

FARO TECHNOLOGIES INC  
Form 10-Q  
November 03, 2016  
Table of Contents

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 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 September 30, 2016

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 of Incorporation or Organization) (I.R.S. Employer Identification No.)

250 Technology Park, Lake Mary, Florida 32746  
(Address of Principal Executive Offices) (Zip Code)  
(407) 333-9911  
(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

Indicate 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.

Large accelerated filer  Accelerated filer

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

Edgar Filing: FARO TECHNOLOGIES INC - Form 10-Q

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

There were 16,674,374 shares of the registrant's common stock outstanding as of October 31, 2016.

---

Table of Contents

FARO TECHNOLOGIES, INC.  
Quarterly Report on Form 10-Q  
Quarter Ended September 30, 2016  
INDEX

	PAGE
<b>PART I. <u>FINANCIAL INFORMATION</u></b>	
Item 1. <u>Financial Statements</u>	
a) <u>Condensed Consolidated Balance Sheets As of September 30, 2016 (Unaudited) and December 31, 2015</u>	<u>3</u>
b) <u>Condensed Consolidated Statements of Operations (Unaudited) For the Three and Nine Months Ended September 30, 2016 and September 26, 2015</u>	<u>4</u>
c) <u>Condensed Consolidated Statements of Comprehensive Income (Loss) (Unaudited) For the Three and Nine Months Ended September 30, 2016 and September 26, 2015</u>	<u>5</u>
d) <u>Condensed Consolidated Statements of Cash Flows (Unaudited) For the Nine Months Ended September 30, 2016 and September 26, 2015</u>	<u>6</u>
e) <u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	<u>7</u>
Item 2. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>17</u>
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>28</u>
Item 4. <u>Controls and Procedures</u>	<u>28</u>
<b>PART II. <u>OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	<u>29</u>
Item 1A. <u>Risk Factors</u>	<u>29</u>
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>29</u>
Item 6. <u>Exhibits</u>	<u>30</u>
<u>SIGNATURES</u>	<u>31</u>

Table of Contents

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)	September 30, 2016 (unaudited)	December 31, 2015
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 121,349	\$ 107,356
Short-term investments	31,957	42,994
Accounts receivable, net	57,431	69,918
Inventories, net	55,206	45,571
Deferred income tax assets, net	8,619	7,792
Prepaid expenses and other current assets	20,426	18,527
Total current assets	294,988	292,158
Property and equipment:		
Machinery and equipment	57,197	54,124
Furniture and fixtures	6,291	5,945
Leasehold improvements	18,942	18,471
Property and equipment, at cost	82,430	78,540
Less: accumulated depreciation and amortization	(49,671)	(42,594)
Property and equipment, net	32,759	35,946
Goodwill	41,721	26,371
Intangible assets, net	21,967	15,985
Service and sales demonstration inventory, net	33,661	33,709
Deferred income tax assets, net	4,535	4,050
Other long term assets	971	967
Total assets	\$ 430,602	\$ 409,186
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 11,507	\$ 11,345
Accrued liabilities	24,325	22,574
Current portion of unearned service revenues	27,212	26,114
Customer deposits	2,763	2,998
Total current liabilities	65,807	63,031
Unearned service revenues - less current portion	15,600	15,025
Deferred income tax liabilities	1,163	686
Other long-term liabilities	2,430	2,800
Total liabilities	85,000	81,542
Commitments and contingencies - See Note 16		
Shareholders' equity:		
Common stock - par value \$.001, 50,000,000 shares authorized; 18,163,850 and 18,077,594 issued; 16,674,374 and 16,588,118 outstanding, respectively	18	18
Additional paid-in capital	211,227	206,996
Retained earnings	179,891	172,329
Accumulated other comprehensive loss	(13,696)	(19,861)
Common stock in treasury, at cost - 1,489,476 shares	(31,838)	(31,838)
Total shareholders' equity	345,602	327,644

Total liabilities and shareholders' equity	\$ 430,602	\$ 409,186
--	------------	------------

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

Table of Contents

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
 (UNAUDITED)

(in thousands, except share and per share data)	Three Months Ended		Nine Months Ended	
	September	September	September	September
	30, 2016	26, 2015	30, 2016	26, 2015
<b>SALES</b>				
Product	\$61,280	\$ 57,803	\$182,232	\$182,284
Service	18,320	14,704	51,654	43,937
Total sales	79,600	72,507	233,886	226,221
<b>COST OF SALES</b>				
Product	25,870	28,943	74,933	80,652
Service	11,051	8,693	29,665	26,541
Total cost of sales (exclusive of depreciation and amortization, shown separately below)	36,921	37,636	104,598	107,193
<b>GROSS PROFIT</b>	42,679	34,871	129,288	119,028
<b>OPERATING EXPENSES:</b>				
Selling and marketing	19,729	18,944	56,101	58,112
General and administrative	10,775	8,239	31,483	27,106
Depreciation and amortization	3,381	2,790	9,733	8,022
Research and development	7,953	5,820	22,303	19,430
Total operating expenses	41,838	35,793	119,620	112,670
<b>INCOME (LOSS) FROM OPERATIONS</b>	841	(922)	9,668	6,358
<b>OTHER (INCOME) EXPENSE</b>				
Interest (income) expense, net	(21)	) 7	(119)	) (36)
Other (income) expense, net	(167)	) 131	824	1,521
<b>INCOME (LOSS) BEFORE INCOME TAX (BENEFIT) EXPENSE</b>	1,029	(1,060)	8,963	4,873
<b>INCOME TAX (BENEFIT) EXPENSE</b>	(61)	) (176)	1,401	945
<b>NET INCOME (LOSS)</b>	\$1,090	\$ (884)	\$7,562	\$3,928
<b>NET INCOME (LOSS) PER SHARE - BASIC</b>	\$0.07	\$ (0.05)	\$0.45	\$0.23
<b>NET INCOME (LOSS) PER SHARE - DILUTED</b>	\$0.07	\$ (0.05)	\$0.45	\$0.22
Weighted average shares - Basic	16,674,176	17,395,824	16,647,662	17,372,562
Weighted average shares - Diluted	16,701,617	17,395,824	16,669,550	17,496,190

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

Table of Contents

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)  
 (UNAUDITED)

(in thousands)	Three Months		Nine Months	
	Ended	Ended	Ended	Ended
	September	September	September	September
	30,	26, 2015	30,	26, 2015
	2016		2016	
Net income (loss)	\$1,090	\$ (884 )	\$7,562	\$ 3,928
Currency translation adjustments, net of income tax	1,339	(3,475 )	6,165	(8,062 )
Comprehensive income (loss)	\$2,429	\$ (4,359 )	\$13,727	\$ (4,134 )

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

Table of Contents

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (UNAUDITED)

(in thousands)	Nine Months Ended	
	September	September
	30, 2016	26, 2015
<b>CASH FLOWS FROM:</b>		
<b>OPERATING ACTIVITIES:</b>		
Net income	\$7,562	\$ 3,928
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,733	8,022
Compensation for stock options and restricted stock units	4,068	3,791
Provision for bad debts	727	462
Loss on disposal of assets	814	877
Write-down of inventories	2,937	9,560
Deferred income tax (benefit) expense	(734	) 556
Income tax benefit from exercise of stock options	(354	) (292 )
Change in operating assets and liabilities:		
Decrease (increase) in:		
Accounts receivable	12,850	17,205
Inventories	(8,689	) (21,693 )
Prepaid expenses and other current assets	(995	) (5,740 )
(Decrease) increase in:		
Accounts payable and accrued liabilities	1,128	(8,779 )
Customer deposits	(1,155	) (473 )
Unearned service revenues	559	467
Net cash provided by operating activities	28,451	7,891
<b>INVESTING ACTIVITIES:</b>		
Proceeds from sale of investments	11,000	—
Purchases of property and equipment	(5,272	) (8,462 )
Payments for intangible assets	(1,440	) (1,751 )
Acquisition of business, net of cash received	(20,911	) (12,066 )
Net cash used in investing activities	(16,623	) (22,279 )
<b>FINANCING ACTIVITIES:</b>		
Payments on capital leases	(6	) (6 )
Payment of contingent consideration for acquisitions	(434	) —
Income tax benefit from exercise of stock options	354	292
Proceeds from issuance of stock, net	519	2,286
Net cash provided by financing activities	433	2,572
<b>EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS</b>	1,732	(1,498 )
<b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	13,993	(13,314 )
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	107,356	109,289
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	\$121,349	\$ 95,975

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



Table of Contents

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

NOTE 1 – DESCRIPTION OF BUSINESS

FARO Technologies, Inc. and its subsidiaries (collectively “FARO,” the “Company,” “us,” “we” or “our”) design, develop, manufacture, market and support software driven, three-dimensional (3D) measurement, imaging and realization systems. We sell the majority of our products through a direct sales force across a broad number of customers in a range of manufacturing, industrial, architecture, surveying, building information modeling, construction, public safety forensics, cultural heritage and other applications. Our FaroArm®, FARO Laser ScanArm®, FARO Gage, FARO Laser Tracker™, FARO Cobalt Array Imager, and their companion CAM2® software, provide for Computer-Aided Design, or 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. Our FARO Focus<sup>3D</sup> and FARO Freestyle<sup>3D</sup> laser scanners, and their companion SCENE, FARO public safety forensics and FARO 3D software, are utilized for a wide variety of 3D modeling, documentation and high-density surveying applications, including in two of our key vertical markets – Construction Building Information Modeling/Construction Information Management (“construction BIM/CIM”) and public safety forensics.

NOTE 2 – PRINCIPLES OF CONSOLIDATION

Our condensed consolidated financial statements include the accounts of FARO Technologies, Inc. and its subsidiaries, all of which are wholly owned. All intercompany transactions and balances have been eliminated. The financial statements of our 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. Foreign currency transaction gains and losses are included in income.

NOTE 3 – BASIS OF PRESENTATION

The condensed consolidated financial statements and notes thereto are unaudited. These statements 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 condensed consolidated results of operations for the three months and nine months ended September 30, 2016 are not necessarily indicative of results that may be expected for the year ending December 31, 2016 or any future interim period.

The information included in this Quarterly Report on Form 10-Q, including the interim condensed consolidated financial statements and the accompanying notes, should be read in conjunction with the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015. The accompanying December 31, 2015 condensed consolidated balance sheet has been derived from those audited consolidated financial statements.

Prior to January 1, 2016, we used a 4-4-5 fiscal quarter end for interim financial reporting. Effective January 1, 2016, we transitioned to calendar quarters for interim financial reporting. As such, September 30, 2016 is the end of our third quarter of fiscal year 2016 instead of October 1, 2016. We believe this change had minimal impact on the presentation of the comparative periods in this Quarterly Report on Form 10-Q and will not impact the presentation of our future annual consolidated financial statements in our Annual Report on Form 10-K.

NOTE 4 – RECLASSIFICATIONS

During the third quarter of 2016, we reclassified certain service costs that were previously classified as product costs. This reclassification did not have a material impact on either the current or prior year periods. As such, the prior year amounts have not been reclassified in our condensed consolidated financial statements.



Table of Contents

**NOTE 5 – IMPACT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

In August 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (“ASU 2016-15”), which clarifies how companies present and classify certain cash receipts and cash payments in the statement of cash flows. ASU 2016-15 is effective for annual periods beginning after December 15, 2017, and interim periods therein. Early adoption is permitted. We do not expect the adoption of this guidance will have a material impact on our consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers: (Topic 606) (“ASU 2014-09”), amending its accounting guidance related to revenue recognition. Under this ASU and subsequently issued amendments, revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Additional disclosures are required to provide the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. The ASU and subsequently issued amendments to the revenue recognition accounting guidance are effective for us on January 1, 2018 and permit the use of either the retrospective or cumulative effective transition method. We have not yet selected a transition method nor have we determined the effect of the revenue recognition accounting guidance on our ongoing financial reporting.

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting (“ASU 2016-09”), which is intended to simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 is effective for annual periods beginning after December 15, 2016, and interim periods therein (our fiscal year 2017). Early application is permitted. We are evaluating the impact of adopting this standard on our consolidated financial statements and related disclosures.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) (“ASU 2016-02”), which is intended to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. ASU 2016-02 must be applied on a modified retrospective basis and is effective for fiscal years beginning after December 15, 2018, and interim periods within those years, with early adoption permitted. We are evaluating the impact of adopting this standard on our consolidated financial statements and related disclosures.

In September 2015, the FASB issued ASU 2015-16, Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments (“ASU 2015-16”), which eliminates the requirement for an acquirer in a business combination to account for measurement-period adjustments retrospectively. Instead, acquirers must recognize measurement-period adjustments during the period in which the amounts are determined. We adopted ASU 2015-16 effective as of January 1, 2016. The implementation of this standard did not have an impact on our consolidated financial statements.

In July 2015, the FASB issued ASU 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory (“ASU 2015-11”), which changes the measurement principle for inventory from the lower of cost or market to the lower of cost and net realizable value. ASU 2015-11 defines net realizable value as estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The new guidance must be applied on a prospective basis and is effective for fiscal years beginning after December 15, 2016, and interim periods within those years, with early adoption permitted. We do not believe the implementation of this standard will have a material impact on our consolidated financial statements.

**NOTE 6 – STOCK-BASED COMPENSATION**

Stock-based compensation expense reflects the fair value of stock-based awards measured at the grant date and is recognized over the requisite service period.

We have three compensation plans that provide for the granting of stock options and other share-based awards to key employees and members of the Board of Directors. The 2004 Equity Incentive Plan (“2004 Plan”), the 2009 Equity Incentive Plan (“2009 Plan”), and the 2014 Equity Incentive Plan (“2014 Plan”) provide for granting options, restricted stock, restricted stock units or stock appreciation rights to employees and directors. There are awards still outstanding under the 2004 Plan and 2009 Plan; however, we will not make any further grants under either of those plans.

8

---

Table of Contents

Annually, we grant restricted stock to our directors. These director awards are granted the day following our Annual Meeting of Shareholders during the second quarter of each fiscal year and vest the day before our Annual Meeting of Shareholders in the following year, subject to a director's continued membership on the board. The fair value of these awards is determined by using the current market price of our common stock on the grant date.

Annually, upon approval by our Compensation Committee, we grant stock options and restricted stock units to certain employees. We also grant stock options and restricted stock units to certain new employees throughout the year. Prior to 2016, these awards vested in three equal annual installments beginning one year after the grant date. The fair value of these stock-based awards is determined by using (a) the current market price of our common stock on the grant date in the case of restricted stock units or (b) the Black-Scholes option valuation model in the case of stock options.

In 2015, we granted performance-based stock options and restricted stock units to certain executives. These awards vest in three annual installments beginning one year after the grant date if the applicable performance measures or strategic objectives are achieved. The related stock-based compensation expense is recognized over the requisite service period, taking into account the probability that we will satisfy the performance measures or strategic objectives. In addition to certain strategic objectives, the performance-based stock options and restricted stock units granted in 2015 are earned and vest based upon (1) our achievement of specified revenue and earnings per share targets, and (2) our total shareholder return ("TSR") relative to the TSR attained by companies within our defined peer group.

Due to the TSR presence in certain performance-based grants, the fair value of these awards is determined using the Monte Carlo Simulation valuation model. We expense these market condition awards over the three-year vesting period regardless of the value the award recipients ultimately receive. In February 2016, our Compensation Committee determined the number of performance-based stock options and restricted stock units that were earned for the 2015 performance period. Based on the performance and strategic objectives achieved in 2015, 7,225 stock options and 226 restricted stock units were earned and vested and 23,328 stock options and 677 restricted stock units were determined to be unearned, as the required metrics were not achieved.

We did not grant performance-based stock options and restricted stock units to our employees during the nine months ended September 30, 2016. Instead, our annual grant in March 2016 consisted of stock options and restricted stock units that are subject to only time-based vesting. The number of stock options and/or restricted stock units granted was based on the employee's individual objectives, performance against operational metrics assigned to the employee and overall contribution over the last year. The restricted stock unit awards vest in full on the three-year anniversary of the grant date. The stock options vest in three equal annual installments beginning one year after the grant date. The fair value of these stock-based awards is determined by using (a) the current market price of our common stock on the grant date in the case of restricted stock units or (b) the Black-Scholes option valuation model in the case of stock options.

In May 2016, we granted an aggregate of 18,615 restricted stock units to certain non-executive key employees as a retention incentive in recognition of the significant efforts required from such employees to assist us in executing our initiatives in 2016 to reorganize our business around certain vertical markets, modernize our sales process to improve the efficiency of our sales organization, accelerate and maintain a consistent schedule of new product introductions, and harmonize our global functions to improve effectiveness. These restricted stock unit awards vest in full on the three-year anniversary of the grant date. The fair value of these restricted stock units is determined by using the current market price of our common stock on the grant date.

The Black-Scholes option valuation model incorporates assumptions as to stock price volatility, the expected life of options or awards, a risk-free interest rate and dividend yield. The weighted-average grant-date fair value of the stock options that were granted during the nine months ended September 30, 2016 and September 26, 2015 and valued using the Black-Scholes option valuation model was \$12.42 and \$16.33 per option, respectively. For stock options granted during the nine months ended September 30, 2016 and September 26, 2015 valued using the Black-Scholes option valuation model, we used the following assumptions:

Table of Contents

	Nine Months Ended	
	September 30, 2016	September 26, 2015
Risk-free interest rate	1.06% - 1.21%	0.80% - 1.09%
Expected dividend yield	—	% — %
Expected option life	4 years	3 years
Expected volatility	46.7% - 47.0%	42.3% - 48.5%
Weighted-average expected volatility	46.7	% 43.1 %

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 the 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.

There were no market condition awards granted during the nine months ended September 30, 2016 and, as such, the Monte Carlo Simulation valuation model was not used to determine the fair value of the stock options and restricted stock units granted in the first, second or third quarter of 2016. In 2015, we granted performance-based stock options and restricted stock units which included the presence of a market condition and were valued using the Monte Carlo Simulation model. This valuation model incorporates assumptions as to stock price volatility, the expected life of options or awards, a risk-free interest rate and dividend yield. The assumptions used to estimate the fair value of the performance-based stock options and restricted stock units granted during the nine months ended September 26, 2015 and valued under the Monte Carlo Simulation model were as follows:

	Nine Months Ended	
	September 30, 2016	September 26, 2015
Risk-free interest rate	% 0.95% - 1.48%	
Expected dividend yield	% —	%
Expected option life	— 4 years	
Expected volatility	% 44.5	%
Weighted-average expected volatility	% 44.5	%

A summary of stock option activity and weighted-average exercise prices during the nine months ended September 30, 2016 follows:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value as of September 30, 2016
Outstanding at January 1, 2016	1,178,585	\$ 48.14		
Granted	194,740	33.17		
Forfeited	(192,304 )	45.59		
Exercised	(105,207 )	17.66		
Unearned performance-based options	(23,328 )	59.97		
Outstanding at September 30, 2016	1,052,486	\$ 48.61	4.6	\$ 1,070,788
Options exercisable at September 30, 2016	816,776	\$ 50.64	2.3	\$ 258,330

The total intrinsic value of stock options exercised during the three months ended September 30, 2016 and September 26, 2015 was \$0.0 million and \$0.1 million, respectively. For the nine months ended September 30, 2016 and September 26, 2015, the total intrinsic value of stock options exercised was \$1.7 million in each period. The fair value of stock options vested during both the three months ended September 30, 2016 and September 26, 2015 was \$0.1 million. The fair value of stock options vested during the nine months ended September 30, 2016 and September 26, 2015 was \$3.5 million and \$3.9 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 September 30, 2016:



Table of Contents

	Shares	Weighted-Average Grant Date Fair Value
Non-vested at January 1, 2016	15,916	\$ 43.47
Granted	160,228	33.20
Forfeited	(8,212 )	33.05
Vested	(13,247 )	42.79
Unearned performance-based awards (677 )		53.74
Non-vested at September 30, 2016	154,008	\$ 33.40

We recorded total stock-based compensation expense of \$1.4 million and \$1.3 million for the three months ended September 30, 2016 and September 26, 2015, respectively, and \$4.1 million and \$3.8 million for the nine months ended September 30, 2016 and September 26, 2015, respectively.

As of September 30, 2016, there was \$8.9 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 2.0 years.



Table of Contents

## NOTE 7 – CASH AND CASH EQUIVALENTS

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

## NOTE 8 – SHORT TERM INVESTMENTS

Short-term investments at September 30, 2016 consisted of U.S Treasury Bills totaling \$32.0 million that mature through March 16, 2017. Short-term investments at December 31, 2015 consisted of U.S. Treasury Bills totaling \$43.0 million that matured through April 14, 2016. 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 plus accrued interest, which approximates fair value. The fair value of the U.S. Treasury Bills at September 30, 2016 and December 31, 2015 were classed as Level 1 as they are traded with sufficient frequency and volume to enable us to obtain pricing information on an ongoing basis. For further discussion of fair value, refer to Note 14, Fair Value of Financial Instruments.

## NOTE 9 – ACCOUNTS RECEIVABLE

Accounts receivable consist of the following:

	As of September 30, 2016	As of December 31, 2015
Accounts receivable	\$ 59,162	\$ 71,335
Allowance for doubtful accounts	(1,731 )	(1,417 )
Total	\$ 57,431	\$ 69,918

## NOTE 10 – INVENTORIES

Inventories are stated at the lower of cost or net realizable value using the first-in first-out (FIFO) method. Shipping and handling costs are classified as a component of cost of sales in the consolidated statements of operations. Sales demonstration inventory is comprised of measuring, imaging and realization devices utilized by sales representatives to present our products to customers. We expect sales demonstration inventory to be held by our sales representatives for up to three years, at which time it would be refurbished and transferred to finished goods as used equipment, stated at the lower of cost or net realizable value. Management expects these refurbished units to remain in finished goods inventory and to be sold within twelve months at prices that may produce reduced gross margins. Sales demonstration inventory is classified as inventory, as it is available for sale and any required refurbishment prior to sale is minimal. Service inventory is typically used to provide a temporary replacement product to a customer covered by a premium warranty when the customer's unit requires service or repair and as training equipment. Service inventory is available for sale; however, management does not expect service inventory to be sold within 12 months and, as such, classifies this inventory as a long-term asset.

Inventories consist of the following:

	As of September 30, 2016	As of December 31, 2015
Raw materials	\$ 34,508	\$ 28,190
Finished goods	20,698	17,381
Inventories, net	\$ 55,206	\$ 45,571
Service and demonstration inventory, net	\$ 33,661	\$ 33,709

Table of Contents

## NOTE 11 – EARNINGS PER SHARE

Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding. Diluted earnings per share is computed by also considering the impact of potential common stock on both net income and the weighted average number of shares outstanding. Our potential common stock consists of employee and director stock options, restricted stock, restricted stock units and performance-based awards. Our potential common stock is excluded from the basic earnings per share calculation and is included in the diluted earnings per share calculation when doing so would not be anti-dilutive. In 2015, we granted performance-based stock options and restricted stock units. These performance-based awards are included in the computation of diluted earnings per share only to the extent that the underlying performance conditions (and any applicable market condition) (a) are satisfied as of the end of the reporting period or (b) would be considered satisfied if the end of the reporting period were the end of the related contingency period and the result would be dilutive under the treasury stock method. For the three and nine months ended September 30, 2016 there were approximately 1,002,856 and 1,042,366, respectively, additional shares issuable upon exercise of anti-dilutive options and contingent vesting of performance-based awards, which were excluded from the dilutive calculations. The effect of 1,199,397 and 797,844 additional shares were not included in the dilutive calculations for the three and nine months ended September 26, 2015, respectively.

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		September 26, 2015	
	September 30, 2016		September 26, 2015	
	Shares	Per-Share Amount	Shares	Per-Share Amount
Basic EPS	16,674,176	\$ 0.07	17,395,824	\$ (0.05 )
Effect of dilutive securities	27,441	—	—	—
Diluted EPS	16,701,617	\$ 0.07	17,395,824	\$ (0.05 )

	Nine Months Ended		September 26, 2015	
	September 30, 2016		September 26, 2015	
	Shares	Per-Share Amount	Shares	Per-Share Amount
Basic EPS	16,647,662	\$ 0.45	17,372,562	\$ 0.23
Effect of dilutive securities	21,888	—	123,628	(0.01 )
Diluted EPS	16,669,550	\$ 0.45	17,496,190	\$ 0.22

## NOTE 12 – ACCRUED LIABILITIES

Accrued liabilities consist of the following:

	As of September 30, 2016	As of December 31, 2015
Accrued compensation and benefits	\$ 13,041	\$ 12,798
Accrued warranties	2,676	2,309
Professional and legal fees	1,848	2,014
Taxes other than income	1,829	2,160
Other accrued liabilities	4,931	3,293
	\$ 24,325	\$ 22,574

Activity related to accrued warranties was as follows:

Table of Contents

	Nine Months Ended September	
	30, 2016	September 26, 2015
Balance, beginning of period	\$2,309	\$ 2,719
Provision for warranty expense	2,292	2,394
Fulfillment of warranty obligations	(1,925 )	(2,909 )
Balance, end of period	\$2,676	\$ 2,204

## NOTE 13 – INCOME TAXES

For the three months ended September 30, 2016, we recorded income tax benefit of \$0.1 million compared with \$0.2 million for the three months ended September 26, 2015. Our effective tax rate was a 5.9% benefit for the three months ended September 30, 2016 compared with a 16.6% benefit in the prior year period. This decrease of \$0.1 million in income tax benefit and the change in our effective rate was due to the increase in pretax income during the third quarter of 2016 compared with a pretax loss in the same period of 2015 and the geographical mix shift in pretax income expected for the full year 2016. Income tax expense increased by \$0.5 million to \$1.4 million for the nine months ended September 30, 2016 from \$0.9 million for the nine months ended September 26, 2015. Our effective tax rate decreased by 3.8 percentage points to 15.6% for the nine months ended September 30, 2016 from 19.4% for the same prior year period. Our effective tax rate continued to be lower than the statutory tax rate in the United States, mainly due to our global footprint in foreign jurisdictions with lower tax rates. However, our effective tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of our products and the resulting effect on taxable income in each jurisdiction.

## NOTE 14 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Our financial instruments include cash and cash equivalents, short-term investments, accounts receivable, customer deposits, accounts payable and accrued liabilities. The carrying amounts of such financial instruments approximate their fair value due to the short-term nature of these instruments.

Assets and liabilities measured at fair value on a recurring basis are categorized in the tables below based upon the lowest level of significant input to the valuations:

	As of September 30, 2016		
	Level 1	Level 2	Level 3
Assets:			
Short-term investments (1)	\$31,957	\$	—\$
Total	\$31,957	\$	—\$
Liabilities:			
Contingent consideration (2)	\$—	\$	—\$2,322
Total	\$—	\$	—\$2,322

	As of December 31, 2015		
	Level 1	Level 2	Level 3
Assets:			
Short-term investments (1)	\$42,994	\$	—\$
Total	\$42,994	\$	—\$
Liabilities:			

Contingent consideration (2)	\$—	\$	—\$2,695
Total	\$—	\$	—\$2,695

(1) Short-term investments in the accompanying consolidated balance sheets are six-month U.S. Treasury Bills. The fair values of these assets are based on Level 1 inputs in the fair value hierarchy.

Contingent consideration liability represents arrangements to pay the former owners of certain companies we (2) acquired. The undiscounted maximum payment under the arrangements was \$7.9 million, based on future revenues, gross profits

Table of Contents

and certain milestones. We estimated the fair value of the contingent consideration using a Monte Carlo Simulation, which is based on significant inputs, primarily forecasted future results of the acquired businesses not observable in the market, and thus represents a Level 3 measure. For the three and nine months ended September 30, 2016, we paid \$0.3 million and \$0.4 million, respectively, as part of these arrangements. The remaining change in the fair value of the contingent consideration from December 31, 2015 to September 30, 2016 is related to changes in foreign currency.

**NOTE 15 – SEGMENT REPORTING**

We have three reportable segments based upon geographic regions: Americas, Europe/Africa and Asia-Pacific. We include costs related to Corporate in the Americas region. We do not incur research and development expenses in the Asia-Pacific region.

We develop, manufacture, market, support and sell CAD-based quality assurance products integrated with CAD-based inspection and statistical process control software, and three-dimensional documentation systems in each of these regions. These activities represent more than 99% of consolidated sales. Our Chief Operating Decision Maker (“CODM”), our Chief Executive Officer, evaluates segment performance and allocates resources based upon profitable growth and assets deployed. Each of our segments employ consistent accounting policies.

The following table presents information about our reportable segments:

	Three Months Ended		Nine Months Ended	
	September	September	September	September
	30, 2016	26, 2015	30, 2016	26, 2015
<b>Americas Region</b>				
Net sales to external customers	\$37,032	\$33,666	\$103,875	\$103,024
Depreciation and amortization	1,719	1,726	5,222	4,865
Operating (loss) income	(1,064 )	628	(1,353 )	(429 )
Long-lived assets	67,879	48,672	67,879	48,672
Capital expenditures	1,199	1,377	1,984	5,412
Total assets	204,894	222,787	204,894	222,787
<b>Europe/Africa Region</b>				
Net sales to external customers	\$23,114	\$22,460	\$72,540	\$71,170
Depreciation and amortization	1,222	756	3,280	2,161
Operating loss	(2,143 )	(5,065 )	(1,201 )	(5,432 )
Long-lived assets	25,857	25,232	25,857	25,232
Capital expenditures	1,338	817	2,760	2,489
Total assets	136,913	126,338	136,913	126,338
<b>Asia-Pacific Region</b>				
Net sales to external customers	\$19,454	\$16,381	\$57,471	\$52,027
Depreciation and amortization	440	308	1,231	996
Operating income	4,048	3,515	12,222	12,219
Long-lived assets	2,711	2,603	2,711	2,603
Capital expenditures	155	195	528	561
Total assets	88,795	73,931	88,795	73,931
<b>Totals</b>				
Net sales to external customers	\$79,600	\$72,507	\$233,886	\$226,221
Depreciation and amortization	3,381	2,790	9,733	8,022
Operating income (loss)	841	(922 )	9,668	6,358
Long-lived assets	96,447	76,507	96,447	76,507
Capital expenditures	2,692	2,389	5,272	8,462
Total assets	430,602	423,056	430,602	423,056

Table of Contents

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 individually accounted for 10% or more of total revenue in any of the periods presented above.

**NOTE 16 – COMMITMENTS AND CONTINGENCIES**

**Leases** — We lease buildings and equipment in the normal course of business under non-cancellable operating leases that expire in or before 2026. Total obligations under these leases are approximately \$6.7 million for 2016.

**Purchase Commitments** — We enter into purchase commitments for products and services in the ordinary course of business. These purchases generally cover production requirements for 60 to 120 days as well as materials necessary to service customer units through the product lifecycle and for warranty commitments. As of September 30, 2016, we had approximately \$32.6 million in purchase commitments that are expected to be delivered within the next 12 months. To ensure adequate component availability in preparation for new product introductions, as of September 30, 2016, we also had \$30.3 million in long-term commitments for purchases to be delivered after 12 months.

**Legal Proceedings** — We are not involved in any legal proceedings other than routine litigation arising in the normal course of business, none of which we believe will have a material adverse effect on our business, financial condition or results of operations.

**NOTE 17 – BUSINESS COMBINATIONS**

In August 2016, we acquired Laser Projection Technologies, Inc. (“LPT”) for a purchase price, net of cash acquired, of \$17.1 million, paid with cash on hand, subject to certain additional post-closing adjustments. LPT, located in Londonderry, New Hampshire, specializes in laser projection and measurement systems used throughout manufacturing environments around the globe to maximize productivity and efficiency. The acquisition enhances our portfolio of 3D measurement solutions and supports our long-term strategy to expand our presence in key markets, which complement our existing product lines.

In July 2016, we acquired BuildIT Software & Solutions Ltd. (“BuildIT”) for a purchase price, net of cash acquired, of \$3.8 million, paid with cash on hand, subject to certain additional post-closing adjustments. BuildIT, a software solutions business located in Montreal, Canada, specializes in process-configurable 3D metrology software solutions with hardware agnostic interfaces. The addition of BuildIT enhances our metrology portfolio, providing customers greater software options to use in a variety of applications to reduce inspection and assembly times and increase productivity.

The acquisitions of BuildIT and LPT constitute business combinations as defined by the FASB Accounting Standards Codification (“ASC”) Topic 805, Business Combinations. Accordingly, the assets acquired and liabilities assumed were recorded at their fair values on the date of acquisition. The following preliminary purchase price allocations are based on the information that was available to make estimates of the fair value and may change as further information becomes available and additional analyses are completed. While we believe such information provided a reasonable basis for estimating the fair values, we may obtain more information and evidence during the measurement period that may result in changes to the estimated fair value amounts. The measurement period ends on the earlier of one year after the acquisition date or the date we received the information about the facts and circumstances that existed at the acquisition date. Subsequent adjustments, if necessary, will be recognized during the period in which the amounts are determined. These refinements include: (1) changes in the estimated fair value of certain intangible assets acquired; and (2) changes in deferred tax assets and liabilities related to the fair value estimates.

Following is a summary of our preliminary allocations of the purchase price to the fair values of the assets acquired and liabilities assumed as of the date of each acquisition:

Table of Contents

	BuildIT	LPT
Accounts receivable	\$237	\$54
Inventory	—	322
Other assets	36	248
Deferred income tax assets	—	1,112
Intangible assets (1)	1,381	5,224
Goodwill (2)	3,042	11,922
Accounts payable and accrued liabilities	(95 )	(697 )
Other liabilities	(485 )	(1,086 )
Deferred income tax liability	(304 )	—
Total purchase price, net of cash acquired	\$3,812	\$17,099

- (1) Intangible assets acquired with BuildIT and LPT will be amortized over their weighted-average lives of about 7 to 10 years.
- (2) The goodwill arising from the acquisitions consists largely of the expected synergies from combining operations as well as the value of the workforce. The goodwill value is not expected to be tax deductible.

Acquisition and integration costs are not included as components of consideration transferred, but are recorded as expense in the period in which such costs are incurred. To date, we have incurred approximately \$0.7 million in acquisition and integration costs for the BuildIT and LPT acquisitions.

Pro forma results of operations for BuildIT and LPT have not been presented because the effects of these acquisitions, individually and in aggregate, were not material to our consolidated results of operations.

## Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following information should be read in conjunction with the Condensed Consolidated Financial Statements, including the notes thereto, included elsewhere in this Form 10-Q and Management’s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2015.

FARO Technologies, Inc. (“FARO,” the “Company,” “us,” “we” or “our”) has made “forward-looking statements” in this report (within the meaning of the 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,” “might,” “would,” “will,” “will be,” “future,” “strategy,” “believe,” “plan,” “should,” “could,” “seek,” “expect,” “anticipate,” “intend,” “estimate,” “goal,” “objective,” “project” and similar words identify forward-looking statements. Specifically, this Quarterly Report on Form 10-Q contains, among others, forward-looking statements regarding:

- our 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 our products or their components;
- the impact of new product introductions;
- our ability to execute the initiatives we are undertaking in 2016 to reorganize our business around certain vertical markets, modernize our sales process to improve the efficiency of our sales organization, accelerate and maintain a

consistent schedule of new product introductions, and harmonize our global functions to improve operational effectiveness;

17

---



Table of Contents

- the magnitude of increased warranty costs from new product introductions and enhancements to existing products;
- the sufficiency of our plants to meet manufacturing requirements;
- the continuation of our share repurchase program;
- the sufficiency of our working capital and cash flow from operations to fund our long-term liquidity requirements;
- the impact of geographic changes in the manufacturing or sales of our products on our tax rate; and
- our ability to comply with the requirements for favorable tax rates in foreign jurisdictions.

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 actual results to differ materially from those contemplated in such forward-looking statements include, among others, the following:

- economic downturn in the manufacturing industry or the domestic and international economies in the regions of the world where we operate;
- our inability to further penetrate our customer base and target markets;
- development by others of new or improved products, processes or technologies that make our products less competitive or obsolete;
- our inability to maintain our technological advantage by developing new products and enhancing our existing products;
- 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;
- our inability to successfully identify and acquire target companies and achieve expected benefits from, and effectively integrate, acquisitions that are consummated;
- the cyclical nature of the industries of our customers and material adverse changes in our customers' access to liquidity and capital;
- change in the potential for the computer-aided measurement ("CAM2") market and the potential adoption rate for our products, which are difficult to quantify and predict;
- the inability to protect our patents and other proprietary rights in the United States and foreign countries;
- the material weakness in the design and operating effectiveness of our internal control over financial reporting and our ability to remediate this issue completely and promptly;
- 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, shrinkage or other inventory losses due to product obsolescence, change in demand for our products, scrap or material price changes, (iv) raw material price fluctuations and other inflationary pressures, (v) expansion of our manufacturing capability, (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) the success of our sales and marketing programs, (xiv) start-up costs associated with opening new sales offices outside of the United States, (xv) fluctuations in revenue without proportionate adjustments in fixed costs, (xvi) the efficiencies achieved in managing inventories and fixed assets, (xvii) compliance with government regulations including health, safety, and environmental matters, and (xviii) costs associated with our initiatives in 2016 to reorganize our business

around certain vertical markets, modernize our sales process to improve the efficiency of our sales organization,

18

---

## Table of Contents

accelerate and maintain a consistent schedule of new product introductions, and harmonize our global functions to improve effectiveness;

- changes in gross margins due to changing mix of products sold and the different gross margins on different products and sales channels;
- our inability to successfully maintain the requirements of Restriction of use of Hazardous Substances (“RoHS2”) and Waste Electrical and Electronic Equipment (“WEEE”) compliance in our products;
- the inability of our products to displace traditional measurement devices and attain broad market acceptance;
- the impact of competitive products and pricing on our current offerings;
- the effects of increased competition as a result of recent consolidation in the CAM2 market;
- the loss of our Chief Executive Officer or other key personnel;
- difficulties in recruiting research and development engineers and application engineers;
- the failure to effectively manage the effects of our growth;
- the impact of reductions or projected reductions in government spending, particularly in the defense sector;
- 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 of time or on commercially reasonable terms;
- the impact of disruption, delays, or deficiencies in the design and effectiveness of our global enterprise resource planning (“ERP”) system; and
- other risks and uncertainties discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2015.

Moreover, new risks and uncertainties emerge from time to time, and we undertake no obligation to update publicly or review the risks and uncertainties included in this Quarterly Report on Form 10-Q unless otherwise required by law.

### Overview

We design, develop, manufacture, market and support software driven, three-dimensional (3D) measurement, imaging and realization systems. We sell the majority of our products through a direct sales force across a broad number of customers in a range of manufacturing, industrial, architecture, surveying, building information modeling, construction, public safety forensics, cultural heritage and other applications. Our FaroArm®, FARO Laser ScanArm®, FARO Gage, FARO Laser Tracker™, FARO Cobalt Array Imager, and their companion CAM2® software, provide for Computer-Aided Design, or 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. Our FARO Focus<sup>3D</sup> and FARO Freestyle<sup>3D</sup> laser scanners, and their companion SCENE, FARO public safety forensics and FARO 3D software, are utilized for a wide variety of 3D modeling, documentation and high-density surveying applications, including in two of our key vertical markets – construction BIM/CIM and public safety forensics.

We derive our revenues primarily from the sale of our measurement equipment and their related multi-faceted software programs. Revenue related to these products is generally recognized upon shipment. In addition, we sell extended warranties and training and technology consulting services relating to our products. We recognize the revenue from extended warranties on a straight-line basis over the term of the warranty and revenue from training and technology consulting services when the services are provided. To date, our products have been purchased by over 15,000 customers.

We operate in international markets throughout the world and maintain sales offices in Australia, Brazil, Canada, China, France, Germany, India, Italy, Japan, Malaysia, Mexico, the Netherlands, Poland, Portugal, Singapore, South Korea, Spain, Switzerland, Thailand, Turkey, the United Kingdom, the United States, and Vietnam. We manage and report our global sales in three regions: the Americas, Europe/Africa and Asia-Pacific.

We manufacture our FaroArm®, FARO Laser ScanArm®, FARO Gage, and FARO Laser Tracker™ products in our manufacturing facility located in Switzerland for customer orders from the Europe/Africa region, in our manufacturing facility located in Singapore for customer orders from the Asia-Pacific region, and in our

manufacturing facilities located in Florida

19

---

Table of Contents

and Pennsylvania for customer orders from the Americas. We manufacture our FARO Focus<sup>3D</sup> and FARO Freestyle<sup>3D</sup> products in our facilities located in Germany and Switzerland. We manufacture our FARO Cobalt Array Imager in our facility located in Pennsylvania. We expect all of our existing plants to have the production capacity necessary to support our volume requirements through 2016.

Total sales by region for the three months and nine months ended September 30, 2016 and September 26, 2015 were as follows (in thousands):

	Three Months Ended			
	September 30, 2016	% of Total	September 26, 2015	% of Total
Americas	\$37,032	47 %	\$ 33,666	46 %
Europe/Africa	23,114	29 %	22,460	31 %
Asia-Pacific	19,454	24 %	16,381	23 %
Total sales	\$79,600		\$ 72,507	

	Nine Months Ended			
	September 30, 2016	% of Total	September 26, 2015	% of Total
Americas	\$103,875	44 %	\$ 103,024	46 %
Europe/Africa	72,540	31 %	71,170	31 %
Asia-Pacific	57,471	25 %	52,027	23 %
Total sales	\$233,886		\$ 226,221	

New order bookings by region for the three months and nine months ended September 30, 2016 and September 26, 2015, were as follows (in thousands):

	Three Months Ended		
	September 30, 2016	September 26, 2015	% Change
Americas	\$38,337	\$34,487	11 %
Europe/Africa	21,109	22,317	(5) %
Asia-Pacific	20,397	15,467	32 %
Total new orders	\$79,843	\$72,271	10 %

	Nine Months Ended		
	September 30, 2016	September 26, 2015	% Change
Americas	\$104,003	\$103,567	— %
Europe/Africa	71,175	70,504	1 %
Asia-Pacific	59,726	51,080	17 %
Total new orders	\$234,904	\$225,151	4 %

We account for wholly-owned foreign subsidiaries in the currency of the respective foreign jurisdiction; therefore, fluctuations in exchange rates may have an impact on the value of the intercompany account balances denominated in different currencies and reflected in our condensed 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 Item 3. Quantitative and Qualitative Disclosures about Market Risk – Foreign Exchange Exposure). However, we have not used such instruments in the past, and none were utilized during the year ended December 31, 2015 or the nine months ended September 30, 2016. Over the past decade, we have continued to achieve profitability on an annual basis, with the exception of a loss in 2009 that resulted primarily from the decline of the global economy that year. Historically, our sales and earnings have grown as a result of continuing market demand for and acceptance of our products, increased sales activity in part through additional sales staff worldwide, new product launches or enhancements, and acquisitions. Our historical

financial performance is not indicative of our future financial performance.

20

---

Table of Contents

We are undertaking several important initiatives in 2016 to drive long-term growth and profitability, including reorganizing our business around certain vertical markets, modernizing our sales process to improve the efficiency of our sales organization, accelerating and maintaining a consistent schedule of new product introductions, and harmonizing our global functions to improve effectiveness. The timing of implementation of our reorganization of our sales and marketing organizations around vertical markets in 2016 is dependent upon a number of factors, including making the necessary adjustments to our new ERP system.

## Results of Operations

## Three Months Ended September 30, 2016 Compared to the Three Months Ended September 26, 2015

**Sales.** Total sales increased \$7.1 million, or 9.8%, to \$79.6 million for the three months ended September 30, 2016 from \$72.5 million for the three months ended September 26, 2015. Our sales increase was primarily driven by a significant increase in product sales within the Asia region, a modest product sales growth in the Americas region, and a strong global growth in service revenue, partially offset by a product sales decline in Europe/Africa. Total product sales increased by \$3.5 million, or 6.0%, to \$61.3 million for the three months ended September 30, 2016 from \$57.8 million in the third quarter of 2015. Our product sales increase reflected a strong sales performance within the Asia and Americas regions in certain measurement and reverse engineering and 3D documentation products, partially offset by lower average selling prices. Service revenue increased by \$3.6 million, or 24.6%, to \$18.3 million for the three months ended September 30, 2016 from \$14.7 million in the third quarter of 2015, primarily due to an increase in warranty and customer service revenue driven by the growth of our installed, serviceable base and focused sales initiatives. Foreign exchange rates had a slightly positive impact on sales of \$0.5 million, increasing sales growth by 0.7 percentage points, primarily due to the appreciation of the Japanese yen relative to the U.S. dollar.

Sales in the Americas region increased \$3.3 million, or 10.0%, to \$37.0 million for the three months ended September 30, 2016 from \$33.7 million in the prior year period. Foreign exchange rates had a negative impact on sales of \$0.1 million, decreasing sales growth by 0.4 percentage points. Product sales in the Americas region increased by \$1.8 million, or 6.8%, to \$28.5 million for the three months ended September 30, 2016 from \$26.7 million in the prior year period, primarily reflecting strong unit sales performance of our 3D documentation products in the third quarter of 2016. Service revenue in the Americas region increased by \$1.5 million, or 22.1%, to \$8.5 million for the three months ended September 30, 2016 from \$7.0 million in the prior year period, primarily due to an increase in warranty and customer service revenue.

Sales in the Europe/Africa region increased \$0.7 million, or 2.9%, to \$23.1 million for the three months ended September 30, 2016 from \$22.4 million in the prior year period. Foreign exchange rates had a negative impact on sales of \$0.5 million, decreasing sales growth by 2.2 percentage points. Total product sales in the Europe/Africa region decreased by \$0.6 million, or 3.9%, to \$16.8 million for the three months ended September 30, 2016 from \$17.4 million in the prior year period, mainly reflecting lower average selling prices. Service revenue in the Europe/Africa region increased by \$1.3 million, or 26.9%, to \$6.3 million for the three months ended September 30, 2016 from \$5.0 million in the prior year period, primarily due to an increase in warranty and customer service revenue.

Sales in the Asia-Pacific region increased \$3.1 million, or 18.8%, to \$19.5 million for the three months ended September 30, 2016 from \$16.4 million in the prior year period. Foreign exchange rates had a positive impact on sales of \$1.1 million, increasing sales growth by 6.7 percentage points primarily due to the appreciation of the Japanese yen. Total product sales in the Asia-Pacific region increased by \$2.3 million, or 17.2%, to \$16.0 million for the three months ended September 30, 2016 from \$13.7 million in the prior year period. This increase was primarily driven by a strong year-over-year increase in Japan predominantly due to increased sales of our measurement and reverse engineering products. Service revenue in the Asia-Pacific region increased by \$0.8 million, or 26.7%, to \$3.5 million for the three months ended September 30, 2016 from \$2.7 million in the prior year period, primarily due to an increase in warranty and customer service revenue.

**Gross profit.** Gross profit increased by \$7.8 million, or 22.4%, to \$42.7 million for the three months ended September 30, 2016 from \$34.9 million for the three months ended September 26, 2015. Gross margin increased to 53.6% for the three months ended September 30, 2016 from 48.1% in the prior year period. Gross margin from product revenue increased by 7.9 percentage points to 57.8% for the three months ended September 30, 2016 from

49.9% in the prior year period. This increase was primarily due to a \$7.9 million write-down of inventory recorded in the third quarter of 2015 compared with \$1.5 million recorded in the third quarter of 2016, partially offset by lower average selling prices reflecting an increase in sales of service and demonstration inventory which typically produce lower margins. Gross margin from service revenue decreased by 1.2 percentage points to 39.7% for the three months ended September 30, 2016 from 40.9% for the prior year period, primarily due to higher service material costs related to a reclassification of certain service costs that were previously classified as product costs during the third quarter of 2016.



Table of Contents

**Selling and Marketing Expenses.** Selling and marketing expenses increased by \$0.7 million, or 4.1%, to \$19.7 million for the three months ended September 30, 2016 from \$19.0 million for the three months ended September 26, 2015. The increase in selling and marketing expenses was primarily driven by higher compensation expense due to an increase in headcount along with an increase in recruiting and relocation related expenses.

Worldwide sales and marketing headcount increased by 15, or 2.7%, to 565 at September 30, 2016 from 550 at September 26, 2015. Regionally, our sales and marketing headcount increased by 17, or 9.1%, to 203 at September 30, 2016 from 186 at September 26, 2015 in the Americas; decreased by 14, or 7.5%, to 173 at September 30, 2016 from 187 at September 26, 2015 in Europe/Africa; and increased by 12, or 6.8%, in Asia-Pacific to 189 at September 30, 2016 from 177 at September 26, 2015. The increase in headcount includes our recent acquisitions as well as our commitment to support our expected long-term sales growth.

As a percentage of sales, selling and marketing expenses decreased to 24.8% of sales in the three months ended September 30, 2016 from 26.1% of sales in the three months ended September 26, 2015. Regionally, selling and marketing expenses were 24.0% of sales in the Americas for the three months ended September 30, 2016 compared with 22.4% of sales in the prior year period; 25.3% of sales in Europe/Africa for the three months ended September 30, 2016 compared with 31.9% of sales in the prior year period; and 25.6% of sales in Asia-Pacific for the three months ended September 30, 2016 compared with 25.8% of sales in the prior year period.

**General and administrative expenses.** General and administrative expenses increased by \$2.6 million, or 30.8%, to \$10.8 million, for the three months ended September 30, 2016 from \$8.2 million for the three months ended September 26, 2015. The increase in general and administrative expenses was primarily driven by higher compensation expense due to higher accruals related to incentive compensation as well as an increase in headcount. Furthermore, general and administrative expenses have increased due to higher acquisition related costs as well as advisory fees, partially offset by a decrease in consulting fees mostly related to the implementation of our ERP system in the prior year period. General and administrative expenses were 13.5% of sales for the three months ended September 30, 2016 compared with 11.4% of sales in the prior year period.

**Depreciation and amortization expenses.** Depreciation and amortization expenses increased by \$0.6 million, or 21.2%, to \$3.4 million for the three months ended September 30, 2016 from \$2.8 million for the three months ended September 26, 2015, primarily due to year-over-year increases in depreciation for our new ERP system, service inventory that was transferred to fixed assets, and amortization of intangibles related to acquisitions.

**Research and development expenses.** Research and development expenses increased by \$2.2 million, or 36.7%, to \$8.0 million for the three months ended September 30, 2016 from \$5.8 million for the three months ended September 26, 2015. The year-over-year increase was primarily due to higher compensation expense resulting from increased headcount and higher incentive compensation in connection with our initiative to accelerate new product development and introductions, in addition to the write-off of certain patent assets. Research and development expenses as a percentage of sales increased to 10.0% for the three months ended September 30, 2016 from 8.0% for the three months ended September 26, 2015.

**Other (income) expense.** For the three months ended September 30, 2016, Other (income) was \$0.2 million compared to Other expense of \$0.1 million for the three months ended September 26, 2015. Other (income) expense primarily reflected the favorable impact of changes in foreign exchange rates on the value of the current intercompany account balances of our subsidiaries denominated in other currencies.

**Income tax benefit.** Income tax benefit was \$0.1 million for the three months ended September 30, 2016 compared with \$0.2 million for the three months ended September 26, 2015. Our effective tax rate was a 5.9% benefit for the three months ended September 30, 2016 compared with a 16.6% benefit in the prior year period. The decrease of \$0.1 million in income tax benefit and change in our effective rate was due to the increase in pretax income during the third quarter of 2016 compared with a pretax loss in the same period of 2015 and the geographical mix shift in pretax income expected for the full year 2016. Our effective tax rate continued to be lower than the statutory tax rate in the United States, mainly due to our global footprint in foreign jurisdictions with lower tax rates. However, our effective tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of our products and the resulting effect on taxable income in each jurisdiction.

Net income (loss). Net income (loss) increased by \$2.0 million to net income of \$1.1 million for the three months ended September 30, 2016 from a net loss of \$0.9 million for the three months ended September 26, 2015 as a result of the factors described above.

Table of Contents

Nine Months Ended September 30, 2016 Compared to the Nine Months Ended September 26, 2015

Sales. Total sales increased \$7.7 million, or 3.4%, to \$233.9 million for the nine months ended September 30, 2016 from \$226.2 million for the nine months ended September 26, 2015 primarily due to an increase in service revenue and year-over-year growth in our measurement and reverse engineering product sales in all regions, partially offset by weaker sales of our 3D documentation products in the Americas and Europe/Africa regions. Total product sales were about even at \$182.2 million for the nine months ended September 30, 2016, compared with \$182.3 million for the prior year period. This was primarily due to lower units sold of our 3D documentation products, partially offset by higher average selling prices in both our measurement and reverse engineering and 3D documentation product sales. Service revenue increased by \$7.8 million, or 17.6%, to \$51.7 million for the nine months ended September 30, 2016 from \$43.9 million in the prior year period primarily driven by the growth of our installed, serviceable base and focused sales initiatives. Foreign exchange rates had a negative impact on sales of \$0.3 million, decreasing sales growth by 0.1 percentage points, primarily due to the decline of the Chinese yuan renminbi, British pound and Mexican peso relative to the U.S. dollar, partially offset by the appreciation of the Japanese yen and the Euro relative to the U.S. dollar.

Sales in the Americas region increased \$0.9 million, or 0.8%, to \$103.9 million for the nine months ended September 30, 2016 from \$103.0 million in the prior year period. Foreign exchange rates had a negative impact on sales of \$1.1 million, decreasing sales growth by 1.1 percentage points. Product sales in the Americas region decreased by \$2.6 million, or 3.2%, to \$79.3 million for the nine months ended September 30, 2016 from \$81.9 million in the prior year period, primarily driven by a decline in units sold of our 3D documentation products, partially offset by higher unit sales in our measurement and reverse engineering products and higher average prices for our 3D documentation products. Service revenue in the Americas region increased by \$3.5 million, or 16.3%, to \$24.6 million for the nine months ended September 30, 2016 from \$21.1 million in the prior year period, primarily due to an increase in warranty revenue.

Sales in the Europe/Africa region increased \$1.3 million, or 1.9%, to \$72.5 million for the nine months ended September 30, 2016 from \$71.2 million in the prior year period. Foreign exchange rates had a negative impact on sales of \$0.8 million, decreasing sales growth by 1.2 percentage points. Total product sales in the Europe/Africa region decreased by \$1.5 million, or 2.6%, to \$54.6 million for the nine months ended September 30, 2016 from \$56.1 million in the prior year period, primarily driven by a decline in units sold for both our measurement and reverse engineering and 3D documentation products, partially offset by a year-over-year increase in average selling prices in our measurement and reverse engineering products. Service revenue in the Europe/Africa region increased by \$2.8 million, or 18.9%, to \$17.9 million for the nine months ended September 30, 2016 from \$15.1 million in the prior year period, primarily due to an increase in warranty and customer service revenue.

Sales in the Asia-Pacific region increased \$5.5 million, or 10.5%, to \$57.5 million for the nine months ended September 30, 2016 from \$52.0 million in the prior year period. Foreign exchange rates had a positive impact on sales of \$1.6 million, increasing sales growth by 3.1 percentage points. Total product sales in the Asia-Pacific region increased by \$4.0 million, or 9.1%, to \$48.3 million for the nine months ended September 30, 2016 from \$44.3 million in the prior year period. This increase was primarily driven by a year-over-year increase in average selling prices for both our measurement and reverse engineering and 3D documentation products and higher units sold of our measurement and reverse engineering products, partially offset by a slight decrease in units sold for our 3D documentation products. Service revenue in the Asia-Pacific region increased by \$1.5 million, or 18.4%, to \$9.2 million for the nine months ended September 30, 2016 from \$7.7 million in the prior year period, primarily due to higher warranty and customer service revenue.

Gross profit. Gross profit increased by \$10.3 million, or 8.6%, to \$129.3 million for the nine months ended September 30, 2016 from \$119.0 million for the nine months ended September 26, 2015, primarily driven by a year-over-year increase in service revenue and a \$7.9 million inventory write-off recorded in the third quarter of 2015, compared with \$1.5 million recorded in the third quarter of 2016. Gross margin increased to 55.3% for the nine months ended September 30, 2016 from 52.6% in the prior year period. Gross margin from product revenue increased by 3.1 percentage points to 58.9% for the nine months ended September 30, 2016 from 55.8% in the prior year period. This increase was primarily driven by higher average selling prices and favorable sales mix shift to products with

higher margins. Gross margin from service revenue increased by 3.0 percentage points to 42.6% for the nine months ended September 30, 2016 from 39.6% for the prior year period, primarily due to higher warranty and customer service revenue, partially offset by higher service material costs related to a reclassification of certain service costs that were previously classified as product costs during the third quarter of 2016.

Selling and Marketing Expenses. Selling and marketing expenses decreased by \$2.0 million, or 3.5%, to \$56.1 million for the nine months ended September 30, 2016 from \$58.1 million for the nine months ended September 26, 2015. The decrease in selling and marketing expenses was primarily related to not holding our annual sales meeting, previously held in January, in

Table of Contents

2016, as well as a decrease in commission costs resulting from a change in our commission structure to higher fixed based salaries and lower commission percentages, which was implemented during 2016.

As a percentage of sales, selling and marketing expenses decreased to 24.0% of sales in the nine months ended September 30, 2016 from 25.7% of sales in the nine months ended September 26, 2015. Regionally, selling and marketing expenses were 22.7% of sales in the Americas for the nine months ended September 30, 2016 compared with 22.8% in the prior year period; 26.2% of sales in Europe/Africa for the nine months ended September 30, 2016 compared with 30.6% of sales in the prior year period; and 23.5% of sales in Asia-Pacific for the nine months ended September 30, 2016 compared with 24.8% of sales in the prior year period.

General and administrative expenses. General and administrative expenses increased by \$4.4 million, or 16.1%, to \$31.5 million, for the nine months ended September 30, 2016 from \$27.1 million for the nine months ended September 26, 2015. The increase in general and administrative expenses was primarily driven by higher compensation expense due to higher headcount, incentive compensation, recruiting costs and certain severance costs, partially offset by lower year-over-year consulting fees. General and administrative expenses were 13.5% of sales for the nine months ended September 30, 2016 compared to 12.0% of sales in the prior year period.

Depreciation and amortization expenses. Depreciation and amortization expenses increased by \$1.7 million, or 21.3%, to \$9.7 million for the nine months ended September 30, 2016 from \$8.0 million for the nine months ended September 26, 2015, primarily due to increased depreciation for our new ERP system and service inventory that was transferred to fixed assets as well as increased amortization of intangibles related to the acquisitions.

Research and development expenses. Research and development expenses increased \$2.9 million, or 14.8%, to \$22.3 million for the nine months ended September 30, 2016 from \$19.4 million for the nine months ended September 26, 2015. This increase was mainly due to higher project material costs and higher compensation expense on increased engineering headcount in connection with our initiative to accelerate new product development and introductions and an increase in incentive compensation. Research and development expenses as a percentage of sales increased to 9.5% for the nine months ended September 30, 2016 from 8.6% for the nine months ended September 26, 2015.

Other (income) expense. Other expense decreased by \$0.8 million to \$0.7 million for the nine months ended September 30, 2016 compared to \$1.5 million for the nine months ended September 26, 2015. The decrease in other expense was primarily due to the favorable impact of changes in foreign exchange rates on the value of the current intercompany account balances of our subsidiaries denominated in other currencies.

Income tax expense. Income tax expense was \$1.4 million for the nine months ended September 30, 2016 compared with \$0.9 million for the nine months ended September 26, 2015. This increase in income tax expense was primarily due to an increase in pretax income for the nine months ended September 30, 2016 compared with the same period of 2015. Our effective tax rate was 15.6% for the nine months ended September 30, 2016 compared with 19.4% in the prior year period. Our effective tax rate continued to be lower than the statutory tax rate in the United States, mainly due to our global footprint in foreign jurisdictions with lower tax rates. However, our effective tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of our products and the resulting effect on taxable income in each jurisdiction.

Net income. Net income increased by \$3.7 million to \$7.6 million for the nine months ended September 30, 2016 from \$3.9 million for the nine months ended September 26, 2015 as a result of the factors described above.

#### Liquidity and Capital Resources

Cash and cash equivalents increased by \$13.9 million to \$121.3 million at September 30, 2016 from \$107.4 million at December 31, 2015. The increase was primarily driven by strong cash flow from operations reflecting the decline in our accounts receivable balance, partially offset by the cash paid as consideration for the two acquisitions completed during the nine months ended September 30, 2016.

Cash flows from operating activities provide our primary source of liquidity. We generated positive cash flows from operations of \$28.5 million during the nine months ended September 30, 2016 compared to cash provided by operations of \$7.9 million during the nine months ended September 26, 2015. The increase was mainly due to lower inventory spending, higher collection of account receivable and higher net income during the nine months ended September 30, 2016 compared with the nine months ended September 26, 2015.



## Table of Contents

Cash flows used in investing activities during the nine months ended September 30, 2016 and September 26, 2015 were \$16.6 million and \$22.3 million, respectively. The decrease in cash used in investing activities was primarily due to increased proceeds from the sale of investments and lower capital expenditures, partially offset by the increase in cash paid as consideration for the two acquisitions completed during the nine months ended September 30, 2016 compared to the two acquisitions completed during the nine months ended September 26, 2015.

Cash flows provided by financing activities during the nine months ended September 30, 2016 and September 26, 2015 were \$0.4 million and \$2.6 million, respectively. The decrease was primarily due to a decrease in proceeds from the issuance of stock in connection with the exercise of stock options.

Of our cash and cash equivalents, \$92.5 million was held by foreign subsidiaries. Our intent is to indefinitely reinvest these funds in our foreign operations, as the cash is needed to fund on-going operations. In the event circumstances change, leading to the conclusion that these funds will not be indefinitely reinvested, we would need to accrue at the time of such determination for the income taxes that would be triggered upon their repatriation.

On November 24, 2008, our Board of Directors approved a \$30 million share repurchase program. Acquisitions for the share repurchase program may 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 expiration date or other restriction governing the period over which we can repurchase shares under the program. In October 2015, our Board of Directors authorized an increase to the existing share repurchase program from \$30 million to \$50 million. We made no stock repurchases during the nine month period ended September 30, 2016 under this program. As of September 30, 2016, we had authorization to repurchase \$18.3 million remaining under the repurchase program.

We believe that our working capital and anticipated cash flow from operations will be sufficient to fund our long-term liquidity requirements for the foreseeable future.

We have no off balance sheet arrangements.

### Contractual Obligations and Commercial Commitments

We enter into purchase commitments for products and services in the ordinary course of business. These purchases generally cover production requirements for 60 to 120 days as well as materials necessary to service customer units through the product lifecycle and for warranty commitments. As of September 30, 2016, we had \$32.6 million in purchase commitments that are expected to be delivered within the next 12 months. To ensure adequate component availability in preparation for new product introductions, as of September 30, 2016, we also had \$30.3 million in long-term commitments for purchases to be delivered after 12 months. Other than as described in the preceding sentences, there have been no material changes to the contractual obligations and commercial commitments table included in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2015.

### Critical Accounting Policies

The preparation of our consolidated financial statements requires 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. We base our 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 our management there may be other estimates or assumptions that are reasonable, we believe 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.

In response to the Securities and Exchange Commission's ("SEC") 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 our 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, the reserve for warranties, goodwill impairment, business combinations, and stock-based compensation. These policies affect current assets and operating results and are therefore critical





## Table of Contents

in assessing our financial and operating status. These policies involve certain assumptions that, if incorrect, could have an adverse impact on our operations and financial position.

### Revenue Recognition

Revenue is recognized when the price is fixed, collectability is reasonably assured, the title and risks and rewards of ownership have passed to the customer, and the earnings process is complete. Revenue related to our measurement, imaging, and realization equipment and related software is generally recognized upon shipment, as we consider the earnings process complete as of the shipping date. Fees billed to customers associated with the distribution of products are classified as revenue. We warrant our 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. We separately sell extended warranties. Extended warranty revenues are recognized on a straight-line basis over the term of the warranty. Costs relating to extended warranties 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. These software arrangements generally include short-term maintenance that is considered post-contract support (“PCS”). We generally establish vendor-specific objective evidence (“VSOE”) of fair value for this PCS component based on our maintenance renewal rate. Maintenance renewals, when sold, are recognized on a straight-line basis over the term of the maintenance agreement. 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. Revenues are presented net of sales-related taxes.

### Reserve for Excess and Obsolete Inventory

Because 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 potentially 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 potentially 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 are 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 of recoverability, 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 over at least a two-year period.

Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of operating a global business, there are many transactions for which the ultimate tax outcome is uncertain. We establish 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 FASB Accounting Standards Codification (“ASC”) Topic 740, Income Taxes, 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, we are examined by various federal, state, and foreign tax authorities. We regularly assess the potential outcome of these examinations and any future examinations for the current or prior years in determining the adequacy of our provision for income taxes. We assess the likelihood and amount of potential adjustments and adjust 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.

Reserve for Warranties

We establish at the time of sale a liability for the one year warranty included with the initial purchase price of 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 included in accrued liabilities in the accompanying

26

---

## Table of Contents

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. We evaluate our 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. We have a history of new product introductions and enhancements to existing products, which may result in unforeseen issues that increase our warranty costs. While such expenses have historically been within expectations, we 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. Goodwill is not amortized but is tested for impairment, at least annually. We perform our 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 in the financial statements and our current fair value is recognized as an expense in the period in which the impairment occurs.

Each period, and for any of our reporting units, we can elect to initially perform a qualitative assessment to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. If we believe, as a result of the qualitative assessment, that it is more likely than not that the fair value of a reporting unit containing goodwill is not less than the carrying amount, then the first and second steps of the quantitative goodwill impairment test are unnecessary. If we elect to bypass the qualitative assessment option, or if the qualitative assessment was performed and resulted in us being unable to conclude that it is not more likely than not that the fair value of a reporting unit containing goodwill is less than the carrying amount, we will perform the two-step quantitative goodwill impairment test. We perform the first step of the two-step quantitative goodwill impairment test by calculating the fair value of the reporting unit using a discounted cash flow method, and then comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of the reporting unit exceeds the fair value, the second step of the quantitative goodwill impairment test is performed to measure the amount of the impairment loss, if any. Management has concluded there was no goodwill impairment for the nine months ended September 30, 2016 or the year ended December 31, 2015.

### Business Combinations

We allocate the fair value of purchase consideration to the assets acquired and liabilities assumed based on their fair values at the acquisition date. The excess of the fair value of purchase consideration over the fair value of the assets acquired and liabilities assumed is recorded as goodwill. When determining the fair values of assets acquired and liabilities assumed, management makes significant estimates and assumptions, especially with respect to intangible assets. Critical estimates in valuing intangible assets include, but are not limited to, expected future cash flows, which include consideration of future growth rates and margins, customer attrition rates, future changes in technology and brand awareness, loyalty and position, and discount rates. Fair value estimates are based on the assumptions management believes a market participant would use in pricing the asset or liability. Amounts recorded in a business combination may change during the measurement period, which is a period not to exceed one year from the date of acquisition, as additional information about conditions existing at the acquisition date becomes available.

### Stock-Based Compensation

We measure and record compensation expense using the applicable accounting guidance for share-based payments related to stock options, restricted stock, and performance-based awards granted to our directors and employees. The fair value of stock options, including performance awards, without a market condition is determined by using the Black-Scholes option valuation model. The fair value of restricted stock awards and stock options with a market condition is estimated, at the date of grant, using the Monte Carlo Simulation valuation model. The Black-Scholes and Monte Carlo Simulation valuation models incorporate assumptions as to stock price volatility, the expected life of options or awards, a risk-free interest rate and dividend yield. In valuing our stock options, significant judgment is required in determining the expected volatility of our common stock and the expected life that individuals will hold

their stock options prior to exercising. Expected volatility for stock options is based on the historical and implied volatility of our own common stock while the volatility for our restricted stock units with a market condition is based on the historical volatility of our own stock and the stock of companies within our defined peer group. The expected life of stock options is derived from the historical actual term of option grants and an estimate of future exercises during the remaining contractual period of the option. While volatility and estimated life are assumptions that do not bear the risk of change subsequent to the grant date of stock options, these assumptions may be difficult to measure as they represent future expectations based on historical experience. Further, our expected volatility and expected life may change in

27

---

Table of Contents

the future, which could substantially change the grant-date fair value of future awards of stock options and, ultimately, the expense we record. The fair value of restricted stock, including performance awards, without a market condition is estimated using the current market price of our common stock on the date of grant. Additionally, in calculating compensation expense for these awards, we are also required to estimate the extent to which awards will be forfeited prior to vesting. Many factors are considered when estimating expected forfeitures, including types of awards, employee class and historical experience. To the extent actual results or updated estimates of forfeiture differ from current estimates, such amounts are recorded as a cumulative adjustment to the previously recorded amounts.

We expense stock-based compensation for stock options, restricted stock awards, and performance awards over the requisite service period. For awards with only a service condition, we expense stock-based compensation, adjusted for estimated forfeitures, using the straight-line method over the requisite service period for the entire award. For awards with both performance and service conditions, we expense the stock-based compensation, adjusted for estimated forfeitures, on a straight-line basis over the requisite service period for each separately vesting portion of the award, taking into account the probability that we will satisfy the performance condition. Furthermore, we expense awards with a market condition over the three-year vesting period regardless of the value that the award recipients ultimately receive. Excess tax benefits are credited to common stock when the deduction reduces cash taxes payable. When we have tax deductions in excess of the compensation cost, they are classified as financing cash inflows in the Condensed Consolidated Statements of Cash Flows.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

#### Foreign Exchange Exposure

We conduct a significant portion of our business outside the United States. As of and for the nine months ended September 30, 2016, 59% of our revenue was invoiced, and a significant portion of our operating expenses paid, in foreign currencies, as well as 57% of our assets were denominated in foreign currencies. Fluctuations in exchange rates between the U.S. dollar and such foreign currencies may have a material effect on our 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 due to the constantly changing exposure to various currencies, the fact that all foreign currencies do not react in the same manner in relation to the U.S. dollar and the number of currencies involved, although our most significant exposures are to the Euro, British pound sterling, Swiss franc, Japanese yen, Chinese yuan renminbi, Mexican peso and Brazilian real. To the extent that the percentage of our non-U.S. dollar revenues derived from international sales increases in the future, our exposure to risks associated with fluctuations in foreign exchange rates may increase. 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. However, we have not used such instruments in the past, and none were utilized in 2015 or the nine months ended September 30, 2016.

### Item 4. Controls and Procedures

#### Evaluation of Disclosure Controls and Procedures

We are responsible for establishing and maintaining disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), that are designed to ensure that information required to be disclosed in our reports filed under the Exchange Act, such as this Quarterly Report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures also include, without limitation, controls and procedures that are designed to ensure that such information is accumulated and communicated to our management, including our Chief Executive Officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

At the time that our Annual Report on Form 10-K for the year ended December 31, 2015 was filed on February 29, 2016, our Chief Executive Officer and principal financial officer concluded that our disclosure controls and procedures were not effective as of December 31, 2015 because of a material weakness in the design and operating effectiveness of our internal control over financial reporting related to the review of certain deferred income tax accounts. Specifically, inaccurate unearned service revenue balances were used to calculate the deferred tax amounts in China and our internal controls over the review of the related deferred income tax accounts in foreign jurisdictions were not sufficiently designed to identify reasonably possible errors, including the lack of certain specific,

documented instructions to the reviewers of the foreign income tax provisions. We have also conducted an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and principal financial officer, pursuant to Rule 13a-15 of the Exchange Act, of the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2016. Based on that evaluation, our Chief Executive Officer and our principal financial officer concluded that, because the material weakness in our internal control over

Table of Contents

financial reporting described above had not been fully remediated as of September 30, 2016, our disclosure controls and procedures were not effective as of September 30, 2016.

Notwithstanding the existence of this material weakness, our management has concluded that our condensed consolidated financial statements in this Quarterly Report on Form 10-Q fairly present, in all material respects, our financial position, results of operations and cash flows for all periods and dates presented.

**Management's Plan for Remediation**

Our management and Board of Directors are committed to the remediation of the identified material weakness, as well as the continued improvement of our overall system of internal control over financial reporting. We are currently working to remediate the underlying causes of the control deficiencies that gave rise to the material weakness, primarily through additional training, review procedures and engaging supplemental resources. As we perform our interim testing, we may take additional measures or modify the remediation plan. We believe these measures will remediate the control deficiencies; however, the material weakness will not be considered remediated until the applicable controls operate at least through this fiscal year-end financial reporting period and management has concluded, through required testing, that these controls are operating effectively. We expect that the remediation of this material weakness will be completed at the end of the fiscal year 2016 reporting period.

**Changes in Internal Control Over Financial Reporting**

Except for the continued implementation of the remediation measures described above, there were no other changes in our internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) during the quarter ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are not involved in any legal proceedings other than routine litigation arising in the normal course of business, none of which we believe will have a material adverse effect on our 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 our Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the SEC, before deciding to invest in, or retain, shares of our common stock. These risks could materially and adversely affect our business, financial condition, and results of operations. The risks described in our Annual Report on Form 10-K for the year ended December 31, 2015 are not the only risks we face. Our operations could also be affected by additional factors that are not presently known by us or by factors that we currently consider immaterial to our business. As of September 30, 2016, there were no material changes in our risk factors from those set forth in our Annual Report on Form 10-K for the year ended December 31, 2015.

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

**Purchases of Equity Securities by the Issuer Under the Share Repurchase Plan**

On November 24, 2008, our Board of Directors approved a \$30 million share repurchase program. Acquisitions for the share repurchase program may 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 expiration date or other restriction governing the period over which we can repurchase shares under the program. In October 2015, our Board of Directors authorized an increase to the existing share repurchase program from \$30 million to \$50 million. We made no stock repurchases during the nine month period ended September 30, 2016 under this program. As of September 30, 2016, we had authorization to repurchase \$18.3 million remaining under the repurchase program.

Table of Contents

Item 6. Exhibits

- 2.1 Stock Purchase Agreement, dated as of August 26, 2016, by and among FARO Technologies, Inc., Laser Projection Technologies, Inc., each of the shareholders of Laser Projection Technologies, Inc. and Steven P. Kaufman in the capacity of the Seller Representative (Filed as Exhibit 2.1 to our Current Report on Form 8-K, filed August 30, 2016, and incorporated herein by reference)\*
- 3.1 Amended and Restated Articles of Incorporation, as amended (Filed as Exhibit 3.1 to our Registration Statement on Form S-1/A filed September 10, 1997, No. 333-32983, and incorporated herein by reference)
- 3.2 Amended and Restated Bylaws (Filed as Exhibit 3.1 to our Current Report on Form 8-K, filed February 3, 2010 and incorporated herein by reference, SEC File No. 000-23081)
- 4.1 Specimen Stock Certificate (Filed as Exhibit 4.1 to our Registration Statement on Form S-1/A filed September 10, 1997, No. 333-32983, and incorporated herein by reference)
- 31-A Certification of the President and Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31-B Certification of the Principal Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32-A Certification of the President and Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32-B Certification of the Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Labels Linkbase Document
- 101.PRE XBRL Taxonomy Presentation Linkbase Document

Schedules and exhibits are omitted pursuant to Item 601(b)(2) of Regulation S-K. The Company agrees to furnish \*supplementally a copy of any omitted schedules or exhibits to the Securities and Exchange Commission upon request.



Table of Contents

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 3, 2016 By: /s/ Robert Seidel  
Name: Robert Seidel  
Title: Vice President of Finance & Investor Relations  
(Principal Financial Officer)