	567	356
Other income (expense), net	790	(806)	362
Interest expense	(16)	(89)	(12)
INCOME BEFORE INCOME TAX	9,776	9,898	15,289
INCOME TAX EXPENSE	1,580	1,719	358
NET INCOME	$ 8,196	$ 8,179	$ 14,931
NET INCOME PER SHARE BASIC	$ 0.57	$ 0.58	$ 1.08
NET INCOME PER SHARE DILUTED	$ 0.56	$ 0.57	$ 1.06
Weighted average shares Basic	14,397,050	14,169,140	13,833,590
Weighted average shares Diluted	14,560,331	14,442,248	14,023,159

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

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FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2006, 2005, and 2004

(in thousands except share data)	Common Stock Shares	Common Stock Amounts	Additional Paid-in Capital	Unearned Compensation	Retained Earnings (Deficit)	Accumulated Other Comprehensive (Loss) Income	Common Stock in Treasury	Total
BALANCE DECEMBER 31, 2003	13,518,998	$ 14	$ 75,133	$ (227)	$ (5,854)	$ 6	$ (151)	$ 68,921
Net income					14,931			14,931
Currency translation adjustment						1,425		1,425
Comprehensive income								16,356
Options subject to variable accounting			(455)	455				
Amortization of unearned compensation				277				277
Stock options exercised	485,512		1,171					1,171
Tax benefit from employee stock option exercises			2,434					2,434
Cancellation of SMX shares	(418)		(1)					(1)
BALANCE DECEMBER 31, 2004	14,004,092	$ 14	$ 78,282	$ 505	$ 9,077	$ 1,431	$ (151)	$ 89,158
Net income					8,179			8,179
Currency translation adjustment						(3,630)		(3,630)
Comprehensive income								4,549
Options subject to variable accounting			207	(207)				
Amortization of unearned compensation				(150)				(150)
Amortization of restricted stock units			93					93
Stock issued for iQvolution purchase	152,292		3,499					3,499
Accrual for iQvolution milestone earn-outs			675					675
Stock issued for iQvolution milestone earn-outs	12,183		252					252
Stock options exercised	137,499		340					340
Tax benefit from employee stock option exercises			382					382
Board compensation	24,851		62					62
BALANCE DECEMBER 31, 2005	14,330,917	$ 14	$ 83,792	$ 148	$ 17,256	$ (2,199)	$ (151)	$ 98,860
Net income					8,196			8,196
Currency translation adjustment						2,779		2,779
Comprehensive income								10,975
Reclassification related to SFAS 123R			148	(148)				
Amortization of unearned compensation			28					28
FAS 123-R stock option expense			29					29
Amortization of restricted stock units			178					178
Issuance of restricted stock units	31,776		176					176
Stock issued for iQvolution milestone earn-outs	68,574		408					408
Stock options exercised	61,398		351					351
Tax benefit from employee stock option exercises			10					10
Board compensation	12,050		40					40

BALANCE DECEMBER 31, 2006	14,504,715	$ 14	$ 85,160	$	$ 25,452	$ 580	$ (151)	$ 111,055

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

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FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31,		
	2006	2005	2004
CASH FLOWS FROM:			
OPERATING ACTIVITIES:			
Net income	$ 8,196	$ 8,179	$ 14,931
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	4,135	3,453	2,339
Amortization of stock options and restricted stock units	401	(57)	277
Provision for bad debts	230	112	154
Income tax (expense) benefit from exercise of stock options	(102)	382	2,434
Deferred income tax benefit	20	(854)	(3,309)
Change in operating assets and liabilities:			
Decrease (increase) in:			
Accounts receivable, net	(12,173)	(7,830)	(5,474)
Inventories	2,804	(13,788)	(5,354)
Prepaid expenses and other current assets	(933)	508	(1,019)
Increase (decrease) in:			
Accounts payable and accrued liabilities	3,062	4,309	2,138
Income taxes payable	526	1,454	(502)
Customer deposits	399	(302)	69
Unearned service revenues	3,189	1,030	611
Net cash provided by (used in) operating activities	9,754	(3,404)	7,295
INVESTING ACTIVITIES:			
Acquisition of iQvolution		(6,385)	
Purchases of property and equipment	(3,357)	(3,937)	(2,451)
Payments for intangible assets	(820)	(937)	(1,004)
Purchases of short-term investments		(10,900)	(30,390)
Proceeds from short-term investments	700	16,895	23,942
Net cash used in investing activities	(3,477)	(5,264)	(9,903)
FINANCING ACTIVITIES:			
Payments of capital leases	(204)	(34)	(38)
Proceeds from issuance of stock, net	463	402	1,171
Net cash (used in) provided by financing activities	259	368	1,133
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	(125)	1,221	407
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	6,411	(7,079)	(1,068)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	9,278	16,357	17,425
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 15,689	$ 9,278	$ 16,357

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

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FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2006, 2005 and 2004

(in thousands, except share and per share data, or as otherwise noted)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business FARO Technologies, Inc. and subsidiaries (collectively the Company or FARO) design, develop, manufacture, market and support software-based three-dimensional measurement devices for manufacturing, industrial, building construction and forensic applications. The Company s principal products include the Faro Arm, Faro Scan Arm, and Faro Gage, all articulated electromechanical measuring devices, and the Faro Laser Tracker and the Faro Laser Scanner LS, both laser-based measuring devices. Markets for the Company s products include automobile, aerospace, heavy equipment, and law enforcement agencies. The Company sells the vast majority of its products though a direct sales force located in many of the world s largest industrialized countries.

Principles of Consolidation The consolidated financial statements of the Company include the accounts of FARO Technologies, Inc. and all its subsidiaries. All intercompany transactions and balances have been eliminated. The financial statements of the foreign subsidiaries are translated into U.S. dollars using exchange rates in effect at period-end for assets and liabilities and average exchange rates during each reporting period for results of operations. Adjustments resulting from financial statement translations are reflected as a separate component of accumulated other comprehensive (loss) income.

Revenue Recognition, Product Warranty and Extended Maintenance Contracts Revenue related to the Company s measurement systems (integrated combinations of a measurement device, a computer and software loaded on the computer and the measurement device) is generally recognized upon shipment as the Company considers the earnings process substantially complete as of the shipping date. The Company warrants its products against defects in design, materials and workmanship for one year. A provision for estimated future costs relating to warranty expenses is recorded when products are shipped. The Company separately sells one and three year extended warranties. Extended warranty revenues are recognized on a straight-line basis over the term of the warranty. Costs relating to extended maintenance plans are recognized as incurred. Revenue from sales of software only is recognized when no further significant production, modification or customization of the software is required and when the following criteria are met: persuasive evidence of a sales agreement exists, delivery has occurred, and the sales price is fixed or determinable and deemed collectible. Revenues resulting from sales of comprehensive support, training and technology consulting services are recognized as such services are performed and are deferred when billed in advance of the performance of services. Revenue from the licensing agreements for the use of its technology for medical applications is generally recognized as licensees use the technology. Amounts representing royalties for the current year and not received as of year-end are estimated as due based on historical data and recognized in the current year.

Cash and Cash Equivalents The Company considers cash on hand and amounts on deposit with financial institutions which have maturities of three months or less when purchased to be cash and cash equivalents. The Company had deposits with foreign banks totaling $9,861 and $7,336 as of December 31, 2006 and 2005, respectively.

Short-term investments Short-term investments ordinarily consist of short-term debt securities acquired with cash not immediately needed in operations, and are held at fair value.

Management determines the appropriate classification of its short-term investments at the time of the purchase and reevaluates such determinations at each balance sheet date. The Company s short-term investments are diversified among high credit quality securities in accordance with the Company s investment policy.

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Accounts receivable and related allowance for doubtful accounts Credit is extended to customers based on an evaluation of a customer s financial condition and, generally, collateral is not required. Accounts receivable are generally due within 30-90 days and are stated at amounts due from customers net of an allowance for doubtful accounts. Accounts outstanding longer than the contractual payment terms are considered past due. The Company makes judgments as to the collectibility of accounts receivable based on historical trends and future expectations. Management estimates an allowance for doubtful accounts which adjusts gross trade accounts receivable to its net realizable value. The allowance for doubtful accounts is based on an analysis of all receivables for possible impairment issues, and historical write-off percentages. The Company writes off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts. The Company does not generally charge interest on past due receivables.

Inventories Inventories are stated at the lower of cost or net realizable value using the first-in first-out method. Shipping and handling costs are classified as a component of cost of sales in the consolidated statements of income. Sales demonstration inventory is comprised of measuring devices utilized by sales representatives to present the Company s products to customers. These products remain in sales demonstration inventory for approximately six to twelve months and are subsequently sold at prices that produce slightly reduced gross margins. Service inventory is comprised of inventory that is not expected to be sold within twelve months, such as training and loaned equipment.

Property and Equipment Property and equipment purchases exceeding a thousand dollars are capitalized and recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the various classes of assets as follows:

Machinery and equipment	2 to 5 years
Furniture and fixtures	3 to 10 years

Leasehold improvements are amortized on the straight-line basis over the lesser of the life of the asset or the term of the lease, not to exceed 7 years.

Depreciation expense was $2,842, $2,154 and $1,453 in 2006, 2005 and 2004, respectively. Accelerated methods of depreciation are used for income tax purposes in contrast to book purposes, and as a result, appropriate provisions are made for the related deferred income taxes.

Goodwill and Intangibles Goodwill represents the excess cost of a business acquisition over the fair value of the net assets acquired. In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets,* indefinite-life identifiable intangible assets and goodwill are not amortized. The Company periodically reviews its identifiable intangible assets and goodwill, considering factors such as projected cash flows and revenue and earnings multiples, to determine whether the value of the assets are impaired and the amortization periods are appropriate. If an asset is impaired, the difference between the value of the asset reflected on the financial statements and its current fair value is recognized as an expense in the period in which the impairment occurs.

Other acquired intangibles principally include patents, existing product technology and customer relationships that arose in connection with the acquisition of iQvolution AG (See note 2). Other acquired intangibles are recorded at fair value at the date of acquisition and are amortized over their estimated useful lives of 3 to 15 years.

Patents are recorded at cost. Amortization is computed using the straight-line method over the lives of the patents.

Research and Development Research and development costs incurred in the discovery of new knowledge and the resulting translation of this new knowledge into plans and designs for new products, prior to the attainment of the related products technological feasibility, are recorded as expenses in the period incurred.

The Reserve for Warranties The Company establishes a liability for included twelve-month warranties by the creation of a warranty reserve, which is an estimate of the repair expenses likely to be incurred for the remaining period of warranty measured in installation-months in each major product group. Warranty reserve is reflected in accrued liabilities in the accompanying consolidated balance sheets. The warranty expense is estimated by determining the total repair expenses for each product group in the period and determining a rate of repair expense per installation month. The rate is multiplied by the number of machine-months of warranty for each product group sold during the period to determine the provision for warranty expenses for the period. The Company reevaluates its exposure to warranty costs at the end of each period using the estimated expense per installation month for each major product group, the number of machines remaining under warranty and the remaining number of months each machine will be under warranty. While such expenses have historically been within its expectations, we cannot guarantee this will continue in the future.

Income Taxes The Company reviews its deferred tax assets on a regular basis to evaluate their recoverability based upon expected future reversals of deferred tax liabilities, projections of future taxable income, and tax planning strategies that the Company might employ to utilize such assets, including net operating loss carryforwards. Based on the positive and negative evidence described in Financial Accounting Standards Board (FASB) Statement No. 109, *Accounting for Income Taxes* (SFAS 109), the Company establishes a valuation allowance against the net deferred assets of a taxing jurisdiction in which the Company operates unless it is more likely than not that the Company will recover such assets through the above means. In the future, our evaluation of the need for the valuation allowance will be significantly influenced by the Company s ability to achieve profitability and the Company s ability to predict and achieve future projections of taxable income over a two year period.

The Company operates in a number of different countries around the world. In 2003, the Company began to manufacture its products in Switzerland, where it has received a permanent income tax rate commitment from the Swiss government as an incentive to establish a manufacturing plant there. In 2005, the Company opened a regional headquarters and began to manufacture its products in Singapore, where it has received in 2006 a favorable multi-year income tax rate commitment from the Singapore Economic Development Board as an incentive to establish a manufacturing plant and regional headquarters there.

Significant judgment is required in determining the Company s worldwide provision for income taxes. In the ordinary course of global business, there are many transactions for which the ultimate tax outcome is uncertain. The Company has appropriately reserved for our tax uncertainties based on the criteria established by SFAS 5, *Accounting for Loss Contingencies.*

Fair Value of Financial Instruments The Company s financial instruments include cash and cash equivalents, short-term investments, accounts receivable and accounts payable and accruals. The carrying amounts of such financial instruments approximate their fair value due to the short-term nature of these instruments.

Earnings Per Share Basic earnings per share (EPS) is computed by dividing earnings available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS includes the effect of all dilutive stock options and equity instruments. A reconciliation of the number of common shares used in calculation of basic and diluted EPS is presented in Note 17.

Concentration of Credit Risk Financial instruments which potentially expose the Company to concentrations of credit risk consist principally of short-term investments and operating demand deposit accounts. The Company s policy is to place its operating demand deposit accounts with high credit quality financial institutions.

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Stock-Based Compensation In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure.* SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation, to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based compensation and the effect of the method used on reported results. SFAS No. 148 is effective for financial statements for fiscal years ending after December 15, 2002 and for interim periods beginning after December 15, 2002. The annual disclosure requirements of SFAS No. 148 were adopted by the Company on January 1, 2003.

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment.* SFAS No. 123R requires employee stock options and rights to purchase shares under stock participation plans to be accounted for under the fair value method, and eliminates the ability to account for these instruments under the intrinsic value method prescribed by APB Opinion No. 25, as allowed under the original provisions of SFAS No. 123. Under the intrinsic value based method, compensation cost is measured by the excess, if any, of the quoted market price of the stock at the grant date over the amount an employee must pay to acquire the stock. Under the fair value based method, compensation cost is measured at the grant date based on the fair value of the award and is recognized over the service period, which is usually the vesting period.

SFAS 123R provides two alternative transition methods in the period of adoption: the modified prospective application method and the modified retrospective application method. The Company has adopted the provisions of SFAS No. 123R effective January 1, 2006 using the modified prospective application transition method. The modified prospective application requires the compensation cost for the portion of awards for which the requisite service has not yet been rendered that are outstanding as of the adoption date be recognized over the remaining service period. The compensation cost for that portion of awards will be based on the grant date fair value of those awards as calculated for pro forma disclosures under SFAS No. 123, as originally issued. All new awards and awards that are modified, repurchased, or cancelled after the adoption date will be accounted for under the provisions of SFAS No. 123R. The Company uses the Black-Scholes option pricing model to determine the fair value of stock option grants. The impact of this statement was not material to the Company s financial position or results of operations. Compensation costs of $29 related to the Company s stock option plan and $181 related to compensation costs of the restricted stock unit grants are included in operations in the year ended December 31, 2006.

Had compensation expense for the Company s stock based compensation plans been determined consistent with SFAS 123, the Company s net income and earnings per share would have been as follows:

	Years Ended December 31, 2005	2004
Net income, as reported	$ 8,179	$ 14,931
(Deduct) Add: Stock-based employee compensation (income) expense included in reported net income, net of related tax effects*	(94)	173
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(7,468)	(1,358)
Pro forma net income	$ 617	$ 13,746
Earnings per share:		
Basic as reported	$ 0.58	$ 1.08
Basic pro forma	$ 0.04	$ 0.99
Diluted as reported	$ 0.57	$ 1.06
Diluted pro forma	$ 0.04	$ 0.98

* The years ended 2005 and 2004 assume a U.S. tax rate of 37.6%.

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We incurred minimal expenses in 2006 as calculated under the Black-Scholes method of SFAS 123, related to our adoption of SFAS 123(R) for the expensing of stock options as we vested substantially all of our unvested options in the fourth quarter of 2005. The reduction in pre-tax charges estimated by the Company as a result of the acceleration amounts to approximately $7.7 million over the course of the original vesting periods. Options to purchase approximately 704,310 shares of the Company s stock or 52.5% of the Company s outstanding options were accelerated. The weighted average exercise price of the options subject to acceleration was $21.30. The aggregate pretax expense for the shares subject to acceleration that would have been reflected in the Company s consolidated financial statements beginning in 2006 is approximately $7.7 million, including $4.3 million in 2006, $2.7 million in 2007, and $0.7 million in 2008. The fair value for any future grants will be included in expense over the vesting periods. These expenses will be apportioned according to the classification of the employees who have received stock options into cost of sales, selling, general and administrative or research and development costs.

The Company used the Black-Scholes option-pricing model to determine the fair value of grants made. The following assumptions were applied in determining the pro forma compensation cost:

	Years Ended December 31,	
	2005	**2004**
Risk-free interest rate	3.30% to 4.47%	2.54% to 3.82%
Expected dividend yield	0%	0%
Expected option life	4 years	5 years
Stock price volatility	62.7%	80.5%

Long-Lived Assets Effective January 1, 2002, the Company adopted SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* SFAS No. 144 supersedes SFAS No. 121 and requires that one accounting impairment model be used for long-lived assets to be held and used and to be disposed of by sale, whether previously held and used or newly acquired, and broadens the presentation of discontinued operations to include more disposal transactions. The adoption of SFAS No. 144 had no financial impact on the results of operations or financial position of the Company. During the fourth quarter of 2006, management reviewed the Company s long-lived assets and concluded that there was no impairment of these assets for the year ended December 31, 2006.

Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Impact of Recently Issued Accounting Standards

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs, an Amendment of ARB No. 43, Chapter 4.* SFAS No. 151 retains the general principle of ARB No. 43, Chapter 4, *Inventory Pricing,* that inventories are presumed to be stated at cost; however, it amends ARB No. 43 to clarify that abnormal amounts of idle facilities, freight, handling costs and spoilage should be recognized as current period expenses. Also, SFAS No. 151 requires fixed overhead costs be allocated to inventories based on normal production capacity. The guidance in SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The implementation of SFAS No. 151 did not have a material impact on its financial position or results of operations.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 was issued to provide consistency between how registrants quantify financial statement misstatements.

Historically, there have been two widely-used methods for quantifying the effects of financial statement misstatements. These methods are referred to as the roll-over and iron curtain method. The roll-over method quantifies the amount by which the current year income statement is misstated. Exclusive reliance on an income statement approach can result in the accumulation of errors on the balance sheet that may not have been material to any individual income statement, but which may misstate one or more balance sheet accounts. The iron curtain method quantifies the error as the cumulative amount by which the current year balance sheet is misstated. Exclusive reliance on a balance sheet approach can result in disregarding the effects of errors in the current year income statement that results from the correction of an error existing in previously issued financial statements. The Company previously used the roll-over method for quantifying identified financial statement misstatements.

SAB 108 established an approach that requires quantification of financial statement misstatements based on the effects of the misstatement on each of the Company s financial statements and the related financial statement disclosures. This approach is commonly referred to as the dual approach because it requires quantification of errors under both the roll-over and iron curtain methods.

SAB 108 allows registrants to initially apply the dual approach either by (1) retroactively adjusting prior financial statements as if the dual approach had always been used or by (2) recording the cumulative effect of initially applying the dual approach as adjustments to the carrying values of assets and liabilities as of January 1, 2006 with an offsetting adjustment recorded to the opening balance of retained earnings. Use of this cumulative effect transition method requires detailed disclosure of the nature and amount of each individual error being corrected through the cumulative adjustment and how and when it arose.

The Company has evaluated SAB 108 and it did not have a material impact on the Company s financial condition or results of operations.

In July 2006, the FASB issued FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes an interpretation of SFAS No. 109* (FIN 48). The intent of FIN 48 is to clarify the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with SFAS 109. This interpretation imposes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the requirements of FIN 48 and has not yet determined the impact this adoption will have on its consolidated financial statements.

2. ACQUISITION

iQvolution On March 29, 2005, the Company acquired 100% of the outstanding stock of privately held iQvolution AG (iQvolution). iQvolution, a German company, designs, manufactures and supplies three-dimensional laser scanning products and services. This purchase was a strategic acquisition to enable the Company to enter broader three-dimensional measurement markets. The purchase price for the transaction was approximately $13.6 million, including an initial cash payment of approximately $3.8 million and 314,736 shares of common stock valued at approximately $7.2 million based on the average closing price for the three days immediately preceding the closing, 152,292 shares of which were payable immediately. The remaining 162,444 shares of common stock, valued at approximately $3.7 million, were placed in escrow and may be paid over the following five years subject to achieving predetermined milestones with respect to purchased assets. Subsequent to the purchase, approximately $1.8 million in cash was paid out for the repayment of loans and approximately $0.4 million was paid in fees associated with the purchase. Additionally, the purchase price was adjusted downward by $0.1 million, and these funds were repaid to the Company in the third quarter relating to the settlement of a purchase price adjustment clause within the purchase agreement. In the fourth quarter of 2005, 12,183 shares were issued as a result of the successful qualification of milestones, with a corresponding addition to goodwill of $252. During 2006, 25,991 shares were released from escrow with a corresponding addition to Goodwill of $408. At December 31, 2006, there were 81,267 shares being held in escrow.

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During the third quarter of 2005, approximately $3.8 million of the purchase price was allocated to intangible assets reflecting the Company s preliminary estimate of the fair value of technology and software assets acquired. The hardware assets acquired were valued at approximately $2.3 million with an estimated life of 17 years, while the software assets were valued at approximately $1.6 million with an estimated life of 10 years. As of December 31, 2005, these estimates were in the process of being reviewed and validated by a third party. The Company completed in the first quarter of 2006 the third party valuation of the assets acquired. The Company made an adjustment to the purchase price to reflect a deferred tax liability of approximately $1.5 million. The following table represents the fair value of the assets acquired and liabilities assumed and includes the final determination of the estimated fair values of deferred tax assets, non-compete, and intangible assets, which were preliminary as of December 31, 2005.

Current assets	$ 907
Property and equipment	595
Deferred tax assets	141
Non-compete	348
Intangible assets	3,492
Goodwill	8,309
Current liabilities	(2,235)
Long term debt	(167)
Deferred tax liability	(1,506)
	$ 9,884

The operating results of iQvolution have been included in the consolidated statements of income since the date of acquisition. The following unaudited pro-forma results of operations for the years ended December 31, 2005 and December 31, 2004 are presented for informational purposes only and do not purport to be indicative of the results of operations which actually would have resulted had the acquisition occurred on the date indicated, or the results of operations which may result in the future.

	Years ended December 31,	
	2005 (unaudited)	**2004 (unaudited)**
Revenues	$ 125,961	$ 103,022
Net income	$ 7,463	$ 13,891
Income per share:		
Basic	$ 0.53	$ 0.99
Diluted	$ 0.52	$ 0.98

3. SUPPLEMENTAL CASH FLOW INFORMATION

Selected cash payments and non-cash activities were as follows:

	Years ended December 31,		
	2006	**2005**	**2004**
Cash paid for interest	$ 16	$ 91	$ 12
Cash paid for income taxes	976	2,027	357
Cash received from income tax refund		1,161	
Non-cash investing and financing activities:			
Value of shares issued for acquisition of iQvolution	408	3,756	
Fixed assets acquired under capital lease obligations			317
Retirement of fully depreciated property and equipment			4,016

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4. ALLOWANCE FOR DOUBTFUL ACCOUNTS

The allowance for doubtful accounts is as follows:

	Years ended December 31, 2006	2005	2004
Balance, beginning of year	$ 214	$ 339	$ 255
Provision	257	112	154
Amounts written off, net of recoveries	(13)	(237)	(70)
Balance, end of year	$ 458	$ 214	$ 339

5. SHORT-TERM INVESTMENTS

The underlying investments of the Company s variable rate municipal bonds are long term tax-exempt municipal bonds. These variable rate municipal bonds mature every seven days, at which time the interest rate adjusts to current market conditions. As they are considered available-for-sale securities, the Company has classified them as short-term investments on the accompanying consolidated balance sheets.

6. INVENTORIES

Inventories consist of the following:

	December 31, 2006	2005
Raw materials	$ 9,754	$ 11,820
Finished goods	2,160	4,976
Sales demonstration inventory	11,919	12,227
Reserve for excess and obsolete	(404)	(373)
Inventory	23,429	28,650
Service inventory	7,278	4,333
Total	$ 30,707	$ 32,983

7. GOODWILL

The Company s goodwill at December 31, 2006 and 2005 is related to its acquisition of three previous businesses. The Company tests for goodwill impairment in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets.* The Company evaluates each reporting unit s fair value versus its carrying value in the fourth quarter of each year or more frequently if events or changes in circumstances indicate that the carrying value may exceed the fair value. The Company prepares a discounted cash flow model to estimate the fair value of the reporting unit and compares this amount against the carrying value. Impairments to goodwill are charged against earnings in the period the impairment is identified. The Company has three reporting units for which goodwill was tested on December 31, 2006, the Americas Region, the Europe/Asia Region, and the Asia Pacific Region, as shown in the table. As of December 31, 2006 and 2005, the Company did not have any goodwill that was identified as impaired. The increase in goodwill of $2.7 million in 2006 and $6.5 million in 2005 relates primarily to the purchase of iQvolution.

December 31, 2006	Beginning Balance	Additions	Foreign Currency Translation	Ending Balance
Americas Region	$ 6,994	$		$ 6,994
Europe/Africa region	7,580	1,625	1,067	10,272
Asia Pacific Region				
Total	$ 14,574	$ 1,625	$ 1,067	$ 17,266

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December 31, 2005	Beginning Balance	Additions	Foreign Currency Translation	Ending Balance
Americas Region	$ 6,994	$		$ 6,994
Europe/Africa region	1,083	6,633	(136)	7,580
Asia Pacific Region				
Total	$ 8,077	$ 6,633	$ (136)	$ 14,574

8. INTANGIBLE ASSETS

Intangible assets consist of the following:

	December 31, 2006	December 31, 2005
Amortizable intangible assets:		
Existing product technology	$ 10,273	$ 8,767
Patents	2,984	2,544
Other	6,791	6,055
Total	20,048	17,316
Accumulated amortization	(13,827)	(10,921)
Intangible assets net	$ 6,221	$ 6,395

In 2005, the Company wrote off patents with an original cost of $503 and a net book value of $334 which had been abandoned. Amortization expense was $1,293, $1,299 and $886, in 2006, 2005, and 2004, respectively. The estimated amortization expense for each of the five succeeding fiscal years is as follows:

Years ending December 31,	Amount
2007	$ 892
2008	474
2009	465
2010	465
2011	465
Thereafter	3,210
	$ 5,971

9. ACCRUED LIABILITIES

Accrued liabilities consist of the following:

December 31,

	2006	2005
Accrued compensation and benefits	$ 7,195	$ 2,641
Accrued warranties	1,369	861
Professional and legal fees	972	1,239
Other accrued liabilities	843	828
	$ 10,379	$ 5,569

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Activity related to accrued warranties was as follows:

	December 31, 2006	December 31, 2005
Beginning Balance	$ 861	$ 565
Provision for warranty expense	1,326	1,050
Warranty expired	(818)	(754)
Ending Balance	$ 1,369	$ 861

10. LINE OF CREDIT

On July 11, 2006, the Company entered into a loan agreement providing for an available line of credit of $30.0 million. Loans under the loan agreement bear interest at the rate of LIBOR plus 1.75% and require the Company to maintain certain ratios with respect to a debt covenant agreement, including current ratio, consolidated EBITDA, and senior funded debt to EBITDA. As of December 31, 2006, the Company is in compliance with all of the covenants under the Amended Loan Agreement. The term of the Amended Loan Agreement extends to April 30, 2009. The Company has not drawn on this line of credit.

11. CAPITAL LEASES AND LONG-TERM DEBT

Required future payments of obligations under capital leases are as follows:

Year ending December 31,	Capital Lease Obligations
2007	$ 87
2008	70
2009	8
2010	2
2011	
Total future minimum lease payments	167
Less Current maturities	(52)
	$ 115

Assets under capital leases were $559 and $384 at December 31, 2006 and 2005, respectively. Accumulated depreciation under capital leases was $366 and $235 at December 31, 2006 and 2005, respectively.

The current portion of long-term debt of $38 is included in capital leases and long-term debt in the accompanying consolidated balance sheets as of December 31, 2006.

12. RELATED PARTY TRANSACTIONS

Related party lease The Company leases its headquarters in Lake Mary, Florida from Xenon Research, Inc., a company owned by Simon Raab, the Company s Chairman, and Diana Raab, his spouse. The prior lease expired on February 28, 2006, and the Company executed a new Lease Agreement on August 8, 2006 with Xenon Research. The term of the lease commenced as of July 1, 2006 and expires on July 1, 2011. The Lease will be automatically renewed for one successive five-year term unless the Company provides Xenon Research with written notice of non-renewal at least 90 days prior to the end of the term. The Company also has a one-time right to terminate the Lease after three years (from July 1, 2006) upon written notice delivered to the Landlord one year prior to the date upon which the Company wishes to terminate the Lease. The Company s independent directors negotiated and approved the lease on behalf of the Company. In that process, the independent directors consulted with a real estate broker to verify that the lease rate and terms were competitive and at market.

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During the first year of the Initial Term, the fixed rent will be $302,750 per annum payable monthly. Each year thereafter (on July 1), the fixed rent will be increased by three percent over the fixed rent for the preceding year. The lease is a net lease, meaning that the Company also is responsible for real estate taxes and insurance expenses covering the leased premises. The real estate taxes and insurance expenses are paid by Xenon Research, and the Company reimburses Xenon Research in equal monthly payments for such real estate taxes and insurance expenses with the reimbursement amount to be computed annually based on the real estate taxes and insurance expenses actually paid by Xenon Research. All payments of fixed rent and additional rent will include all applicable sales and use taxes. Rent expense under this lease and the prior lease was $398 in 2006, 2005 and 2004.

13. OTHER INCOME (EXPENSE), NET

Other income (expense), net consists of the following:

	Years ended December 31,		
	2006	**2005**	**2004**
Foreign exchange gains (losses)	$ 827	$ (794)	$ 337
Disposal of patents		(334)	
Other	(37)	322	25
Total other income (expense), net	$ 790	$ (806)	$ 362

14. INCOME TAXES

Income before income taxes consists of the following:

	Years ended December 31,		
	2006	**2005**	**2004**
Domestic	$ 932	$ 5,304	$ 5,729
Foreign	8,844	4,594	9,560
Income before income taxes	$ 9,776	$ 9,898	$ 15,289

The components of the income tax expense are as follows:

	Years ended December 31,		
	2006	**2005**	**2004**
Current:			
Federal	$ 517	$ 1,792	$ 987
State	50	173	65
Foreign	1,028	1,317	1,316
	1,595	3,282	2,368
Deferred:			
Federal	(470)	(395)	(278)
State	(46)	(38)	(18)
Foreign	501	(1,130)	(1,714)

	(15)	(1,563)	(2,010)
	$ 1,580	$ 1,719	$ 358

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Income tax expense for the years ended December 31, 2006, 2005, and 2004 differ from the amount computed by applying the federal statutory corporate rate to income before income taxes. The differences are reconciled as follows:

	Years ended December 31,		
	2006	2005	2004
Tax expense at statutory rate of 35%	$ 3,422	$ 3,464	$ 5,351
State income taxes, net of federal benefit	36	84	147
Foreign tax rate difference	(3,064)	(2,771)	(1,309)
Research and development credit	(121)	(274)	(270)
Change in valuation allowance	1,411	1,247	(3,191)
Other	(104)	(31)	(370)
Total income tax expense	$ 1,580	$ 1,719	$ 358

The components of the Company s net deferred income tax asset are as follows:

	December 31,	
	2006	2005
Net deferred income tax asset Current		
Intercompany profit in inventory	$ 1,592	$ 2,166
Warranty costs	268	242
Bad debt reserve	87	32
Inventory reserve	(38)	59
Unearned service revenue	1,436	723
Other	(102)	4
Deferred income tax asset Current	3,243	3,226
Valuation Allowance	(1,398)	(1,071)
Net deferred income tax asset Current	$ 1,845	$ 2,155
Net deferred income tax asset Non-current		
Depreciation	$ 1,228	$ 886
Goodwill amortization	(847)	(880)
Product design costs	(59)	(128)
Employee stock options	100	55
Unearned service revenue	52	199
Tax credits	279	716
Loss carryforwards	6,251	5,422
Deferred income tax asset Non-current	7,004	6,270
Valuation Allowance	(3,019)	(2,415)
Net deferred income tax asset Non-current	$ 3,985	$ 3,855
Net deferred income tax liability Non-current		
Intangible assets	$ (1,200)	$

At December 31, 2006 and 2005, the Company s domestic entities had deferred income tax assets in the amount of $3,996 and $4,074, respectively. The Company has determined that these amounts are fully realizable and have not established any valuation allowance based on the assessment that they are more-likely-than-not to be utilized.

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At December 31, 2006 and 2005, the Company s foreign subsidiaries had deferred income tax assets relating to net operating loss carry forwards, which do not expire, of $6,251 and $5,422, respectively. For financial reporting purposes, a valuation allowance of $4,417 and $3,486, respectively has been recognized to offset the deferred tax assets relating to net operating losses.

The Company continues to maintain a valuation allowance on net operating losses in jurisdictions for which it does not have a history of earnings over the last three years and where the Company believes that the deferred tax assets are not more-likely-than-not to be realized based upon two-year projections of taxable income. The Company increased the overall valuation allowance in 2006 on its deferred tax assets in the amount of $931. The increase in the valuation allowance for 2006 relates to the net generation of deferred tax assets in foreign jurisdictions, including $451 related to the purchase of iQvolution.

At December 31, 2006 and 2005, the Company had $279 and $716 in tax credits, respectively. These credits are related to the Company s research and development activities and expire in 16 to 20 years. The Company fully expects to realize these credits before expiration.

The Company operates in a number of different countries around the world. In 2003, the Company began to manufacture its products in Switzerland, where it has received a favorable income tax rate commitment from the Swiss government as an incentive to establish a manufacturing plant there. The aggregate dollar effect of this favorable tax rate was approximately $1.7 million, or $0.12 per share, in the year ended December 31, 2006, and $3.0 million, or $0.21 per share, in the year ended December 31, 2005. In 2005, the Company opened a regional headquarters and began to manufacture its products in Singapore, where it has received a reduced income tax rate commitment from the Singapore Economic Development Board as an incentive to establish a manufacturing plant and regional headquarters there. The aggregate dollar effect of this favorable tax rate was approximately $0.9 million, or $.06 per share, during the year ended December 31, 2006.

We have not recognized any U.S. tax expense on undistributed international earnings since we intend to reinvest the earnings outside the U.S. for the foreseeable future. Our net undistributed international earnings were approximately $10.8 million and $6.3 million at December 31, 2006, and 2005, respectively.

Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of a global business, there are many transactions for which the ultimate tax outcome is uncertain. The Company reviews its tax contingencies on a regular basis and makes appropriate accruals as necessary.

15. COMMITMENTS AND CONTINGENCIES

Leases The following is a schedule of future minimum lease payments required under non-cancelable operating leases with initial terms in excess of one year, including leases with related parties (see Note 12), in effect at December 31, 2006:

Years ending December 31,	**Amount**
2007	$ 3,022
2008	2,422
2009	1,944
2010	906
2011	573
Thereafter	476
Total future minimum lease payments	$ 9,343

Rent expense for 2006, 2005, and 2004, was approximately $3,291, $2,306 and $1,651, respectively.

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Patent Litigation Patent Litigation On November 25, 2003, Cimcore-Romer (now a division of Hexagon) filed a patent infringement suit against us in the Federal District Court for the Southern District of California alleging that certain of our products sold in the United States, including the FARO Arm, infringe U.S. Patent 5,829,148 (148 patent). The Company believes, and has contended in this litigation, that the Company does not infringe the 148 patent and that the 148 patent is invalid.

On July 12, 2005, the court issued an order granting Cimcore-Romer s motion for summary judgment of infringement of three claims of the 148 patent. On July 22, 2005, the Company announced its decision to limit the capability of its U.S.-based FARO Arm products (the FARO Arm, the FARO Gage and the Digital Template) by removing what we call the infinite rotation feature by reducing this capability to 50 rotations or fewer. FARO believes that by limiting the range of the joint rotation to 50 rotations, it has removed from its U.S. products the ability to sweep through an unlimited arc, which is a feature of the 148 patent claims addressed by the court s ruling required to infringe the 148 patent. The revised products have not, however, been considered by the courts. Accordingly, we cannot give assurance that the revised products will not be deemed to infringe the 148 patent.

On September 20, 2005, the Court vacated its order of summary judgment of infringement and agreed to reconsider its conclusions from the patent claim construction (Markman) ruling, which is a pretrial hearing often used in patent infringement cases. The new Markman hearing occurred on October 3, 2005 and the hearing-on-summary judgments of infringement occurred on November 14, 2005. On October 18, 2005, the Court issued a revised claim construction that the Company believes materially alters the Court s previous Markman ruling by substantially narrowing what FARO believes to be key aspects of the claim construction. The Company believes that this narrower claim construction will ultimately lead to a finding that it does not infringe any claim of the 148 patent.

The trial began in November 2006, and on December 6, 2006, the judge presiding over the case declared a mistrial trial. A new trial date has been set for April 3, 2007.

In addition, the Company filed two separate requests for reexamination in the U.S. Patent and Trademark Office (PTO) of the 148 Patent, both of which requests were granted. The PTO ruled in the first reexamination in September 2005. The Company believes that the PTO ruling bolsters the Company s previous position that it does not infringe the 148 patent. More specifically, in the first reexamination, the PTO construed critical claim terms in a relatively narrow manner, which the Company believes is consistent with its stated positions in the patent litigation. The Company s second reexamination request was granted by the PTO in November 2005 and is based on new prior art (that is, earlier issued patent publications) submitted to the PTO which FARO believes will ultimately invalidate the 148 patent. This prior art reference was not at issue in the first reexamination proceeding.

On December 7, 2006, the PTO rejected key claims in Hexagon s 148 patent. Hexagon has appealed the PTO s rejection of the claims. The rejected claims include all the claims involved in the ongoing 148 patent infringement. If the PTO rejection is ultimately made final, the patent claims asserted against the Company in the Hexagon litigation will be invalidated, and FARO will then prevail in its litigation. The Hexagon 148 patent claims cover a four-jointed arm construction with a mechanically unlimited rotation of certain joints. The PTO, in its rejection, determined that this feature was already found in a number of prior patents and so determined that the 148 claims were obvious in view of these prior patents. Hexagon will have the right to respond to, and eventually appeal, the rejection of the claims.

In the event of an adverse ruling in the Romer-Cimcore litigation, we could be required to pay substantial damages, cease the manufacturing, use and sale of any infringing products, discontinue the use of certain processes or obtain a license, if available, from Romer-Cimcore with royalty payment obligations by us. An adverse decision in the Romer-Cimcore case could materially and adversely affect our financial condition and results of operations. At this time, however, the Company cannot estimate the potential impact, if any, that might result from this suit, and therefore, no provision has been made to cover such expense.

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Securities Litigation On December 6, 2005, the first of four essentially identical class action securities fraud lawsuits were filed against the Company and certain officers of the Company. On April 19, 2006, the four lawsuits were consolidated, and Kornitzer Capital Management, Inc. was appointed as the lead plaintiff. On May 16, 2006, Kornitzer filed its Consolidated Amended Class Action Complaint against the Company and the individual defendants. The Amended Complaint also named Grant Thornton LLP, the Company s independent registered public accounting firm, as an additional defendant.

On July 31, 2006, the Company filed a Motion to Dismiss the Amended Complaint. On February 3, 2007, the Court dismissed the Amended Complaint, as against all defendants, with leave to re-plead.

On February 22, 2007, Kornitzer filed its Consolidated Second Amended Class Action Complaint. The Second Amended Complaint principally asserts the same claims set forth in the Amended Complaint, but adds various allegations in an attempt to comply with certain standards stated in the Court s order. As in the Amended Complaint, Kornitzer seeks to represent a class consisting of all persons who purchased or otherwise acquired the Company s publicly traded securities between April 15, 2004 and March 15, 2006. On behalf of the alleged class, Kornitzer seeks an unspecified amount of damages, premised on allegations that each defendant made misrepresentations and omissions of material fact during the class period in violation of the Securities Exchange Act of 1934. Among other things, Kornitzer alleges that the defendants misrepresented matters during the class period related to: (i) the value of the Company s inventory, and the amount of the Company s gross margins and profits, as a result of the inventory valuation; (ii) the amount of the 2005 selling expenses that the Company had accrued and expected; and (iii) the effectiveness of the Company s systems of internals controls, including in connection with the Company s determination of its inventory valuation and selling expenses, and the fact that certain reported sales in Asia were obtained in violation of the Foreign Corrupt Practices Act.

The Company s deadline for responding to the Second Amended Complaint is April 26, 2007. The Company intends to file a motion to dismiss the Second Amended Complaint. The Company has timely notified the issuer of its Executive Liability and Entity Securities Liability insurance policy of the Securities Litigation. Although the Company believes that the material allegations made in the Second Amended Complaint are without merit and intends to vigorously defend the Securities Litigation, no assurances can be given with respect to the outcome of the Securities Litigation.

Purchase Commitments The Company enters into purchase commitments for products and services in the ordinary course of business. These purchases generally cover production requirements for 60 to 90 days. On August 11, 2005, FARO entered into an agreement with DELCAM plc under which the Company agreed to purchase approximately $1.4 million in products over a 12-month term. At December 31, 2006, the Company had completed the purchase of $1.4 million in products under this agreement. Effective November 1, 2005, FARO entered into an agreement with Metrologic Group S.A. under which the Company agreed to purchase approximately $0.4 million in products over a 12-month term. At December 31, 2006, $0.3 million had been purchased under this agreement and the agreement was not renewed. Other than the agreements listed above, the Company does not have any long-term commitments for purchases.

Voluntary Disclosure of Foreign Corrupt Practices Act Matter to the Securities and Exchange Commission and Department of Justice. As previously reported by the Company, the Company learned that its China subsidiary had made payments to certain customers in China that may have violated the FCPA and other applicable laws. The Company s Audit Committee instituted an internal investigation into this matter in February 2006, and the Company voluntarily notified the SEC and the DOJ of this matter in March 2006. The internal investigation into this matter has been completed. The Company has provided to the SEC and the DOJ information obtained during the course of this investigation and is cooperating with both agencies.

The Company s internal investigation has identified certain improper payments made in China and deficiencies in its controls with respect to its operations in China in possible violation of the FCPA. If the SEC or the DOJ determines that violations of the FCPA have occurred, they could seek civil and criminal sanctions,

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including monetary penalties, against the Company and/or certain of its employees, as well as additional changes to the Company s business practices and compliance programs. Based on current information, it is not possible to predict at this time when the SEC or DOJ investigations will be resolved, what the outcome will be, what sanctions, if any, will be imposed, or the effect that such matters may ultimately have on the Company or its consolidated financial statements. Results of the investigation revealed that referral fee payments in possible violation of the FCPA were $165,000 and $265,000 in 2004 and 2005, respectively, which were recorded in selling expenses in the Company s statement of income. The related sales to customers to which payment of these referral fees had been made totaled $1.3 million and $3.24 million in 2004 and 2005, respectively. Additional improper referral fee payments of $122,000 were made in January and February 2006 related to sales contracts in 2005. The Company had sales in China of $9.0 million in 2005 and $4.2 million in 2004, approximately 7% and 4% of total sales, respectively. The Company incurred expenses of $3.8 million in 2006 relating to its internal investigation of the FCPA matter.

The Company has terminated certain personnel in the Asia-Pacific Region and has re-assigned the duties of other personnel in both the Asia-Pacific Region and the U.S. as a result of the internal investigation. The Company is instituting the following remedial measures:

- Contracted with a third party forensics accounting team to conduct an in-depth audit of the operations in China and in other countries in the Asia-Pacific Region and to make recommendations for improvement to the internal control systems.

- Reviewing third party distributor arrangements in an effort to assure that all contracts include adherence to the FCPA.

- Performing due diligence on all third party distributors and implementing a process to assess potential new distributors.

- Established an in-house internal audit function including hiring a Director of Internal Audit.

- Consolidating the human resources, financial accounting and reporting functions for the Asia region into the Singapore Operations.

- Implemented an internal certification process to ascertain whether similar issues may exist elsewhere in the Company.

- Implemented a quarterly internal certification process to confirm adherence to company policy and all applicable laws and regulations that will include all regional leadership, country management and other sales management.

- Implementing additional training on FCPA and other matters for employees and a confidential compliance reporting system.

During the Company s internal investigation of its business practices in China, it became aware that income taxes related to certain commissions and bonus payments to its employees had not been properly reported. The Company has filed the appropriate payroll tax returns and remitted the deficiency.

Other than the litigation mentioned above, the Company is not involved in any other legal proceedings other than routine litigation arising in the normal course of business. The Company does not believe the results of such litigation, even if the outcome were unfavorable to the Company, would have a material adverse effect on the Company s business, financial condition or results of operations.

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16. STOCK COMPENSATION PLANS

The Company has four stock option plans that provide for the granting of stock options to key employees and non-employee members of the Board of Directors. The 1993 Stock Option Plan (1993 Plan) and the 1997 Employee Stock Option Plan (1997 Plan) provide for granting incentive stock options and nonqualified stock options to officers and key employees of the Company. The 1997 Non-employee Director Plan provides for granting nonqualified stock options and formula options to non-employee directors. The 2004 Equity Incentive Plan (2004 Plan) provides for granting options or stock appreciation rights to employees and non-employee directors.

The Company is authorized to grant options for up to 703,100 shares of common stock under the 1993 Plan, of which there are none outstanding. The Company is also authorized to grant options for up to 1,400,000 shares of common stock under the 1997 Plan, of which 308,257 options are currently outstanding at exercise prices between $1.50 and $27.40. These options vest over a 3-year period. The Company is also authorized to grant up to 250,000 shares of common stock under the 1997 Non-employee Director Plan of which 80,000 options are currently outstanding at exercise prices between $1.61 and $21.56. Each non-employee director is granted 3,400 options upon election to the Board of Directors and then annually upon attending the annual meeting of shareholders (formula options). Formula options granted to directors are generally granted upon the same terms and conditions as options granted to officers and employees. These options vest over a 3-year period. The Company is also authorized to grant options for up to 1,750,000 shares of common stock under the 2004 Plan, of which 670,183 options are currently outstanding at exercise prices between $14.06 to $31.45, and 26,163 restricted stock units are outstanding at a stock price of $19.49. These options and restricted stock units vest over a 3-year period. The restricted stock unit grants have a performance-based annual vesting on the anniversary date over their respective terms. The Company records compensation cost associated with its restricted stock unit grants on a straight-line basis over the vesting term.

In addition to the four stock option plans, the Company has the 1997 Non-Employee Directors Fee Plan (1997 Fee Plan) under which the Company is authorized to issue up to 250,000 shares of Common Stock and permits non-employee directors to elect to receive directors fees in the form of common stock rather than cash. Common stock issued in lieu of cash directors fees is issued at the end of the quarter in which the fees are earned, with the number of shares being based on the fair market value of the common stock for the five trading days immediately preceding the last business day of the quarter. The 1997 Fee Plan also permits non-employee directors to irrevocably elect to defer receipt of all or any portion of the shares of common stock which would otherwise be payable. As of December 31, 2005 and 2004 there were 11,090 and 35,941 shares, respectively, which were accrued but not yet issued in connection with director s elections. These shares were issued as of December 31, 2006.

In the fourth quarter of 2001, the Company cancelled approximately 548,000 out of the money options, including approximately 440,000 options issued under the 1997 Plan and approximately 108,000 options issued under the 1997 Non-employee Director Plan. As a result, 62,806 options granted in 2001, under the 1997 Plan and to holders of some of the options cancelled, were subjected to variable accounting treatment. Under FIN 44, stock options issued within six months of a cancellation must be accounted for as variable under certain circumstances. Variable accounting requires companies to re-measure compensation costs for the variable options based on the Company s share price until the options are exercised, cancelled or forfeited without replacement. Compensation is dependent on fluctuations in the quoted market prices for the Company s common stock. Such compensation costs will be recognized over a three-year vesting schedule until the options are fully vested, exercised, cancelled or forfeited, after which time the compensation will be recognized immediately at each reporting period. With the adoption of FAS 123(R) in January of 2006, FIN 44 was superseded and the Company is no longer required to account for these options under variable accounting.

In the fourth quarter of 2005, the Company accelerated the vesting for substantially all of its outstanding options, and has recorded minimal expenses for its remaining unvested stock options during 2006. The pre-tax

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charge estimated by the Company to be avoided as a result of the acceleration amounts to approximately $7.7 million over the course of the original vesting periods. The fair value for any future grants will be included in expense over the vesting periods.

Compensation (income) costs charged to operations associated with the Company s stock option plans were $210, ($150), and $277 in 2006, 2005, and 2004, respectively. The changes in stock option associated compensation cost were due to the vesting of options combined with market price fluctuations in the Company s common stock under variable accounting and the accrual of expenses relating to the issuance of restricted stock.

A summary of stock option activity and weighted average exercise prices follows:

	Years Ended December 31, 2006		2005		2004	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding at beginning of year	1,340,034	$ 16.72	1,215,240	$ 13.69	978,952	$ 2.42
Granted	14,000	14.06	314,123	22.75	750,730	20.86
Forfeited	(234,196)	22.04	(51,830)	20.06	(28,930)	8.06
Exercised	(61,398)	7.57	(137,499)	2.47	(485,512)	2.41
Outstanding at end of year	1,058,440	$ 16.04	1,340,034	$ 16.72	1,215,240	$ 13.69
Outstanding exercisable at year-end	1,044,440	$ 16.06	1,329,366	$ 16.82	339,465	$ 6.40
Weighted-average fair value of options granted during the year	$ 7.32		$ 11.03		$ 13.67	

A summary of stock options outstanding and exercisable as of December 31, 2006 follows:

Exercise Price	Options Outstanding	Weighted-Average Remaining Contractual Life (years)	Average Exercise Price	Options Exercisable	Average Exercise Price
Up to $1.50	14,476	4.84	$ 1.50	14,476	$ 1.50
$1.51-$3.00	255,546	5.05	$ 2.22	255,546	$ 2.22
$3.01-$10.00	24,000	4.67	$ 4.16	24,000	$ 4.16
$10.01-$20.00	407,444	7.72	$ 19.07	393,444	$ 19.24
Over $20.00	356,974	7.60	$ 23.86	356,974	$ 23.86
	1,058,440	6.92	$ 16.04	1,044,440	$ 16.06

Remaining non-exercisable options as of December 31, 2006 become exercisable as follows:

Years ending December 31,	Amount
2007	4,667
2008	4,667
2009	4,666
	14,000

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A table illustrating the effect on net income and net income per share as if the fair value method prescribed by FAS 123 (R) had been applied is presented in Note 1. Summary of Significant Accounting Policies. The Company used the Black-Scholes option-pricing model to determine the fair value of grants made using the following assumptions:

	Year Ended December 31, 2006
Risk-free interest rate	5.00%
Expected dividend yield	0%
Expected option life	4 years
Stock price volatility	63.2%

17. EARNINGS PER SHARE

A reconciliation of the number of common shares used in the calculation of basic and diluted earnings per share (EPS) is presented below:

	Years Ended					
	December 31, 2006		December 31, 2005		December 31, 2004	
	Shares	Per-Share Amount	Shares	Per-Share Amount	Shares	Per-Share Amount
Basic EPS	14,397,050	$ 0.57	14,169,140	$ 0.58	13,833,590	$ 1.08
Effect of dilutive securities	163,281	(0.01)	273,108	(0.01)	189,569	(0.02)
Diluted EPS	14,560,331	$ 0.56	14,442,248	$ 0.57	14,023,159	$ 1.06

The effect of 745,841, 237,419, and 0 dilutive securities were not included for 2006, 2005 and 2004, as they were antidilutive.

18. EMPLOYEE RETIREMENT BENEFIT PLAN

The Company maintains a 401(k) defined contribution retirement plan for its U.S. employees, which provides benefits for all employees meeting certain age and service requirements. The Company may make a discretionary contribution each plan year, as determined by its Board of Directors. Discretionary contributions or employer matches can be made to the participant s account but cannot exceed 100% of compensation. Costs charged to operations in connection with the Plan during 2006, 2005, and 2004 aggregated $247, $201, and $172, respectively.

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19. SEGMENT REPORTING

The Company has three reportable segments based upon geographic regions: Americas, Europe/Africa and Asia Pacific. The company develops, manufactures, markets, supports and sells CAD-based quality assurance products integrated with CAD-based inspection and statistical process control software in each of these regions. These activities represent approximately 99% of consolidated sales. The Company evaluates performance and allocates resources based upon profitable growth and assets deployed.

The following table presents information about the Company s reportable segments:

	2006	2005	2004
Americas Region			
Net sales to external customers	$ 62,967	$ 55,884	$ 41,680
Operating income	(6,191)	(6,640)	(3,810)
Long-lived assets	12,278	12,825	12,661
Capital expenditures	1,684	1,251	1,505
Total assets	$ 69,607	$ 68,304	$ 68,090
Europe/Africa Region			
Net sales to external customers	$ 60,869	$ 44,940	$ 43,111
Operating income	8,130	8,322	13,693
Long-lived assets	16,397	12,461	2,493
Capital expenditures	1,333	1,931	813
Total assets	$ 55,041	$ 39,112	$ 30,527
Asia Pacific Region			
Net sales to external customers	$ 28,569	$ 24,766	$ 12,229
Operating income	6,320	8,544	4,701
Long-lived assets	1,657	1,746	505
Capital expenditures	1,038	1,583	358
Total assets	$ 19,628	$ 15,232	$ 6,461
Totals			
Net sales to external customers	$ 152,405	$ 125,590	$ 97,020
Operating income	8,259	10,226	14,584
Long-lived assets	30,332	27,033	15,659
Capital expenditures	4,055	4,765	2,676
Total assets	$ 144,276	$ 122,648	$ 105,078

The geographical sales information presented above represents sales to customers located in each respective region whereas the long-lived assets information represents assets held in the respective regions. There were no customers that accounted for 10% or more of total revenue.

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20. QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

During the fourth quarter of 2006, the Company identified certain shipments to customers containing the freight term FOB Destination as exceptions to the standard terms and conditions of sale that had been included in sales when shipped and not when delivered. Also during the fourth quarter, the Company noted that freight and duty was not included in the cost of inventory at certain international locations but was improperly expensed as incurred.

The Company recorded an adjustment to decrease sales and cost of sales of $1.4 million and $0.7 million, respectively, resulting in a decrease in pre-tax income of $0.7 million in the fourth quarter of fiscal 2006. The pre-tax effect of these items was not material to any previous quarters.

Quarter ended	April 1, 2006	July 1, 2006	September 30, 2006	December 31, 2006
Sales	$ 32,056	$ 38,042	$ 38,365	$ 43,942
Gross profit	18,835	22,562	22,244	25,817
Net income	496	853	3,189	3,658
Net income per share:				
Basic	$ 0.03	$ 0.06	$ 0.22	$ 0.25
Diluted	$ 0.03	$ 0.06	$ 0.22	$ 0.25

Quarter ended	April 2, 2005	July 2, 2005	October 1, 2005	December 31, 2005
Sales	$ 27,617	$ 30,895	$ 32,598	$ 34,480
Gross profit	17,343	18,390	17,685	19,514
Net income	3,469	1,912	2,615	183
Net income per share:				
Basic	$ 0.25	$ 0.13	$ 0.18	$ 0.01
Diluted	$ 0.24	$ 0.13	$ 0.18	$ 0.01

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 9A. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

The Company s management, under the supervision and with the participation of its Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined under Securities Exchange Act of 1934, as amended (the Exchange Act) Rule 13a-15(e)) as of the end of the period covered by this report. As discussed below, the Company identified the following material weakness in its internal control over financial reporting the Company s review controls did not effectively identify invoices containing delivery terms of FOB Destination which were not delivered to the customer by December 31, 2006. Solely as a result of this material weakness, management has concluded that the Company s disclosure controls and procedures were not effective as of December 31, 2006.

Changes in Internal Control Over Financial Reporting

The internal control over financial reporting changes with respect to the FOB Destination material weakness described below were the only changes in the Company s internal control over financial reporting during the year ended December 31, 2006 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

Management s Report on Internal Control Over Financial Reporting

Our Chief Executive Officer and Chief Financial Officer, together with other members of management of FARO Technologies Inc., are responsible for establishing and maintaining adequate internal control over financial reporting.

Internal control over financial reporting is the process designed under our supervision, and effected by our Board of Directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of our financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

There are inherent limitations in the effectiveness of internal control over financial reporting, including the possibility that misstatements may not be prevented or detected. Accordingly, an effective control system, no matter how well designed and operated, can provide only reasonable assurance of achieving the designed control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management over ride of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

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During the year end closing process, the external auditors identified invoices containing delivery terms of FOB Destination which were not delivered to the customer by December 31, 2006. The Company s terms and conditions of sale generally specify FOB Origin. There are two review controls intended to ensure all customer purchase orders conform to Company policies. These controls failed to operate effectively in identifying the delivery terms containing FOB Destination.

Management has evaluated the effectiveness of internal control over financial reporting as of December 31, 2006, in relation to criteria described in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations Commission of the Treadway Commission (COSO). Based upon this evaluation, management has concluded that certain deficiencies exist in the design and operation of internal controls related to financial reporting, which represent a material weakness in internal control over financial reporting.

As a result of these findings, management has undertaken the following actions to address the control deficiencies:

- Implemented additional training programs for the personnel responsible for reviewing customer purchase orders for compliance with Company policies.

- Modified the Company s internal sales order software to identify those sales orders containing the delivery terms of FOB Destination in order to record the shipment in the correct period.

- Implemented additional month end closing and review procedures to confirm delivery dates for all FOB shipments.

Grant Thornton LLP, our independent registered public accounting firm, has issued their report on management s assessment of internal control over financial reporting.

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PART III

Certain information required by Part III is omitted from this Report in that the Registrant will file a definitive proxy statement pursuant to Regulation 14A (the Proxy Statement) not later than 120 days after the end of the fiscal year covered by this Report and certain information included therein is incorporated herein by reference. Only those sections of the Proxy Statement that specifically address the Items set forth herein are incorporated by reference. Such incorporation does not include the Compensation Committee Report or the Performance Graph included in the Proxy Statement.

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS, AND CORPORATE GOVERNANCE.

The information to be set forth under the captions Election of Directors and Section 16 (a) Beneficial Ownership Reporting Compliance in the Proxy Statement is incorporated herein by reference.

The information concerning the Company s executive officers required by this Item is incorporated by reference herein from the section of this Report in Part I, Item 1, entitled Management of the Registrant.

Code of Business Conduct and Ethics

The Board of Directors has adopted a Code of Ethics, entitled Code of Ethics for Senior Financial Officers, that is applicable to its principal executive officer, principal financial officer, principal accounting officer or controller, and persons performing similar functions. The Board of Directors has also adopted a Global Ethics Policy which is applicable to those officers as well as all of the Company s employees. Both the Code of Ethics for Senior Financial Officers and the Global Ethics Policy are available on the Internet web site at www.faro.com. The Company is not including the information contained on or available through its website as a part of, or incorporating such information by reference into, this Form 10-K. We have adopted a Code of Ethics for Senior Financial Officers that applies to our senior financial officers, including our principal executive officer and principal financial and accounting officer. The Code of Ethics for Senior Financial Officers is posted on our website at *http://www.faro.com/Company/ Corporate_Governance.asp*. We will post any amendments to or waivers from the Code of Ethics for Senior Financial Officers at that location.

ITEM 11. EXECUTIVE COMPENSATION.

The information to be set forth under the caption Executive Compensation in the Proxy Statement is incorporated herein by reference; provided, however that the Company specifically excludes from such incorporation by reference any information set forth under the caption Compensation Committee Report on Executive Compensation.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

Security ownership of certain beneficial owners and management to be set forth under the caption Beneficial Owners and Management and Equity Compensation Plan Information in the Proxy Statement is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE.

The information to be set forth under the caption Certain Relationships and Related Transactions AND Director Independence in the Proxy Statement is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

The information required by this Item is incorporated herein by reference from information included under the caption entitled Our Independent Auditors set forth in our Proxy Statement.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES.

(a) Documents Filed as Part of this Report. The following documents are filed as part of this Report:

(1) Consolidated Financial Statements. Included in Part II, Item 8 are the consolidated financial statements, the notes thereto and the report of the Independent Registered Public Accounting Firm.

(2) Financial Statement Schedules. Schedule II Valuation and Qualifying Accounts is filed as a part hereof along with the related report of the Independent Registered Public Accounting Firm on the Company s financial statement schedule. All other schedules have been omitted because the information required to be set forth therein is not applicable or is included in the consolidated financial statements or notes thereto.

(3) Exhibits.

Exhibit No.	Description
3.1	Articles of Incorporation, as amended *(Filed as Exhibit 3.1 to Registrant s Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)*
3.2	Bylaws, as amended *(Filed as Exhibit 3.2 to Registrant s Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)*
4.1	Specimen Stock Certificate *(Filed as Exhibit 4.1 to Registrant s Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)*
10.1	1993 Stock Option Plan, as amended *(Filed as Exhibit 10.1 to Registrant s Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)**
10.2	1997 Amended and Restated Employee Stock Option Plan *(Filed as Exhibit 4. 2 to Registrant s Registration Statement on Form S-8, No. 333-125021, and incorporated herein by reference)**
10.3	2004 Equity Incentive Plan *(Filed as Exhibit 4.1 to Registrant s Registration Statement on Form S-8, No. 333-125021, and incorporated herein by reference)**
10.4	1997 Non-Employee Director Stock Option Plan *(Filed as Exhibit 10.3 to Registrant s Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)**
10.5	1997 Non-Employee Directors Fee Plan *(Filed as Exhibit 10.4 to Registrant s Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)**
10.6	Form of Patent and Confidentiality Agreement between the Company and each of its employees *(Filed as Exhibit 10.10 to Registrant s Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)*
10.7	Form of Restricted Stock Grant Agreement under the 2004 Equity Incentive Plan*
10.8	Form of Restricted Stock Unit Grant Agreement under the 2004 Equity Incentive Plan*
10.9	Form of Stock Option Grant Agreement under the 2004 Equity Incentive Plan*
10.10	Amended and Restated Loan Agreement, dated as of July 11, 2006, between the Company and SunTrust Bank. *(Filed as Exhibit 10.1 to Registrant s Current report on Form 8-K dated July 11, 2006)*
10.11	Employment Agreement dated October 20, 2006, by and between the Company and Jay Freeland *(Filed as Exhibit 10.1 to Registrant s Current report on Form 8-K dated October 20, 2006, and incorporated herein by reference)**
10.12	Employment Agreement dated December 5, 2006, by and between the Company and Keith Bair (*Filed as Exhibit 10.1 to Registrant s Current report on Form 8-K dated December 5, 2006 and incorporated herein by reference*) *

Exhibit No.	Description
10.13	Employment Agreement dated January 30, 2006 by and between the Company and Simon Raab *(Filed as Exhibit 10.1 to Registrant s Current report on Form 8-K dated January 30, 2006 and incorporated herein by reference)**
10.14	Severance Agreement dated July 24, 2006 by and between the Company and Barbara Smith *(Filed as Exhibit 10.1 to Registrant s Current report on Form 8-K dated July 24, 2006 and incorporated herein by reference)**
10.15	Lease Agreement dated August 8, 2006, by and between the Company and Xenon Research, Inc. (*Filed as Exhibit 10 to Registrant s Form 10-Q dated August 9, 2006 and incorporated herein by reference*)
21.1	List of Subsidiaries
23.1	Consent of Grant Thornton LLP
24.1	Power of Attorney relating to subsequent amendments (included on the signature page(s) of this report).
31-A	Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31-B	Certification of the Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32-A	Certification of the Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32-B	Certification of the Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
99.1	Properties

* Indicates management contracts and compensatory plans and arrangements

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SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS

Valuation and Qualifying Accounts were as follows for the three years ended December 31, 2006:

Description	Balance at beginning of period	Additions charged to costs and expenses or revenues	Deductions for purposes for which accounts were set up	Balance at end of period
Year ended December 31, 2006				
Deducted from assets which apply				
Uncollectible accounts	$ 214	$ 257	$ 13	$ 458
Reserve for inventory obsolescence	373	1,053	1,022	404
Total	$ 587	$ 1,310	$ 1,035	$ 862
Year ended December 31, 2005				
Deducted from assets which apply				
Uncollectible accounts	$ 339	$ 112	$ 237	$ 214
Reserve for inventory obsolescence	191	1,314	1,132	373
Total	$ 530	$ 1,426	$ 1,369	$ 587
Year ended December 31, 2004				
Deducted from assets which apply				
Uncollectible accounts	$ 255	$ 154	$ 70	$ 339
Reserve for inventory obsolescence	155	895	859	191
Total	$ 410	$ 1,049	$ 929	$ 530

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

FARO TECHNOLOGIES, INC.

Date: March 15, 2007

By: /s/ KEITH S. BAIR
Keith S. Bair,
Senior Vice President and Chief Financial Officer
(Duly Authorized Officer and Principal Financial Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated. Each person whose signature appears below constitutes and appoints JAY W. FREELAND, and each of them individually, his true and lawful attorney-in-fact and agent, with full power of substitution and revocation, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this Report and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or either of them, may lawfully do or cause to be done by virtue hereof.

Signature	Title	Date
/s/ SIMON RAAB **Simon Raab**	Chairman of the Board and Director	March 15, 2007
/s/ JAY W. FREELAND **Jay W. Freeland**	President and Chief Executive Officer, (Principal Executive Officer), and Director	March 15, 2007
/s/ KEITH S. BAIR **Keith S. Bair**	Senior Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	March 15, 2007
/s/ JOHN CALDWELL **John Caldwell**	Director	March 15, 2007
/s/ HUBERT D AMOURS **Hubert d Amours**	Director	March 15, 2007
/s/ STEPHEN R. COLE **Stephen R. Cole**	Director	March 15, 2007
/s/ NORMAN H. SCHIPPER **Norman H. Schipper**	Director	March 15, 2007

/s/ Andre Julien	Director	March 15, 2007
Andre Julien		