

FARO TECHNOLOGIES INC  
Form 10-Q  
November 04, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended October 2, 2010

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)

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<b>Florida</b> (State or Other Jurisdiction of Incorporation or Organization)	<b>59-3157093</b> (I.R.S. Employer Identification No.)
<b>250 Technology Park, Lake Mary, Florida</b> (Address of Principal Executive Offices)	<b>32746</b> (Zip Code)
<b>(407) 333-9911</b> (Registrant's Telephone Number, Including Area Code)	

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  NO

Indicated by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act (Check one):.

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

As of November [\_\_], 2010, there were 16,161,858 shares of the registrant's common stock outstanding.

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**FARO TECHNOLOGIES, INC.**

Quarterly Report on Form 10-Q

Quarter Ended October 2, 2010

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****FARO TECHNOLOGIES, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)	October 2, 2010 Unaudited	December 31, 2009
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 44,625	\$ 35,078
Short-term investments	64,985	64,986
Accounts receivable, net	43,218	42,944
Inventories, net	28,395	26,582
Deferred income taxes, net	5,520	4,473
Prepaid expenses and other current assets	9,414	6,016
<b>Total current assets</b>	<b>196,157</b>	<b>180,079</b>
Property and Equipment:		
Machinery and equipment	23,930	19,867
Furniture and fixtures	5,308	5,225
Leasehold improvements	9,430	9,434
Property and equipment at cost	38,668	34,526
Less: accumulated depreciation and amortization	(24,086)	(20,788)
Property and equipment, net	14,582	13,738
Goodwill	19,371	19,934
Intangible assets, net	7,224	7,985
Service inventory	13,369	12,079
Deferred income taxes, net	1,444	1,895
<b>Total Assets</b>	<b>\$ 252,147</b>	<b>\$ 235,710</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 8,083	\$ 8,985
Accrued liabilities	13,292	8,173
Income taxes payable		229
Current portion of unearned service revenues	12,627	12,226
Customer deposits	2,652	2,173
Current portion of obligations under capital leases	23	80
<b>Total current liabilities</b>	<b>36,677</b>	<b>31,866</b>

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Unearned service revenues - less current portion	6,286	5,910
Deferred tax liability, net	2,953	1,143
Obligations under capital leases - less current portion	215	193
<b>Total Liabilities</b>	<b>46,131</b>	<b>39,112</b>
<b>Commitments and contingencies - See Note R</b>		
<b>Shareholders' Equity:</b>		
Common stock - par value \$.001, 50,000,000 shares authorized; 16,842,093 and 16,795,289 issued; 16,161,858 and 16,115,054 outstanding, respectively	17	17
Additional paid-in capital	154,585	152,380
Retained earnings	53,144	46,915
Accumulated other comprehensive income	7,345	6,361
Common stock in treasury, at cost - 680,235 shares	(9,075)	(9,075)
<b>Total Shareholders' Equity</b>	<b>206,016</b>	<b>196,598</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 252,147</b>	<b>\$ 235,710</b>

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

**Table of Contents****FARO TECHNOLOGIES, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS**

(UNAUDITED)

(in thousands, except share and per share data)	Three Months Ended		Nine Months Ended	
	Oct 2, 2010	Oct 3, 2009	Oct 2, 2010	Oct 3, 2009
<b>SALES</b>				
Product	\$ 36,725	\$ 27,876	\$ 107,875	\$ 79,292
Service	8,561	7,837	25,385	22,385
<b>Total Sales</b>	<b>45,286</b>	<b>35,713</b>	<b>133,260</b>	<b>101,677</b>
<b>COST OF SALES</b>				
Product	12,901	11,261	36,796	30,647
Service	6,002	4,850	17,602	15,805
Total Cost of Sales (exclusive of depreciation and amortization, shown separately below)	18,903	16,111	54,398	46,452
<b>GROSS PROFIT</b>	<b>26,383</b>	<b>19,602</b>	<b>78,862</b>	<b>55,225</b>
<b>OPERATING EXPENSES:</b>				
Selling	11,707	11,482	34,969	36,434
General and administrative	7,201	6,158	19,476	18,591
Depreciation and amortization	1,779	1,410	4,834	4,090
Research and development	2,850	2,802	8,836	9,566
<b>Total operating expenses</b>	<b>23,537</b>	<b>21,852</b>	<b>68,115</b>	<b>68,681</b>
<b>INCOME (LOSS) FROM OPERATIONS</b>	<b>2,846</b>	<b>(2,250)</b>	<b>10,747</b>	<b>(13,456)</b>
<b>OTHER (INCOME) EXPENSE</b>				
Interest income	(38)	(31)	(83)	(225)
Other (income) expense, net	(544)	(183)	1,800	(359)
Interest expense	2	3	31	9
<b>INCOME (LOSS) BEFORE INCOME TAX EXPENSE (BENEFIT)</b>	<b>3,426</b>	<b>(2,039)</b>	<b>8,999</b>	<b>(12,881)</b>
<b>INCOME TAX EXPENSE (BENEFIT)</b>	<b>1,098</b>	<b>(766)</b>	<b>2,770</b>	<b>(2,919)</b>
<b>NET INCOME (LOSS)</b>	<b>\$ 2,328</b>	<b>\$ (1,273)</b>	<b>\$ 6,229</b>	<b>\$ (9,962)</b>
<b>NET INCOME (LOSS) PER SHARE - BASIC</b>	<b>\$ 0.14</b>	<b>\$ (0.08)</b>	<b>\$ 0.39</b>	<b>\$ (0.62)</b>

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NET INCOME (LOSS) PER SHARE - DILUTED	\$ 0.14	\$ (0.08)	\$ 0.38	\$ (0.62)
Weighted average shares - Basic	16,160,378	16,093,759	16,144,366	16,131,680
Weighted average shares - Diluted	16,270,741	16,093,759	16,292,938	16,131,680

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

**Table of Contents****FARO TECHNOLOGIES, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(UNAUDITED)

(in thousands)	Nine Months Ended	
	Oct 2, 2010	Oct 3, 2009
<b>CASH FLOWS FROM:</b>		
<b>OPERATING ACTIVITIES:</b>		
Net income (loss)	\$ 6,229	\$ (9,962)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,834	4,090
Compensation for stock options and restricted stock units	1,799	1,827
Provision for bad debts	1,638	961
Deferred income tax expense	1,210	1,919
Change in operating assets and liabilities:		
Decrease (increase) in:		
Accounts receivable	(2,548)	14,040
Inventories, net	(5,141)	6,202
Prepaid expenses and other current assets	(3,455)	(4,234)
Income tax benefit from exercise of stock options	(27)	(2)
Increase (decrease) in:		
Accounts payable and accrued liabilities	4,197	(11,220)
Income taxes payable	(318)	(1,965)
Customer deposits	444	186
Unearned service revenues	923	(1,490)
Net cash provided by (used in) operating activities	9,785	352
<b>INVESTING ACTIVITIES:</b>		
Purchases of property and equipment	(2,533)	(2,919)
Payments for intangible assets	(574)	(504)
Purchases of short-term investments		(64,979)
Proceeds from sales of short-term investments		81,965
Net cash (used in) provided by investing activities	(3,107)	13,563
<b>FINANCING ACTIVITIES:</b>		
Proceeds from notes payable	2,490	
Payments on notes payable	(2,490)	
Payments on capital leases	(60)	(55)
Income tax benefit from exercise of stock options	27	2
Purchases of treasury stock		(8,829)
Proceeds from issuance of stock, net	380	45
Net cash provided by (used in) financing activities	347	(8,837)
<b>EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS</b>	<b>2,522</b>	<b>(1,171)</b>



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INCREASE IN CASH AND CASH EQUIVALENTS	9,547	3,907
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	35,078	23,494
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 44,625	\$ 27,401

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**

For the Nine Months Ended October 2, 2010 and October 3, 2009

(Unaudited)

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

**NOTE A DESCRIPTION OF BUSINESS**

FARO Technologies, Inc. and its 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 FaroArm, FARO Laser ScanArm and FARO Gage, all articulated electromechanical measuring devices, and the FARO Laser Tracker, and the FARO Laser Scanner, both laser-based measuring devices. Primary markets for the Company's products include automobile, aerospace, heavy equipment, light manufacturing, and machine shops. The Company sells the vast majority of its products through a direct sales force located in many of the world's largest industrialized countries.

**NOTE B PRINCIPLES OF CONSOLIDATION**

The consolidated financial statements of the Company include the accounts of FARO Technologies, Inc. and all of the Company's subsidiaries. All intercompany transactions and balances have been eliminated. The financial statements of the Company's 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 income.

**NOTE C BASIS OF PRESENTATION**

The consolidated financial statements of the Company include all normal recurring accruals and adjustments considered necessary by management for their fair presentation in conformity with accounting principles generally accepted in the United States of America ( U.S. GAAP ). Preparing financial statements 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 materially from those estimates. The consolidated results of operations for the three and nine months ended October 2, 2010 are not necessarily indicative of results that may be expected for the year ending December 31, 2010 or any future period.

The information included in this Quarterly Report on Form 10-Q, including the interim consolidated financial statements and the accompanying notes, should be read in conjunction with the audited consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

**NOTE D RECLASSIFICATIONS**

From time to time, the Company may reclassify certain amounts to conform to the current period presentation.

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In June 2009, the Financial Accounting Standards Board ( FASB ) issued guidance now codified within Accounting Standards Codification ( ASC ) Topic 810, *Consolidation* ( ASC 810 ). ASC 810 requires entities to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity. This analysis identifies the primary beneficiary of a variable interest entity as one with the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and obligation to absorb losses of the entity that could potentially be significant to the variable interest. The guidance is effective as of the beginning of the annual reporting period commencing after November 15, 2009, with early adoption prohibited. The adoption of ASC 810 as of January 1, 2010 did not have a material effect on the Company's financial position or results of operations.

In October 2009, the FASB issued Accounting Standards Update ( ASU ) No. 2009-13, *Multiple-Delivery Revenue Arrangements* ( ASU 2009-13 ). ASU 2009-13 establishes the accounting and reporting guidance for arrangements, including multiple revenue-generating activities, and provides amendments to the criteria for separating deliverables and measuring and allocating arrangement consideration to one or more units of accounting. The amendments of ASU 2009-13 also establish a selling price hierarchy for determining the selling price of a deliverable. Significantly enhanced disclosures are also required by ASU 2009-13 to provide information about a vendor's multiple-deliverable revenue arrangements, including information about the nature and terms, significant deliverables, and its performance within arrangements. The amendments also require a reporting company to provide information about the significant judgments made and changes to those judgments and about how the application of the relative selling-price method affects the timing or amount of revenue recognition. The amendments in ASU 2009-13 are effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early application permitted. The Company plans to implement this new standard on January 1, 2011 and does not expect the adoption of ASU 2009-13 to have a material impact on its consolidated financial statements.

In January 2010, the FASB issued ASU 2010-6, *Improving Disclosures About Fair Value Measurements* ( ASU 2010-6 ), which requires reporting entities to make new disclosures about recurring or nonrecurring fair-value measurements, including significant transfers into and out of Level 1 and Level 2 fair-value measurements and information on purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair-value measurements. ASU 2010-6 is effective for annual reporting periods beginning after December 15, 2009, except for Level 3 reconciliation disclosures, which are effective for annual periods beginning after December 15, 2010. The adoption of ASU 2010-6 did not have a material impact on the Company's consolidated financial statements nor is it expected to have a material impact for the portion effective at year end.

In July 2010, the FASB issued guidance to enhance disclosures about the credit quality of a creditor's financing receivables and the adequacy of its allowance for credit losses. The amended guidance is effective for period-end balances beginning with the first interim or annual reporting period ending on or after December 15, 2010. The amended guidance is effective for activity during a reporting period beginning with the first interim or annual reporting period beginning on or after December 15, 2010. The Company expects the amended guidance to impact its disclosures in future periods, but to otherwise not have a significant effect on its consolidated financial statements.

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## NOTE F SHARE-BASED COMPENSATION

Share-based compensation cost is measured at the grant date based on the fair value of the award and is recognized over the service period, typically the vesting period. The vesting period for the share-based compensation awarded by the Company is generally three years. The Company uses the Black-Scholes option pricing model to determine the fair value of stock option grants and the closing market price of its common stock on the date of grant to determine the fair value of restricted stock and restricted stock units.

The Company used the following assumptions for the Black-Scholes option-pricing model to determine the fair value of options granted during the nine months ended October 2, 2010 and October 3, 2009:

	For the Nine Months Ended	
	October 2, 2010	October 3, 2009
Risk-free interest rate	1.85% and 2.14%	1.38% and 1.44%
Expected dividend yield	0%	0%
Expected option life	4 years	4 years
Expected volatility	43.5% and 46.5%	48.3%
Weighted-average expected volatility	46.5%	48.3%

Historical information was the primary basis for the selection of the expected dividend yield, expected volatility and the expected lives of the options. The risk-free interest rate was based on yields of U.S. zero coupon issues and U.S. Treasury issues, with a term equal to the expected life of the option being valued.

The Company recorded total share-based compensation expense of \$596 and \$626 for the three months ended October 2, 2010 and October 3, 2009, respectively, and \$1,819 and \$1,827 for the nine months ended October 2, 2010 and October 3, 2009, respectively.

A summary of stock option activity and weighted average exercise prices for the nine months ended October 2, 2010 follows:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value as of October 2, 2010
Outstanding at January 1, 2010	1,030,578	\$ 20.58		
Granted	231,901	24.31		
Forfeited	(62,516)	20.11		
Exercised	(23,474)	16.13		
Outstanding at October 2, 2010	1,176,489	\$ 21.31	4.9	\$ 3,591
Options exercisable at October 2, 2010	798,382	\$ 21.17	4.5	\$ 2,503

The weighted-average grant-date fair value of the stock options granted during the nine months ended October 2, 2010 and October 3, 2009 was \$9.30 and \$5.08 per option, respectively. The total intrinsic value of stock options exercised during the three months ended October 2, 2010 and October 3, 2009 was \$0.0 million and \$0.0 million, respectively. The total intrinsic value of stock options exercised during the nine months

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ended October 2, 2010 and October 3, 2009 was \$0.2 million and \$0.0 million, respectively. The total fair value of stock options vested during the three months ended October 2, 2010 and October 3, 2009 was \$0.0 million and \$0.0 million, respectively. The total fair value of stock options vested during the nine months ended October 2, 2010 and October 3, 2009 was \$1.7 million and \$1.7 million, respectively.

The following table summarizes the restricted stock and restricted stock unit activity and weighted average grant-date fair values for the nine months ended October 2, 2010:

	Shares	Weighted-Average Grant Date Fair Value
Non-vested at beginning of period	63,495	\$ 18.61
Granted	24,186	26.62
Forfeited	(2,542)	21.55
Vested	(46,903)	18.91
Non-vested at October 2, 2010	38,236	\$ 23.93

As of October 2, 2010, there was \$2.9 million of total unrecognized stock-based compensation expense related to non-vested stock-based compensation arrangements. The expense is expected to be recognized over a weighted average period of 1.8 years.

**NOTE G SUPPLEMENTAL CASH FLOW INFORMATION**

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

	Nine Months Ended	
	October 2, 2010	October 3, 2009
Cash paid for interest	\$ 29	\$ 9
Cash paid for income taxes	\$ 2,749	\$ 2,090
<b>Non-Cash Activity:</b>		
Value of Shares issued for acquisition of iQvolution	\$	\$ 317

**NOTE H CASH AND CASH EQUIVALENTS**

The Company considers cash on hand and all short-term, highly liquid investments that have original maturities of three months or less at the time of purchase to be cash and cash equivalents.

**NOTE I SHORT TERM INVESTMENTS**

Short-term investments at October 2, 2010 include U.S. Treasury Bills totaling \$65.0 million that mature through March 17, 2011. The interest rate on the U.S. Treasury Bills is less than one percent. The investments are classified as held-to-maturity and recorded at cost. The fair value of the U.S. Treasury Bills at October 2, 2010 approximated cost.

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## NOTE J ACCOUNTS RECEIVABLE

Accounts receivable consist of the following:

	As of Oct 2, 2010	As of December 31, 2009
Accounts receivable	\$ 47,477	\$ 46,103
Allowance for doubtful accounts	(4,259)	(3,159)
<b>Total</b>	<b>\$ 43,218</b>	<b>\$ 42,944</b>

## NOTE K INVENTORIES

Inventories consist of the following:

	As of October 2, 2010	As of December 31, 2009
Raw materials	\$ 11,706	\$ 9,382
Finished goods	4,402	3,561
Sales demonstration inventory	14,957	16,111
Reserve for excess and obsolete	(2,670)	(2,472)
<b>Inventory</b>	<b>\$ 28,395</b>	<b>\$ 26,582</b>
Service inventory	\$ 13,369	\$ 12,079

## NOTE L 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:

	Three Months Ended				Nine Months Ended			
	October 2, 2010		October 3, 2009		October 2, 2010		October 3, 2009	
	Shares	Per-Share Amount	Shares	Per-Share Amount	Shares	Per-Share Amount	Shares	Per-Share Amount
Basic EPS	16,160,378	\$ 0.14	16,093,759	\$ (0.08)	16,144,366	\$ 0.39	16,131,680	\$ (0.62)
Effect of dilutive securities	110,363				148,572	(0.01)		
<b>Diluted EPS</b>	<b>16,270,741</b>	<b>\$ 0.14</b>	<b>16,093,759</b>	<b>\$ (0.08)</b>	<b>16,292,938</b>	<b>\$ 0.38</b>	<b>16,131,680</b>	<b>\$ (0.62)</b>

The effect of 732,991 and 1,074,269 shares were not included for the three months ended October 2, 2010 and October 3, 2009, respectively, and 683,034 and 1,074,269 shares were not included for the nine months ended October 2, 2010 and October 3, 2009, respectively, as they were antidilutive.



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## NOTE M ACCRUED LIABILITIES

Accrued liabilities consist of the following:

	As of October 2, 2010	As of December 31, 2009
Accrued compensation and benefits	\$ 5,581	\$ 3,605
Accrued warranties	1,644	1,253
Professional and legal fees	1,694	894
Other accrued liabilities	4,373	2,421
	\$ 13,292	\$ 8,173

## NOTE N INCOME TAXES

Total deferred tax assets for the Company's foreign subsidiaries relating to net operating loss carryforwards were \$13.9 million and \$12.2 million at October 2, 2010 and December 31, 2009, respectively. The related valuation allowance was \$12.4 million and \$10.6 million at October 2, 2010 and December 31, 2009, respectively. The Company's effective tax rate was 30.8% for the nine months ended October 2, 2010, compared with an effective tax benefit rate of 22.7% for the nine months ended October 3, 2009. The Company's tax rate continues to be lower than the statutory tax rate in the United States, primarily as a result of favorable tax rates in foreign jurisdictions. Significant judgment is required in determining the Company's 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.

The effective income tax rate for 2010 and 2009 includes a reduction in the statutory corporate tax rates for the Company's operations in Switzerland. The favorable tax rate ruling requires the Company to maintain a certain level of manufacturing operations in Switzerland. The aggregate dollar effect of this favorable tax rate was approximately \$0.3 million, or \$0.02 per share, in the nine month period ended October 2, 2010, and \$0.3 million, or \$0.02 per share, in the nine month period ended October 3, 2009.

In 2005, the Company opened a regional headquarters and began to manufacture its products in Singapore. In the third quarter of 2006, the Company received confirmation of a tax holiday for its operations from the Singapore Economic Development Board for a period of four years commencing January 1, 2006, with an additional six-year extension at a favorable tax rate subject to certain terms and conditions including employment, spending, and capital investment. The Company satisfied these terms and conditions. The aggregate dollar effect of this favorable tax rate was approximately \$0.6 million, or \$0.04 per share, during the nine month period ended October 2, 2010, and \$0.8 million, or \$0.04 per share, in the nine month period ended October 3, 2009.

## NOTE O 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.



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## NOTE P SEGMENT REPORTING

The Company has three reportable segments based on geographic regions: Americas, Europe/Africa and Asia Pacific. The Company does not allocate corporate expenses to Europe/Africa or Asia Pacific regions. These corporate expenses are included in the Americas region. The Company does not incur R&D expenses in its Asia Pacific region.

The Company develops, manufactures, markets, supports and sells Computer-Aided Design ( 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 the Company's 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:

	Three Months Ended		Nine Months Ended	
	October 2, 2010	October 3, 2009	October 2, 2010	October 3, 2009
<b>Americas Region</b>				
Net sales to external customers	\$ 17,400	\$ 13,713	\$ 50,075	\$ 38,506
Operating income (loss)	(842)	(2,718)	(1,075)	(12,280)
Long-lived assets	21,804	21,925	21,804	21,925
Capital expenditures	332	312	972	2,492
Total assets	135,309	135,774	135,309	135,774
<b>Europe/Africa Region</b>				
Net sales to external customers	\$ 16,610	\$ 14,594	\$ 50,803	\$ 42,032
Operating income (loss)	896	(82)	4,282	(3,502)
Long-lived assets	17,246	18,521	17,246	18,521
Capital expenditures	523	105	1,203	444
Total assets	78,278	66,873	78,278	66,873
<b>Asia Pacific Region</b>				
Net sales to external customers	\$ 11,276	\$ 7,406	\$ 32,382	\$ 21,139
Operating income	2,792	550	7,540	2,326
Long-lived assets	2,127	1,981	2,127	1,981
Capital expenditures	272	45	577	489
Total assets	38,560	27,495	38,560	27,495
<b>Totals</b>				
Net sales to external customers	\$ 45,286	\$ 35,713	\$ 133,260	\$ 101,677
Operating income (loss)	2,846	(2,250)	10,747	(13,456)
Long-lived assets	41,177	42,427	41,177	42,427
Capital expenditures	1,127	462	2,752	3,425
Total assets	252,147	230,142	252,147	230,142

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## NOTE Q COMPREHENSIVE INCOME (LOSS)

	Three Months Ended		Nine Months Ended	
	Oct 2, 2010	Oct 3, 2009	Oct 2, 2010	Oct 3, 2009
NET INCOME (LOSS)	\$ 2,328	\$ (1,273)	\$ 6,229	\$ (9,962)
OTHER COMPREHENSIVE (LOSS) INCOME				
Currency translation adjustments	5,445	2,247	984	1,374
COMPREHENSIVE INCOME (LOSS)	\$ 7,773	\$ 974	\$ 7,213	\$ (8,588)

Other comprehensive income (loss) results from the effect of currency translation adjustments on the investments in (capitalization of) foreign subsidiaries, combined with their accumulated earnings or losses.

## NOTE R COMMITMENTS AND CONTINGENCIES

**Leases** The Company is a party to leases arising in the normal course of business that expire on or before 2019. Total obligations under these leases are approximately \$5.5 million for 2010.

**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. As of October 2, 2010, the Company does not have any long-term commitments for purchases.

**Patent Matters** As previously reported, on July 11, 2008, Metris USA, Inc. and its affiliates, Metris N.V., Metris IPR N.V. and 3-D Scanners Ltd., filed a complaint against the Company for patent infringement in the U.S. District Court for the District of Massachusetts (the Court) concerning U.S. Patent Nos. 6,611,617 and 7,313,264 (hereinafter, the patents-in-suit). Following an acquisition by Nikon Corporation in late 2009, Metris USA, Inc. subsequently changed its name to Nikon Metrology, Inc., Metris N.V. changed its name to Nikon Metrology NV, and Metris IPR N.V. was dissolved and merged into Nikon Metrology NV. We refer to each of Nikon Metrology, Inc., Nikon Metrology NV, and 3-D Scanners Ltd. as Plaintiffs or Nikon.

The Company responded to the complaint with counterclaims alleging that the patents-in-suit, which are generally directed to laser scanning devices, are invalid, non-infringed, and unenforceable due to fraud during prosecution of the patents in the U.S. Patent and Trademark Office. On August 31, 2009, the Court granted the Company's motion to add counterclaims and defenses for violation of federal and state antitrust and unfair competition laws based on the alleged knowing assertion of invalid and fraudulent patents. The Company also filed an amended counterclaim to add the Plaintiff's parent company, Nikon Corporation, as a counterclaim defendant.

On January 29, 2010, the Company filed a motion for summary judgment that the patents-in-suit are unenforceable due to inequitable conduct during patent prosecution. An evidentiary hearing on the issue of inequitable conduct commenced on July 19, 2010, continued on August 12 through 13, 2010, resumed on October 20, 2010 and concluded on October 22, 2010. On July 14, 2010, the Company filed a motion for summary judgment of non-infringement of both patents in-suit. No hearing date has been set. In addition, during the first quarter of 2010, Nikon served a supplemental interrogatory answer revising its alleged date of conception of the patents-in-suit to an earlier date. The Company has filed a motion to strike the supplemental interrogatory answer, and the parties are waiting for the hearing date on the motion. On August 31, 2010, Nikon filed a motion for summary judgment against

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FARO's counterclaims for antitrust violations and unfair trade practices. FARO filed its opposition on October 12, 2010. No hearing date has been set for the motion. No further motions for summary judgment are expected to be filed. No trial date for issues other than inequitable conduct has been set.

The Company believes that it does not infringe the patents-in-suit and/or that the patents-in-suit are invalid and unenforceable. The Company does not anticipate this lawsuit will have a material impact on the Company's business, financial condition or results of operations. However, the outcome is difficult to predict, and an adverse determination could have a material impact on the Company's business, financial condition or results of operations.

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, none of which the Company believes will have a material adverse effect on the Company's business, financial condition or results of operations.

**NOTE 5 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, which was most recently amended on June 18, 2009. Loans under the Amended and Restated Loan Agreement, as amended, bear interest at the rate of LIBOR plus a fixed percentage between 2.25% and 2.50%, and require the Company to maintain a minimum cash balance and tangible net worth, measured at the end of each of the Company's fiscal quarters. As of October 2, 2010, the Company was in compliance with all of the covenants under the Amended and Restated Loan Agreement, as amended. The term of the Amended and Restated Loan Agreement, as amended, extends to March 31, 2012. The Company has not drawn on this line of credit.

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following information should be read in conjunction with the Financial Statements, including the notes thereto, included elsewhere in this Quarterly Report on Form 10-Q, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.*

***Forward Looking Statements***

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, target, 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. Specifically, this Quarterly Report on Form 10-Q contains, among others, forward-looking statements regarding:

the Company's ability to achieve and maintain profitability;

the impact of fluctuations in exchange rates;

the effect of estimates and assumptions with respect to critical accounting policies and the impact of the adoption of recently issued accounting pronouncements;

the impact of changes in technologies on the competitiveness of the Company's products or their components;

the magnitude of increased warranty costs from new product introductions and enhancements to existing products;

the outcome of litigation and its effect on the Company's business, financial condition or results of operations;

the continuation of the Company's share repurchase program;

the sufficiency of the Company's working capital, cash flow from operations, and credit facility to fund its long-term liquidity requirements;

the impact of geographic changes in the manufacturing or sales of the Company's products on its tax rate; and

the imposition of penalties against the Company for failure to comply with its continuing obligations with respect to the FCPA Matter. 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. The Company does 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 actual results to differ materially from those contemplated in such forward-looking statements include, among others,

the following:

the slowdown in the manufacturing industry or the domestic and international economies in the regions of the world where the Company operates;

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the Company's inability to further penetrate its customer base;

development by others of new or improved products, processes or technologies that make the Company's products obsolete or less competitive;

the cyclical nature of the industries of the Company's customers and material adverse changes in its customers' access to liquidity and capital;

the inability to protect the Company's patents and other proprietary rights in the United States and foreign countries;

fluctuations in the Company's annual and quarterly operating results and the inability to achieve its financial operating targets;

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

the Company's inability to successfully maintain the requirements of Restriction of use of Hazardous Substances ( RoHS ) and Waste Electrical and Electronic Equipment ( WEEE ) compliance into its products;

the inability of the Company's products to displace traditional measurement devices and attain broad market acceptance;

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

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

other risks and uncertainties discussed in Part I, Item 1A. Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

**Overview**

The Company designs, develops, manufactures, markets and supports portable, software driven, 3-D measurement and imaging systems used in a broad range of manufacturing, industrial, building construction and forensic applications. The Company's FaroArm, FARO Laser ScanArm and FARO Gage articulated measuring devices, the FARO Laser Scanner LS, the FARO Laser Tracker, the FARO Laser Scanner and their companion CAM2 software, provide for Computer Aided Design ( CAD )-based inspection and/or factory-level statistical process control and high-density surveying. 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 October 2, 2010, the Company's products have been purchased by approximately 11,000 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

America International, Lockheed Martin, Nissan, Siemens and Volkswagen, among many others.

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The Company derives revenues primarily from the sale of its FaroArm, FARO Laser ScanArm, FARO Gage, FARO Laser Tracker, and the FARO Laser Scanner 3-D measurement equipment, and their related multi-faceted software. Revenue related to these products is generally recognized upon shipment. In addition, the Company sells one and three-year extended warranties and training and technology consulting services relating to its products. The Company recognizes the revenue from extended warranties on a straight-line basis. The Company also receives royalties from licensing agreements for its historical medical technology and recognizes the revenue from these royalties as licensees use the technology.

The Company operates in international markets throughout the world. It maintains sales offices in China, France, Germany, Great Britain, Italy, India, Japan, Malaysia, Netherlands, Poland, Spain, Singapore and Vietnam. The Company manages and reports its global sales in three regions: the Americas, Europe/Africa and Asia/Pacific. In the nine months ended October 2, 2010, 37.6% of the Company's sales were in the Americas compared to 37.9% in the first nine months of 2009, 38.1% were in the Europe/Africa region compared to 41.3% in the first nine months of 2009, and 24.3% were in the Asia/Pacific region compared to 20.8% in the same prior year period. In the third quarter of 2010, new order bookings increased \$11.0 million, or 30.7%, to \$46.8 million from \$35.8 million in the prior year period. New orders increased \$4.8 million, or 34.3%, in the Americas to \$18.8 million from \$14.0 million in the prior year period. New orders increased \$1.8 million, or 12.2%, to \$16.6 million in Europe/Africa from \$14.8 million in the third quarter of 2009. In Asia/Pacific, new orders increased \$4.4 million, or 62.9%, to \$11.4 million from \$7.0 million in the third quarter of 2009.

The Company manufactures its FaroArm, FARO Gage, and FARO Laser Tracker products in the Company's manufacturing facilities located in Florida and Pennsylvania for customer orders from the Americas, in its manufacturing facility located in Switzerland for customer orders from the Europe/Africa region, and in its manufacturing facility located in Singapore for customer orders from the Asia/Pacific region. The Company manufactures its FARO Laser Scanner products in its facility located in Stuttgart, Germany. The Company expects all its existing plants to have the production capacity necessary to support its volume requirements through 2010.

The Company's effective tax rate was 30.8% for the nine months ended October 2, 2010 compared with an effective tax benefit rate of 22.7% in the prior year period. The Company's tax rate continues to be lower than the statutory tax rate in the United States primarily as a result of favorable tax rates in foreign jurisdictions. However, the Company's tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of its products. The Company has received a favorable income tax rate commitment from the Swiss government as an incentive to establish a manufacturing plant in Switzerland. In addition, in 2006, the Company received approval from the Singapore Economic Development Board for a favorable multi-year income tax holiday for its Singapore headquarters and manufacturing operations, subject to certain terms and conditions including employment, spending and capital investment.

The Company accounts for wholly owned foreign subsidiaries in the currency of the respective foreign jurisdiction, and therefore, fluctuations in exchange rates may have an impact on inter-company accounts reflected in the Company's consolidated financial statements. The Company is 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 Item 3. Quantitative and Qualitative Disclosures About Market Risk Foreign Exchange Exposure, below). However, it does not regularly use such instruments, and none were utilized in 2009 or the nine months ended October 2, 2010.

The Company incurred a net loss in each of the four quarters of fiscal 2009, primarily as a result of a decrease in product sales, due to the deterioration of the global economy. Prior to the first quarter of 2009, the Company had a history of sales and earnings growth and 26 consecutive profitable quarters through December 31, 2008. Its historical sales and earnings growth were the result of a number of factors, including: continuing market demand for and acceptance of the Company's products; increased sales activity in part through additional sales staff worldwide, new products and product enhancements such as the FARO Gage and Laser Scanner; and the effect of acquisitions. However, the Company's historical financial performance is not indicative of its future financial performance.



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### **FCPA Update**

As previously reported by the Company, the Company conducted an internal investigation in 2006 into certain payments made by its China subsidiary that may have violated the Foreign Corrupt Practices Act ( FCPA ) and other applicable laws (the FCPA Matter ), and entered into settlement agreements and documents with the Securities and Exchange Commission ( SEC ) and the U.S. Department of Justice ( DOJ ), in 2008 related to the FCPA Matter.

Under the terms of the agreements with the SEC and the DOJ, the Company has a two-year monitoring obligation and other continuing obligations with respect to compliance with the FCPA and other laws, including full cooperation with the U.S. government and the adoption of a compliance code containing specific provisions intended to prevent violations of the FCPA. During the second quarter of 2010, the Company, in conjunction with the SEC and the DOJ, completed the selection of the FCPA monitor. The Company is cooperating with the monitor as the monitor implements a work plan to assess the Company's compliance with the requirements for the settlement agreements. Failure to comply with any continuing obligations with respect to the FCPA Matter could result in the SEC and the DOJ seeking to impose penalties against the Company in the future.

### **Results of Operations**

#### **Three Months Ended October 2, 2010 Compared to the Three Months Ended October 3, 2009**

Total sales increased by \$9.6 million, or 26.8%, to \$45.3 million in the three months ended October 2, 2010 from \$35.7 million for the three months ended October 3, 2009. This increase resulted from an increase in worldwide demand for products related, in part, to the recovery in the global economy. Product sales increased by \$8.8 million, or 31.7%, to \$36.7 million for the three months ended October 2, 2010 from \$27.9 million in the third quarter of the prior year. Service revenue increased by \$0.8 million, or 9.2%, to \$8.6 million for the three months ended October 2, 2010 from \$7.8 million in the same period during the prior year, primarily due to an increase in customer service activity.

Sales in the Americas region increased \$3.7 million, or 26.9%, to \$17.4 million for the three months ended October 2, 2010 from \$13.7 million in the three months ended October 3, 2009. Product sales in the Americas region increased by \$2.9 million, or 28.7%, to \$13.4 million for the three months ended October 2, 2010 from \$10.5 million in the third quarter of the prior year. Service revenue in the Americas region increased by \$0.8 million, or 21.2%, to \$4.0 million for the three months ended October 2, 2010 from \$3.2 million in the same period during the prior year.

Sales in the Europe/Africa region increased \$2.0 million, or 13.8%, to \$16.6 million for the three months ended October 2, 2010 from \$14.6 million in the three months ended October 3, 2009. Product sales in the Europe/Africa region increased by \$2.1 million, or 17.5%, to \$13.7 million for the three months ended October 2, 2010 from \$11.6 million in the third quarter of the prior year. Service revenue in the Europe/Africa region decreased by \$0.1 million, or 0.6%, to \$2.9 million for the three months ended October 2, 2010 from \$3.0 million in the same period during the prior year.

Sales in the Asia/Pacific region increased \$3.9 million, or 52.2%, to \$11.3 million for the three months ended October 2, 2010 from \$7.4 million in the three months ended October 3, 2009. Product sales in the Asia/Pacific region increased by \$3.8 million, or 66.0%, to \$9.6 million for the three months ended October 2, 2010 from \$5.8 million in the third quarter of the prior year. Service revenue in the Asia/Pacific region increased by \$0.1 million, or 2.9%, to \$1.7 million for the three months ended October 2, 2010 from \$1.6 million in the same period during the prior year.

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Gross profit increased by \$6.8 million, or 34.6%, to \$26.4 million for the three months ended October 2, 2010 from \$19.6 million for the three months ended October 3, 2009. Gross margin increased to 58.3% for the three months ended October 2, 2010 from 54.9% for the three months ended October 3, 2009, primarily due to a change in the sales mix between product sales and service revenue resulting from an increase in higher margin product sales. Gross margin from product sales increased to 64.9% in the three months ended October 2, 2010 from 59.6% for the three months ended October 3, 2009, primarily due to an increase in the product sales mix of higher margin product lines. Gross margin from service revenues decreased to 29.9% in the three months ended October 2, 2010 from 38.1% for the three months ended October 3, 2009, primarily due to an increase in customer service costs.

Selling expenses increased by \$0.2 million, or 2.0%, to \$11.7 million for the three months ended October 2, 2010 from \$11.5 million for three months ended October 3, 2009. This increase was primarily due to an increase in commissions of \$0.8 million and marketing and advertising expenses of \$0.5 million, offset by a decrease in salaries of \$0.8 million related to lower headcount and a decrease in travel-related costs of \$0.2 million.

Worldwide sales and marketing headcount decreased by 22, or 6.8%, to 302 at October 2, 2010 from 324 at October 3, 2009. Regionally, the Company's sales and marketing headcount decreased for the Americas by 10, or 10.9%, from 92 at October 3, 2009 to 82 at October 2, 2010; decreased in Europe/Africa by 6, or 5.1%, to 111 at October 2, 2010 from 117 at October 3, 2009; and decreased in Asia/Pacific by 6, or 5.2%, to 109 at October 2, 2010 from 115 at October 3, 2009.

As a percentage of sales, selling expenses decreased to 25.9% of sales in the three months ended October 2, 2010 from 32.2% of sales in the three months ended October 3, 2009. Regionally, selling expenses were 21.6% of sales in the Americas for the quarter, compared to 29.0% of sales in the third quarter of 2009; 29.1% of sales for Europe/Africa in the third quarter of 2010 compared to 33.5% of sales from the same period in the prior year; and 27.7% of sales for Asia/Pacific in the three months ended October 2, 2010 compared to 35.3% of sales from the same period in the prior year.

General and administrative expenses increased by \$1.0 million, or 16.9%, to \$7.2 million for the three months ended October 2, 2010 from \$6.2 million for the three months ended October 3, 2009, primarily due to an increase in legal and professional fees of \$0.8 million related to the cost of the FCPA monitor in connection with the DOJ and SEC settlement and legal fees related to patent litigation of \$0.4 million, offset by a decrease in compensation expense of \$0.2 million due to reduced headcount.

Depreciation and amortization expenses increased by \$0.4 million to \$1.8 million for the three months ended October 2, 2010 from \$1.4 million for the three months ended October 3, 2009, primarily due to an increase in property and equipment.

Research and development expenses remained flat at \$2.8 million for the three months ended October 2, 2010 and the three months ended October 3, 2009. Research and development expenses as a percentage of sales decreased to 6.3% for the three months ended October 2, 2010 from 7.8% for the three months ended October 3, 2009.

Other (income) expense, net increased by \$0.3 million to income of \$0.5 million for the three months ended October 2, 2010 from income of \$0.2 million for the three months ended October 3, 2009, primarily as a result of foreign currency transaction gains.

Income tax expense (benefit) increased by \$1.9 million to \$1.1 million for the three months ended October 2, 2010 from a benefit of \$0.8 million for the three months ended October 3, 2009, primarily due to an increase in pre-tax income. Total deferred taxes for the Company's foreign subsidiaries relating to net operating loss carryforwards were \$13.9 million and \$12.2 million at October 2, 2010 and December 31, 2009, respectively. The related valuation allowance was \$12.4 million and \$10.6 million at October 2, 2010 and December 31, 2009, respectively. The Company's effective tax rate was 32.0% for the three months

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ended October 2, 2010, while the Company's effective tax benefit rate was 37.6% in the prior year period, primarily due to an increase in taxable income. The Company's tax rate continues to be lower than the statutory tax rate in the United States primarily as a result of favorable tax rates in foreign jurisdictions. However, the Company's tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of its products and the resulting effect on taxable income in each jurisdiction.

Net income increased by \$3.6 million to \$2.3 million for the three months ended October 2, 2010 from a net loss of \$1.3 million for the three months ended October 3, 2009, as a result of the factors described above.

**Nine Months Ended October 2, 2010 Compared to the Nine Months Ended October 3, 2009**

Total sales increased by \$31.6 million, or 31.1%, to \$133.3 million in the nine months ended October 2, 2010 from \$101.7 million for the nine months ended October 3, 2009. This increase resulted from an increase in worldwide demand for products in all regions. Product sales increased by \$28.6 million, or 36.0%, to \$107.9 million for the nine months ended October 2, 2010 from \$79.3 million for the nine months ended October 3, 2009. Service revenue increased by \$3.0 million, or 13.4%, to \$25.4 million for the nine months ended October 2, 2010 from \$22.4 million in the same period during the prior year, primarily due to an increase in customer service activity.

Sales in the Americas region increased \$11.5 million, or 30.0%, to \$50.1 million for the nine months ended October 2, 2010 from \$38.6 million in the nine months ended October 3, 2009. Product sales in the Americas region increased by \$9.3 million, or 31.9%, to \$38.5 million for the nine months ended October 2, 2010 from \$29.2 million for the same period in the prior year. Service revenue in the Americas region increased by \$2.2 million, or 24.4%, to \$11.6 million for the nine months ended October 2, 2010 from \$9.4 million in the same period during the prior year, due primarily to an increase in customer service revenue.

Sales in the Europe/Africa region increased \$8.8 million, or 20.9%, to \$50.8 million for the nine months ended October 2, 2010 from \$42.0 million in the nine months ended October 3, 2009. Product sales in the Europe/Africa region increased by \$8.6 million, or 26.0%, to \$41.6 million for the nine months ended October 2, 2010 from \$33.0 million for the same period of the prior year. Service revenue in the Europe/Africa region increased by \$0.2 million, or 2.1%, to \$9.2 million for the nine months ended October 2, 2010 from \$9.0 million in the same period during the prior year, primarily due to an increase in customer service revenue.

Sales in the Asia/Pacific region increased \$11.3 million, or 53.2%, to \$32.4 million for the nine months ended October 2, 2010 from \$21.1 million in the nine months ended October 3, 2009. Product sales in the Asia/Pacific region increased by \$10.7 million, or 62.6%, to \$27.8 million for the nine months ended October 2, 2010 from \$17.1 million in the same period of the prior year. Service revenue in the Asia/Pacific region increased by \$0.6 million, or 13.3%, to \$4.6 million for the nine months ended October 2, 2010 from \$4.0 million in the same period during the prior year, due primarily to an increase in customer service revenue.

Gross profit increased by \$23.7 million, or 42.8%, to \$78.9 million for the nine months ended October 2, 2010 from \$55.2 million for the nine months ended October 3, 2009. Gross margin increased to 59.2% for the nine months ended October 2, 2010 from 54.3% for the nine months ended October 3, 2009. The increase in gross margin is primarily due to a change in the sales mix between product sales and service revenue resulting from an increase in higher margin product sales. Gross margin from product sales increased to 65.9% in the nine months ended October 2, 2010 from 61.3% for the nine months ended October 3, 2009, primarily due to an increase in the product sales of higher margin product lines. Gross margin from service revenue increased to 30.7% in the nine months ended October 2, 2010 from 29.4% for the nine months ended October 3, 2009, primarily due to a decrease in customer service costs.

Selling expenses decreased by \$1.4 million, or 4.0%, to \$35.0 million for the nine months ended October 2, 2010 from \$36.4 million for nine months ended October 3, 2009, primarily due to a decrease in salaries of \$3.0 million as a result of lower headcount and a decrease in travel-related expenses of \$0.9 million, offset by an increase in commissions of \$2.3 million.

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Worldwide sales and marketing headcount decreased by 22, or 6.8%, to 302 at October 2, 2010 from 324 at October 3, 2009. Regionally, the Company's sales and marketing headcount decreased by 10, or 10.9%, to 82 at October 2, 2010 from 92 for the Americas; decreased by 6 or 5.1%, to 111 at October 2, 2010 from 117 in Europe/Africa; and decreased by 6, or 5.2%, in Asia/Pacific to 109 at October 2, 2010 from 115 at October 3, 2009.

As a percentage of sales, selling expenses decreased to 26.2% of sales in the nine months ended October 2, 2010 from 35.8% in the nine months ended October 3, 2009. Regionally, selling expenses were 22.0% of sales in the Americas for the nine months ended October 2, 2010, compared to 33.4% of sales in the prior year period; 29.4% of sales for Europe/Africa compared to 38.1% of sales from the same period in the prior year; and 27.9% of sales compared to 35.8% of sales for Asia/Pacific from the same period in the prior year.

General and administrative expenses increased by \$0.9 million, or 4.8%, to \$19.5 million for the nine months ended October 2, 2010 from \$18.6 million for the nine months ended October 3, 2009, primarily due to an increase in legal and professional fees of \$0.8 million related to the costs of the FCPA monitor in connection with the DOJ and the SEC settlement and \$0.8 million related to patent litigation costs, offset by decreases in compensation expenses of \$0.9 million due to lower headcount.

Depreciation and amortization expenses increased by \$0.7 million to \$4.8 million for the nine months ended October 2, 2010 from \$4.1 million for the nine months ended October 3, 2009, primarily due to an increase in property and equipment.

Research and development expenses decreased to \$8.8 million for the nine months ended October 2, 2010 from \$9.6 million for the nine months ended October 3, 2009, primarily as a result of a decrease in subcontractors' expense of \$0.4 million and material costs of \$0.2 million. Research and development expenses as a percentage of sales decreased to 6.6% for the nine months ended October 2, 2010 from 9.4% for the nine months ended October 3, 2009.

Interest income decreased by \$0.1 million to \$0.1 million for the nine months ended October 2, 2010 from \$0.2 million for the nine months ended October 3, 2009, due to a decrease in interest rates related to cash and short term investments.

Other (income) expense, net increased by \$2.2 million to an expense of \$1.8 million for the nine months ended October 2, 2010 from income of \$0.4 million for the nine months ended October 3, 2009, primarily as a result of foreign currency transaction losses.

Income tax expense (benefit) increased by \$5.7 million to \$2.8 million for the nine months ended October 2, 2010 from a benefit of \$2.9 million for the nine months ended October 3, 2009. This change was primarily due to an increase in pre-tax income. Total deferred taxes for the Company's foreign subsidiaries relating to net operating loss carryforwards were \$13.9 million and \$12.2 million at October 2, 2010 and December 31, 2009, respectively. The related valuation allowance was \$12.4 million and \$10.6 million at October 2, 2010 and December 31, 2009, respectively. The Company's effective tax rate was 30.8% for the nine months ended October 2, 2010, while the Company's effective tax benefit rate was 22.7% in the prior year period. The Company's tax rate continues to be lower than the statutory tax rate in the United States primarily as a result of favorable tax rates in foreign jurisdictions. However, the Company's tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of its products and the resulting effect on taxable income in each jurisdiction.

Net income increased by \$16.2 million to \$6.2 million for the nine months ended October 2, 2010 from a net loss of \$10.0 million for the nine months ended October 3, 2009, as a result of the factors described above.

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### **Liquidity and Capital Resources**

Cash and cash equivalents increased by \$9.5 million to \$44.6 million at October 3, 2010 from \$35.1 million at December 31, 2009. The increase was primarily attributable to an increase in net income and non-cash expenses of \$15.7 million, the effect of exchange rate changes on cash of \$2.5 million, and proceeds from stock option exercises of \$0.4 million, offset by a decrease in working capital of \$5.9 million and \$3.1 million in purchases of equipment and intangible assets.

On July 11, 2006, the Company entered into a loan agreement providing for an available line of credit of \$30.0 million, which was most recently amended on June 18, 2009. Loans under the Amended and Restated Loan Agreement, as amended, bear interest at the rate of LIBOR plus a fixed percentage between 2.25% and 2.50%, and require the Company to maintain a minimum cash balance and tangible net worth measured at the end of each of the Company's fiscal quarters. As of October 2, 2010, the Company was in compliance with all of the covenants under the Amended and Restated Loan Agreement, as amended. The term of the Amended and Restated Loan Agreement, as amended, extends to March 31, 2012. The Company has not drawn on this line of credit.

The Company believes that its working capital, anticipated cash flow from operations, and credit facility will be sufficient to fund its long-term liquidity requirements for the foreseeable future.

The Company has no off balance sheet arrangements.

### **Critical Accounting Policies**

The preparation of the Company's 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 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 Company's financial statements.

In response to the SEC's financial reporting release, FR-60, Cautionary Advice Regarding Disclosure About Critical Accounting Policies, the Company has selected its critical accounting policies for purposes of explaining the methodology used in its calculations in addition to any inherent uncertainties pertaining to the possible effects on its financial condition. The critical policies discussed below are the Company's processes of recognizing revenue, the reserve for excess and obsolete inventory, income taxes, the reserve for warranties, and goodwill impairment. These policies affect current assets and operating results and are therefore critical in assessing the Company's financial and operating status. These policies involve certain assumptions that, if incorrect, could have an adverse impact on the Company's operations and financial position.

### **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 is only 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. Extended maintenance plan revenues are recognized

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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 expense 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 when the technology is sold by the licensees.

### **The Reserve for Excess and Obsolete Inventory**

Since the value of inventory that will ultimately be realized cannot be known with exact certainty, the Company relies upon both past sales history and future sales forecasts to provide a basis for the determination of the reserve. Inventory is considered obsolete if the Company has withdrawn those products from the market or had no sales of the product for the past 12 months and has no sales forecasted for the next 12 months. Inventory is considered excess if the quantity on hand exceeds 12 months of expected 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. The Company's products are subject to changes in technologies that may make certain of its products or their components obsolete or less competitive, which may increase its historical provisions to the reserve.

### **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 over a two-year period, and tax planning strategies that it might employ to utilize such assets, including net operating loss carryforwards. Based on the positive and negative evidence of recoverability, the Company establishes a valuation allowance against the net deferred assets of a taxing jurisdiction in which it operates unless it is more likely than not that it will recover such assets through the above means. In the future, the Company's evaluation of the need for the valuation allowance will be significantly influenced by its ability to achieve profitability and its 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 \$0.3 million, or \$0.02 per share, for the nine months ended October 2, 2010 and \$0.3 million, or \$0.02 per share, for the nine months ended October 3, 2009.

In 2005, the Company opened a regional headquarters and began to manufacture its products in Singapore, where it 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 \$0.6 million, or \$0.04 per share, for the nine months ended October 2, 2010, and \$0.8 million, or \$0.04 per share, for the nine months ended October 3, 2009.

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 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 establishes provisions for income taxes when, despite the belief that tax positions are fully supportable, there remain certain positions that do not meet the minimum probability threshold as described by ASC 740, which is a tax position that is more likely than not to be sustained upon examination by the applicable taxing authority. In the ordinary course of business, the Company and its subsidiaries are examined by various federal, state and foreign tax authorities. The Company regularly assesses the potential outcomes of these examinations and any future examinations for the current or prior years in determining the adequacy of its provision for income taxes. The Company assesses the likelihood and amount of potential adjustments and adjusts the income tax provision, the current tax liability and deferred taxes in the period in which the facts that gave rise to a revision become known.

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**Table of Contents****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. The warranty reserve is reflected in accrued liabilities in the Company's 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 its warranty costs. While such expenses have historically been within expectations, the Company cannot guarantee this will continue in the future.

**Goodwill Impairment**

Goodwill represents the excess cost of a business acquisition over the fair value of the net assets acquired. Indefinite-life identifiable intangible assets and goodwill are not amortized but are tested for impairment. The Company performs an annual review in the fourth quarter of each year, or more frequently if indicators of potential impairment exist, to determine if the carrying value of the recorded goodwill is impaired. 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.

The goodwill impairment test is applied using a two-step approach. In performing the first step, the company calculates the fair values of the reporting units using discounted cash flows (DCF) of each reporting unit. If the carrying amount of the reporting unit exceeds the fair market value, the second step is performed to measure the amount of the impairment loss, if any. In the second step, the implied fair value of the goodwill is estimated as the fair value of the reporting unit, as calculated in the first step, less the fair values of the net tangible and intangible assets of the reporting unit other than goodwill. If the carrying amount of goodwill exceeds its implied fair market value, an impairment loss is recognized in an amount equal to that excess, not to exceed the carrying amount of the goodwill. Management has concluded there was no goodwill impairment in the year ended December 31, 2009.

**Item 3. 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, 62.4% of its revenues are invoiced, and a significant portion of its operating expenses are 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 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 its non-U.S. dollar revenues derived from international sales increases (or decreases) in the future, the Company's exposure to risks associated with fluctuations in foreign exchange rates may increase (or decrease).

**Item 4. Controls and Procedures**  
**Evaluation of Disclosure Controls and Procedures**

The Company maintains disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) that are designed to provide reasonable assurance that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed,

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summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

As of the end of the period covered by this report, the Company's management carried out an evaluation, under the supervision and with the participation of its Chief Executive Officer and its Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures, as defined by Rule 13a-15(e) under the Exchange Act, were effective as of October 2, 2010.

**Changes in Internal Control Over Financial Reporting**

There were no changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended October 2, 2010 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.



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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

**Patent Matters** As previously reported, on July 11, 2008, Metris USA, Inc. and its affiliates, Metris N.V., Metris IPR N.V. and 3-D Scanners Ltd., filed a complaint against the Company for patent infringement in the U.S. District Court for the District of Massachusetts (the Court ) concerning U.S. Patent Nos. 6,611,617 and 7,313,264 (hereinafter, the patents-in-suit ). Following an acquisition by Nikon Corporation in late 2009, Metris USA, Inc. subsequently changed its name to Nikon Metrology, Inc., Metris N.V. changed its name to Nikon Metrology NV, and Metris IPR N.V. was dissolved and merged into Nikon Metrology NV. We refer to each of Nikon Metrology, Inc., Nikon Metrology NV, and 3-D Scanners Ltd. as Plaintiffs or Nikon .

The Company responded to the complaint with counterclaims alleging that the patents-in-suit, which are generally directed to laser scanning devices, are invalid, non-infringed, and unenforceable due to fraud during prosecution of the patents in the U.S. Patent and Trademark Office. On August 31, 2009, the Court granted the Company s motion to add counterclaims and defenses for violation of federal and state antitrust and unfair competition laws based on the alleged knowing assertion of invalid and fraudulent patents. The Company also filed an amended counterclaim to add the Plaintiff s parent company, Nikon Corporation, as a counterclaim defendant.

On January 29, 2010, the Company filed a motion for summary judgment that the patents-in-suit are unenforceable due to inequitable conduct during patent prosecution. An evidentiary hearing on the issue of inequitable conduct commenced on July 19, 2010, continued on August 12 through 13, 2010, resumed on October 20, 2010 and concluded on October 22, 2010. On July 14, 2010, the Company filed a motion for summary judgment of non-infringement of both patents in-suit. No hearing date has been set. In addition, during the first quarter of 2010, Nikon served a supplemental interrogatory answer revising its alleged date of conception of the patents-in-suit to an earlier date. The Company has filed a motion to strike the supplemental interrogatory answer, and the parties are waiting for the hearing date on the motion. On August 31, 2010, Nikon filed a motion for summary judgment against FARO s counterclaims for antitrust violations and unfair trade practices. FARO filed its opposition on October 12, 2010. No hearing date has been set for the motion. No further motions for summary judgment are expected to be filed. No trial date for issues other than inequitable conduct has been set.

The Company believes that it does not infringe the patents-in-suit and/or that the patents-in-suit are invalid and unenforceable. The Company does not anticipate this lawsuit will have a material impact on the Company s business, financial condition or results of operations. However, the outcome is difficult to predict, and an adverse determination could have a material impact on the Company s business, financial condition or results of operations.

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, none of which the Company believes will have a material adverse effect on the Company s business, financial condition or results of operations.

**Item 1A. Risk Factors**

In addition to the other information set forth in this Form 10-Q, you should carefully consider the factors discussed under Risk Factors in the Company s Form 10-K for the year ended December 31, 2009 as filed with the SEC. These risks could materially and adversely affect the Company s business, financial condition, and results of operations. The risks described in the Company s Form 10-K for the year ended December 31, 2009 are not the only risks it faces. The Company s operations could also be affected by additional factors that are not presently known to the Company or by factors that it currently considers immaterial to its business.

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**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On November 24, 2008, the Company's Board of Directors approved a \$30 million share repurchase program. Acquisitions for the share repurchase program will be made from time to time at prevailing prices as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The share repurchase program may be discontinued at any time. There is no restriction date or other restriction governing the period over which the Company can repurchase shares under the program. All such purchases were open market transactions. The Company made no stock repurchases during the nine months ended October 2, 2010 under this program.

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**Item 6. Exhibits**

- 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 Amended and Restated Bylaws (Filed as Exhibit 3.1 to current Report on Form 8-K, dated January 28, 2010 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 Joint Marketing and Sales Agreement, dated September 14, 2010, by and between the Company and Carl Zeiss IMT Corporation (Filed as Exhibit 99.2 to the Current Report on Form 8-K dated September 15, 2010 and incorporated herein by reference)
- 31-A Certification of the President and Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31-B Certification of the Principal Financial and Accounting Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32-A Certification of the President and Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32-B Certification of the Principal Financial and Accounting Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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**SIGNATURES**

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

**FARO Technologies, Inc.**  
(Registrant)

Date: November 4, 2010

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

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