

FARO TECHNOLOGIES INC
Form 10-Q
October 31, 2012
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended September 29, 2012

OR

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

For the transition period from to

Commission File Number: 0-23081

FARO TECHNOLOGIES, INC.

(Exact Name of Registrant as Specified in Its Charter)

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Florida
(State or other Jurisdiction of
Incorporation or Organization)

59-3157093
(I.R.S. Employer
Identification No.)

250 Technology Park, Lake Mary, Florida
(Address of Principal Executive Offices)

32746
(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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

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

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

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

There were 16,971,545 shares of the registrant's common stock outstanding as of October 26, 2012.

Table of Contents

FARO TECHNOLOGIES, INC.

Quarterly Report on Form 10-Q

Quarter Ended September 29, 2012

INDEX

| | PAGE NUMBER |
|---|---|
| <u>PART I. FINANCIAL INFORMATION</u> | |
| Item 1. | <u>Financial Statements</u> |
| | <u>a) Consolidated Balance Sheets As of September 29, 2012 (Unaudited) and December 31, 2011</u> |
| | 3 |
| | <u>b) Consolidated Statements of Operations (Unaudited) For the Three and Nine Months Ended September 29, 2012 and October 1, 2011</u> |
| | 4 |
| | <u>c) Consolidated Statements of Comprehensive Income (Unaudited) For the Three and Nine Months Ended September 29, 2012 and October 1, 2011</u> |
| | 5 |
| | <u>d) Consolidated Statements of Cash Flows (Unaudited) For the Nine Months Ended September 29, 2012 and October 1, 2011</u> |
| | 6 |
| | <u>e) Notes to Consolidated Financial Statements (Unaudited) For the Nine Months Ended September 29, 2012 and October 1, 2011</u> |
| | 7-16 |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> |
| | 17-26 |
| Item 3. | <u>Quantitative and Qualitative Disclosures about Market Risk</u> |
| | 26 |
| Item 4. | <u>Controls and Procedures</u> |
| | 27 |
| <u>PART II. OTHER INFORMATION</u> | |
| Item 1. | <u>Legal Proceedings</u> |
| | 27 |
| Item 1A. | <u>Risk Factors</u> |
| | 28 |
| Item 2. | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> |
| | 29 |
| Item 6. | <u>Exhibits</u> |
| | 29 |
| <u>SIGNATURES</u> | |
| | 30 |
| <u>CERTIFICATIONS</u> | |
| | 30-33 |

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

| (in thousands, except share data) | September 29, 2012 Unaudited | December 31, 2011 |
|---|---------------------------------|-------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 80,505 | \$ 64,540 |
| Short-term investments | 64,989 | 64,997 |
| Accounts receivable, net | 51,014 | 57,512 |
| Inventories, net | 53,348 | 49,934 |
| Deferred income taxes, net | 6,090 | 5,297 |
| Prepaid expenses and other current assets | 10,383 | 9,207 |
| Total current assets | 266,329 | 251,487 |
| Property and Equipment: | | |
| Machinery and equipment | 31,427 | 29,171 |
| Furniture and fixtures | 6,406 | 5,963 |
| Leasehold improvements | 10,780 | 10,233 |
| Property and equipment at cost | 48,613 | 45,367 |
| Less: accumulated depreciation and amortization | (32,776) | (29,134) |
| Property and equipment, net | 15,837 | 16,233 |
| Goodwill | 18,517 | 18,610 |
| Intangible assets, net | 6,727 | 6,849 |
| Service inventory | 19,535 | 17,316 |
| Deferred income taxes, net | 2,270 | 2,296 |
| Total Assets | \$ 329,215 | \$ 312,791 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$ 7,995 | \$ 13,396 |
| Accrued liabilities | 16,242 | 18,076 |
| Income taxes payable | 1,611 | 2,682 |
| Current portion of unearned service revenues | 17,163 | 15,638 |
| Customer deposits | 2,347 | 4,072 |
| Current portion of obligations under capital leases | 18 | 84 |
| Total current liabilities | 45,376 | 53,948 |
| Unearned service revenues - less current portion | 9,648 | 9,540 |
| Deferred tax liability, net | 1,259 | 1,148 |

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| | | |
|--|------------|------------|
| Obligations under capital leases - less current portion | 66 | 257 |
| Total Liabilities | 56,349 | 64,893 |
| Commitments and contingencies - See Note Q | | |
| Shareholders' Equity: | | |
| Common stock - par value \$.001, 50,000,000 shares authorized; 17,651,780 and 17,381,110 issued; 16,971,545 and 16,700,875 outstanding, respectively | 18 | 17 |
| Additional paid-in-capital | 179,975 | 169,780 |
| Retained earnings | 96,519 | 81,360 |
| Accumulated other comprehensive income | 5,429 | 5,816 |
| Common stock in treasury, at cost - 680,235 shares | (9,075) | (9,075) |
| Total Shareholders' Equity | 272,866 | 247,898 |
| Total Liabilities and Shareholders' Equity | \$ 329,215 | \$ 312,791 |

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

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

(UNAUDITED)

| (in thousands, except share and per share data) | Three Months Ended | | Nine Months Ended | |
|---|---------------------|---------------------|----------------------|----------------------|
| | Sept 29, 2012 | Oct 1, 2011 | Sept 29, 2012 | Oct 1, 2011 |
| SALES | | | | |
| Product | \$ 49,274 | \$ 54,032 | \$ 159,130 | \$ 146,682 |
| Service | 11,460 | 10,775 | 33,595 | 30,402 |
| Total Sales | 60,734 | 64,807 | 192,725 | 177,084 |
| COST OF SALES | | | | |
| Product | 21,107 | 21,605 | 63,933 | 56,527 |
| Service | 7,323 | 6,813 | 22,242 | 20,380 |
| Total Cost of Sales (exclusive of depreciation and amortization, shown separately below) | 28,430 | 28,418 | 86,175 | 76,907 |
| GROSS PROFIT | 32,304 | 36,389 | 106,550 | 100,177 |
| OPERATING EXPENSES: | | | | |
| Selling | 14,154 | 14,696 | 46,033 | 44,157 |
| General and administrative | 7,266 | 6,424 | 22,028 | 19,931 |
| Depreciation and amortization | 1,796 | 1,711 | 5,164 | 5,047 |
| Research and development | 4,065 | 3,591 | 12,998 | 11,037 |
| Total operating expenses | 27,281 | 26,422 | 86,223 | 80,172 |
| INCOME FROM OPERATIONS | 5,023 | 9,967 | 20,327 | 20,005 |
| OTHER (INCOME) EXPENSE | | | | |
| Interest income | (20) | (19) | (141) | (84) |
| Other (income) expense, net | (46) | 780 | 215 | 775 |
| Interest expense | 2 | 2 | 22 | 33 |
| INCOME BEFORE INCOME TAX EXPENSE | 5,087 | 9,204 | 20,231 | 19,281 |
| INCOME TAX EXPENSE | 1,414 | 2,775 | 5,074 | 5,376 |
| NET INCOME | \$ 3,673 | \$ 6,429 | \$ 15,157 | \$ 13,905 |
| NET INCOME PER SHARE - BASIC | \$ 0.22 | \$ 0.39 | \$ 0.90 | \$ 0.85 |
| NET INCOME PER SHARE - DILUTED | \$ 0.21 | \$ 0.38 | \$ 0.88 | \$ 0.83 |

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| | | | | |
|-----------------------------------|------------|------------|------------|------------|
| Weighted average shares - Basic | 16,944,120 | 16,609,005 | 16,892,338 | 16,435,337 |
| Weighted average shares - Diluted | 17,094,102 | 16,849,282 | 17,148,555 | 16,788,776 |

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

Table of Contents

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(UNAUDITED)

| (in thousands) | Three Months Ended | | Nine Months Ended | |
|----------------------------------|--------------------|-------------|-------------------|-------------|
| | Sept 29, 2012 | Oct 1, 2011 | Sept 29, 2012 | Oct 1, 2011 |
| Net income | \$ 3,673 | \$ 6,429 | \$ 15,157 | \$ 13,905 |
| Currency translation adjustments | 1,303 | (4,578) | (385) | 764 |
| Comprehensive income | \$ 4,976 | \$ 1,851 | \$ 14,772 | \$ 14,669 |

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

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

(UNAUDITED)

| (in thousands) | Nine Months Ended | |
|---|-------------------|------------------|
| | Sept 29, 2012 | Oct 1, 2011 |
| CASH FLOWS FROM: | | |
| OPERATING ACTIVITIES: | | |
| Net income | \$ 15,157 | \$ 13,905 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 5,164 | 5,047 |
| Compensation for stock options and restricted stock units | 2,956 | 2,042 |
| Provision for (net recovery of) bad debts | (155) | 1,620 |
| Deferred income tax (benefit) expense | (670) | 111 |
| Change in operating assets and liabilities: | | |
| Decrease (increase) in: | | |
| Accounts receivable | 6,398 | (460) |
| Inventories, net | (5,998) | (23,682) |
| Prepaid expenses and other current assets | (1,231) | (2,707) |
| Income tax benefit from exercise of stock options | (1,135) | (1,412) |
| Increase (decrease) in: | | |
| Accounts payable and accrued liabilities | (7,307) | 1,068 |
| Income taxes payable | 82 | 597 |
| Customer deposits | (1,707) | (1,116) |
| Unearned service revenues | 1,730 | 3,593 |
| Net cash provided by (used in) operating activities | 13,284 | (1,394) |
| INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (3,139) | (3,370) |
| Payments for intangible assets | (772) | (646) |
| Net cash used in investing activities | (3,911) | (4,016) |
| FINANCING ACTIVITIES: | | |
| Payments on capital leases | (119) | (140) |
| Income tax benefit from exercise of stock options | 1,135 | 1,412 |
| Proceeds from issuance of stock, net | 6,107 | 7,727 |
| Net cash provided by financing activities | 7,123 | 8,999 |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS | (531) | 34 |
| INCREASE IN CASH AND CASH EQUIVALENTS | 15,965 | 3,623 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 64,540 | 50,722 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$ 80,505 | \$ 54,345 |

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

Table of Contents

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Unaudited for the Nine Months Ended September 29, 2012 and October 1, 2011

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

NOTE A DESCRIPTION OF BUSINESS

FARO Technologies, Inc. and subsidiaries (collectively, the Company or FARO) design, develop, manufacture, market and support software-based three-dimensional measurement devices for manufacturing, industrial, building construction and forensic applications. The Company's principal products include the FaroArm, FARO Laser Scan Arm and FARO Gage, all articulated electromechanical measuring devices, and the FARO Laser Tracker Vantage, FARO Focus 3D and FARO 3D Imager AMP, all laser-based measuring devices. Primary markets for the Company's products include automobile, aerospace, heavy equipment, light manufacturing and machine shops. The Company sells the vast majority of its products through a direct sales force located in many of the world's largest industrialized countries.

NOTE B PRINCIPLES OF CONSOLIDATION

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

NOTE C BASIS OF PRESENTATION

The consolidated financial statements of the Company include all normal recurring accruals and adjustments considered necessary by management for their fair presentation in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP). Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates. The consolidated results of operations for the three and nine months ended September 29, 2012 are not necessarily indicative of results that may be expected for the year ending December 31, 2012 or any future period.

The information included in this Quarterly Report on Form 10-Q, including the interim consolidated financial statements and the accompanying notes, should be read in conjunction with the audited consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

NOTE D RECLASSIFICATIONS

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

Table of Contents**NOTE E IMPACT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

In June 2011, the Financial Accounting Standards Board (the FASB) issued Accounting Standards Update (ASU) 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income* (ASU 2011-05). ASU 2011-05 requires companies to present the components of net income and other comprehensive income either as one continuous statement or as two consecutive statements. It eliminates the option to present components of other comprehensive income as part of the changes in stockholders' equity. The standard does not change the items which must be reported in other comprehensive income, how such items are measured or when they must be reclassified to net income. ASU 2011-05 was effective for interim and annual periods beginning after December 15, 2011. The adoption of ASU 2011-05 during the quarter ended March 31, 2012 only impacted presentation and did not have any effect on the Company's condensed consolidated financial statements or on its financial condition.

In December 2011, the FASB issued ASU No. 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05* (ASU 2011-12). ASU 2011-12 defers the specific requirement to present items that are reclassified from accumulated other comprehensive income to net income separately with their respective components of net income and other comprehensive income. As part of this update, the FASB did not defer the requirement to report comprehensive income either in a single continuous statement or in two separate but consecutive financial statements. The specific requirements deferred under ASU 2011-12 are not expected to have any impact on the Company's consolidated financial statements.

NOTE F SHARE-BASED COMPENSATION

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

The Company used the following assumptions for the Black-Scholes option-pricing model to determine the fair value of options granted during the nine months ended September 29, 2012 and October 1, 2011:

| | For the Nine Months Ended | |
|--------------------------------------|---------------------------|-----------------|
| | September 29, 2012 | October 1, 2011 |
| Risk-free interest rate | 0.50% - 0.66% | 0.66% and 1.83% |
| Expected dividend yield | 0% | 0% |
| Expected option life | 4 years | 4 years |
| Expected volatility | 50.4% - 50.7% | 47.9% - 48.7% |
| Weighted-average expected volatility | 50.7% | 48.7% |

Table of Contents

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

The Company recorded total share-based compensation expense of \$1,089 and \$676 for the three months ended September 29, 2012 and October 1, 2011, respectively, and \$3,022 and \$2,070 for the nine months ended September 29, 2012 and October 1, 2011, respectively.

A summary of stock option activity and weighted-average exercise prices for the nine months ended September 29, 2012 follows:

| | Options | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value as of September 29, 2012 |
|---|-----------|------------------------------------|--|--|
| Outstanding at January 1, 2012 | 865,445 | \$ 26.72 | | |
| Granted | 242,866 | 56.86 | | |
| Forfeited | (18,724) | 30.95 | | |
| Exercised | (256,331) | 23.82 | | |
| Outstanding at September 29, 2012 | 833,256 | \$ 36.31 | 4.8 | \$ 7,936 |
| Options exercisable at September 29, 2012 | 364,397 | \$ 24.85 | 3.5 | \$ 6,001 |

The weighted-average grant-date fair value of the stock options granted during the nine months ended September 29, 2012 and October 1, 2011 was \$22.51 and \$14.15 per option, respectively. The total intrinsic value of stock options exercised during the three months ended September 29, 2012 and October 1, 2011 was \$0.5 million and \$1.4 million, respectively. The total intrinsic value of stock options exercised during the nine months ended September 29, 2012 and October 1, 2011 was \$7.1 million and \$8.4 million, respectively. No stock options vested during the three months ended September 29, 2012 and October 1, 2011. The total fair value of stock options vested during the nine months ended September 29, 2012 and October 1, 2011 was \$1.8 million and \$1.6 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 29, 2012:

| | Shares | Weighted-Average Grant Date Fair Value |
|----------------------------------|----------|--|
| Non-vested at January 1, 2012 | 43,527 | \$ 32.31 |
| Granted | 12,719 | 49.98 |
| Forfeited | (1,619) | 27.39 |
| Vested | (23,391) | 30.28 |
| Non-vested at September 29, 2012 | 31,236 | \$ 45.80 |

As of September 29, 2012, there was \$7.5 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 years.

Table of Contents

NOTE G SUPPLEMENTAL CASH FLOW INFORMATION

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

| | Nine Months Ended | |
|----------------------------|-------------------|-------------|
| | Sept 29, 2012 | Oct 1, 2011 |
| Cash paid for interest | \$ 21 | \$ 31 |
| Cash paid for income taxes | \$ 4,780 | \$ 4,266 |

NOTE H CASH AND CASH EQUIVALENTS

The Company considers 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 I SHORT TERM INVESTMENTS

Short-term investments at September 29, 2012 and December 31, 2011 included U.S. Treasury Bills totaling \$65.0 million that mature through March 12, 2013. The weighted-average interest rate on the U.S. Treasury bills is less than one percent. The investments are classified as held-to-maturity and recorded at cost. The fair value of the U.S. Treasury Bills at September 29, 2012 approximated cost plus accrued interest.

NOTE J ACCOUNTS RECEIVABLE

Accounts receivable consist of the following:

| | As of September 29, 2012 | As of December 31, 2011 |
|---------------------------------|-----------------------------|----------------------------|
| Accounts receivable | \$ 55,331 | \$ 62,097 |
| Allowance for doubtful accounts | (4,317) | (4,585) |
| Total | \$ 51,014 | \$ 57,512 |

Table of Contents

NOTE K INVENTORIES

Inventories consist of the following:

| | As of September 29, 2012 | As of December 31, 2011 |
|---------------------------------|-----------------------------|----------------------------|
| Raw materials | \$ 29,646 | \$ 28,675 |
| Finished goods | 8,750 | 7,251 |
| Sales demonstration inventory | 18,109 | 16,794 |
| Reserve for excess and obsolete | (3,157) | (2,786) |
| Inventory | \$ 53,348 | \$ 49,934 |
| Service inventory | \$ 19,535 | \$ 17,316 |

NOTE L EARNINGS PER SHARE

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

| | Three Months Ended | | | | Nine Months Ended | | | |
|-------------------------------|--------------------|---------------------|-------------------|---------------------|--------------------|---------------------|-------------------|---------------------|
| | September 29, 2012 | | October 1, 2011 | | September 29, 2012 | | October 1, 2011 | |
| | Shares | Per-Share Amount | Shares | Per-Share Amount | Shares | Per-Share Amount | Shares | Per-Share Amount |
| Basic EPS | 16,944,120 | \$ 0.22 | 16,609,005 | \$ 0.39 | 16,892,338 | \$ 0.90 | 16,435,337 | \$ 0.85 |
| Effect of dilutive securities | 149,982 | (0.01) | 240,277 | (0.01) | 256,217 | (0.02) | 353,439 | (0.02) |
| Diluted EPS | 17,094,102 | \$ 0.21 | 16,849,282 | \$ 0.38 | 17,148,555 | \$ 0.88 | 16,788,776 | \$ 0.83 |

The effect of 240,616 securities were not included for the three months and nine months ended September 29, 2012, as they were antidilutive. There were no antidilutive securities for the three months and nine months ended October 1, 2011, as a result of all outstanding stock options being in-the-money.

Table of Contents

NOTE M ACCRUED LIABILITIES

Accrued liabilities consist of the following:

| | As of September 29, 2012 | As of December 31, 2011 |
|-----------------------------------|-----------------------------|----------------------------|
| Accrued compensation and benefits | \$ 9,135 | \$ 10,665 |
| Accrued warranties | 2,246 | 2,365 |
| Professional and legal fees | 1,221 | 966 |
| Other accrued liabilities | 3,640 | 4,080 |
| | \$ 16,242 | \$ 18,076 |

Activity related to accrued warranties was as follows:

| | Nine Months Ended | |
|--------------------------------|-------------------|-------------|
| | Sept 29, 2012 | Oct 1, 2011 |
| Beginning Balance | \$ 2,365 | \$ 1,857 |
| Provision for warranty expense | 2,231 | 2,033 |
| Warranty expired | (2,350) | (1,717) |
| Ending Balance | \$ 2,246 | \$ 2,173 |

NOTE N INCOME TAXES

Total deferred income tax assets for the Company's foreign subsidiaries relating to net operating loss carryforwards were \$15.0 million and \$14.9 million at September 29, 2012 and December 31, 2011, respectively. The related valuation allowance was \$12.0 million and \$11.8 million at September 29, 2012 and December 31, 2011, respectively. The Company's effective tax rate decreased to 25.1% for the nine months ended September 29, 2012 from 27.9% for the nine months ended October 1, 2011. The Company's tax rate continues to be lower than the statutory tax rate in the United States primarily as a result of favorable tax rates in foreign jurisdictions. Significant judgment is required in determining the Company's worldwide provision for income taxes. In the ordinary course of a global business, there are many transactions for which the ultimate tax outcome is uncertain. The Company reviews its tax contingencies on a regular basis and makes appropriate accruals as necessary.

The effective income tax rate for 2012 and 2011 includes a reduction in the statutory corporate tax rates for the Company's operations in Switzerland. The favorable tax rate ruling requires the Company to maintain a certain level of manufacturing operations in Switzerland. The aggregate dollar effect of this favorable tax rate was approximately \$0.7 million, or \$0.04 per share, in the nine month period ended September 29, 2012, and \$0.7 million, or \$0.04 per share, in the nine month period ended October 1, 2011.

Table of Contents

In 2005, the Company opened a regional headquarters and began to manufacture certain of its products in Singapore. In the third quarter of 2006, the Company received confirmation of a tax holiday for its operations from the Singapore Economic Development Board for a period of four years commencing January 1, 2006 and an additional six year extension at favorable tax rates subject to certain terms and conditions, including employment, spending, and capital investment, with which the Company expects to continue to comply. The aggregate dollar effect of this favorable tax rate was approximately \$0.3 million, or \$0.02 per share, during the nine month period ended September 29, 2012, and \$0.3 million, or \$0.02 per share, in the nine month period ended October 1, 2011.

NOTE O FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company's financial instruments include cash and cash equivalents, short-term investments, accounts receivable, customer deposits and 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.

NOTE P SEGMENT REPORTING

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

The Company develops, manufactures, markets, supports and sells Computer-Aided Design (CAD)-based quality assurance products integrated with CAD-based inspection and statistical process control software in each of these regions. These activities represent approximately 99% of consolidated sales. The Company evaluates performance and allocates resources based upon profitable growth and assets deployed.

Table of Contents

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

| | Three Months Ended | | Nine Months Ended | |
|---------------------------------|--------------------|-------------|-------------------|-------------|
| | Sept 29, 2012 | Oct 1, 2011 | Sept 29, 2012 | Oct 1, 2011 |
| Americas Region | | | | |
| Net sales to external customers | \$ 24,849 | \$ 24,992 | \$ 75,622 | \$ 66,230 |
| Depreciation and amortization | 1,083 | 991 | 3,189 | 2,970 |
| Operating income | 418 | 3,086 | 467 | 3,690 |
| Long-lived assets | 21,855 | 22,875 | 21,855 | 22,875 |
| Capital expenditures | 175 | 807 | 1,069 | 2,541 |
| Total assets | 170,414 | 152,175 | 170,414 | 152,175 |
| Europe/Africa Region | | | | |
| Net sales to external customers | \$ 21,024 | \$ 25,416 | \$ 67,270 | \$ 68,370 |
| Depreciation and amortization | 409 | 502 | 1,206 | 1,386 |
| Operating income | 1,492 | 2,468 | 5,409 | 3,375 |
| Long-lived assets | 16,514 | 17,250 | 16,514 | 17,250 |
| Capital expenditures | 526 | 429 | 1,288 | 1,438 |
| Total assets | 97,637 | 90,381 | 97,637 | 90,381 |
| Asia/Pacific Region | | | | |
| Net sales to external customers | \$ 14,861 | \$ 14,399 | \$ 49,833 | \$ 42,484 |
| Depreciation and amortization | 304 | 218 | 769 | 691 |
| Operating income | 3,113 | 4,413 | 14,451 | 12,940 |
| Long-lived assets | 2,712 | 1,926 | 2,712 | 1,926 |
| Capital expenditures | 246 | 94 | 1,291 | 497 |
| Total assets | 61,164 | 52,069 | 61,164 | 52,069 |
| Totals | | | | |
| Net sales to external customers | \$ 60,734 | \$ 64,807 | \$ 192,725 | \$ 177,084 |
| Depreciation and amortization | 1,796 | 1,711 | 5,164 | 5,047 |
| Operating income | 5,023 | 9,967 | 20,327 | 20,005 |
| Long-lived assets | 41,081 | 42,051 | 41,081 | 42,051 |
| Capital expenditures | 947 | 1,330 | 3,648 | 4,476 |
| Total assets | 329,215 | 294,625 | 329,215 | 294,625 |

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 each of the periods presented above.

Table of Contents

NOTE Q COMMITMENTS AND CONTINGENCIES

Leases The Company is a party to leases arising in the normal course of business that expire on or before 2019. Total obligations under these leases are approximately \$6.3 million for 2012.

Purchase Commitments The Company enters into purchase commitments for products and services in the ordinary course of business. These purchases generally cover production requirements for 60 to 90 days. As of September 29, 2012, the Company does not have any long-term commitments for purchases.

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

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

On July 14, 2010, the Company filed a motion for summary judgment of non-infringement of both patents-in-suit. On August 31, 2010, Nikon filed a motion for summary judgment against the Company s counterclaims for antitrust violations and unfair trade practices.

On September 19, 2011, the Massachusetts Court ruled that the Company did not infringe U.S. Patent No. 6,611,617. The Massachusetts Court also granted Nikon s motion for summary judgment on the Company s counterclaims for anti-trust violations and unfair trade practices. The Massachusetts Court denied the Company s motion for summary judgment of non-infringement of U.S. Patent No. 7,313,264. The effect of the ruling was to reduce or eliminate the Company s exposure with respect to claims associated with U.S. Patent No. 6,611,617, while the patent dispute with respect to U.S. Patent No. 7,313,264 continued.

On August 10, 2012, following a two-week jury trial on the remaining claims related to U.S. Patent No. 7,313,264, the jury determined the asserted patent claims were invalid, and on August 13, 2012, the Massachusetts Court entered judgment for the Company.

Post-trial motions were filed with the Massachusetts Court on September 21, 2012. The Company filed three motions, including a request for attorneys fees, a renewed request for judgment as a matter of law and a renewed request for judgment that U.S. Patent No. 6,611,617 is unenforceable. Nikon filed a renewed motion for judgment as a matter of law, or alternatively for a new trial, requesting that the Massachusetts Court reverse the jury s verdict and uphold the validity of U.S. Patent No. 7,313,264. Briefing on these motions is scheduled to be completed by November 16, 2012.

Table of Contents

While it is not possible to predict the outcome of this lawsuit, we believe an adverse determination of the patent infringement claims could have a material impact on the Company's business, financial condition or results of operations.

Other than the litigation mentioned above, the Company is not involved in any legal proceedings other than routine litigation arising in the normal course of business, none of which the Company believes will have a material adverse effect on the Company's business, financial condition or results of operations.

NOTE R LINE OF CREDIT

On July 11, 2006, the Company entered into a loan agreement providing for an available line of credit of \$30.0 million, which was most recently amended on March 15, 2012. Loans under the Amended and Restated Loan Agreement, as amended, bear interest at the rate of LIBOR plus a fixed percentage between 1.50% and 2.00% and require the Company to maintain a minimum cash balance and tangible net worth measured at the end of each of the Company's fiscal quarters. As of September 29, 2012, the Company was in compliance with all of the covenants under the Amended and Restated Loan Agreement, as amended. The term of the Amended and Restated Loan Agreement, as amended, expires on March 31, 2015. The Company has not drawn on this line of credit.

Table of Contents

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

The following information should be read in conjunction with the Consolidated Financial Statements, 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 the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

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, will, believe, plan, should, could, seek, expect, anticipate, intend, estimate, project and similar words, or discussions of our intentions identify forward-looking statements. Specifically, this Quarterly Report on Form 10-Q contains, among others, forward-looking statements regarding:

the Company's ability to achieve and maintain profitability;

the impact of fluctuations in exchange rates;

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

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

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

the sufficiency of the Company's plants to meet its manufacturing requirements;

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

the continuation of the Company's share repurchase program;

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

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

the Company's 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. The Company does not intend to update any forward-looking statements, whether as a result of new information, future events, or otherwise, unless otherwise required by law. Important factors that could cause actual results to differ materially from those contemplated in such forward-looking statements include, among others,

the following:

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

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

Table of Contents

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

the Company's inability to maintain its technological advantage by developing new products and enhancing its existing products;

the Company's inability to successfully identify and acquire target companies or achieve expected benefits from acquisitions that are consummated;

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

the market potential for the computer-aided measurement (CAM2) market and the potential adoption rate for the Company's products are difficult to quantify and predict;

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

fluctuations in the Company's annual and quarterly operating results and the inability to achieve its financial operating targets as a result of a number of factors, including, without limitation (i) litigation and regulatory action brought against the Company, (ii) quality issues with its products, (iii) excess or obsolete inventory, (iv) raw material price fluctuations, (v) expansion of the Company's manufacturing capability and other inflationary pressures, (vi) the size and timing of customer orders, (vii) the amount of time that it takes to fulfill orders and ship the Company's products, (viii) the length of the Company's sales cycle to new customers and the time and expense incurred in further penetrating its 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 Company's success in expanding its 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) investments in potential acquisitions or strategic sales, product or other initiatives, (xviii) shrinkage or other inventory losses due to product obsolescence, scrap or material price changes, (xix) adverse changes in the manufacturing industry and general economic conditions, (xx) compliance with government regulations including health, safety, and environmental matters, and (xxi) other factors noted herein;

changes in gross margins due to changing product mix of products sold and the different gross margins on different products, or as a result of extraordinary production costs associated with the roll-out of new products:

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

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

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

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

risks associated with expanding international operations, such as fluctuations in currency exchange rates, difficulties in staffing and managing foreign operations, political and economic instability, 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;

the loss of the Company's 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 the Company's growth;

Table of Contents

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

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

other risks and uncertainties discussed in Part I, Item 1A. Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

Overview

The Company designs, develops, manufactures, markets and supports portable, software driven, 3-D measurement and imaging systems that are used in a broad range of manufacturing, industrial, building construction and forensic applications. The Company's FaroArm®, FARO Laser ScanArm® and FARO Gage articulated measuring devices, the FARO Laser Tracker Vantage, the FARO Focus^{3D}, the FARO 3D Imager AMP 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. The Company uses the acronym CAM2 for this process, which stands for computer-aided measurement.

As of September 29, 2012, the Company's products have been purchased by approximately 15,000 customers worldwide, ranging from small machine shops to such large manufacturing and industrial companies as Audi, Bell Helicopter, Boeing, British Aerospace, Caterpillar, Daimler Chrysler, General Electric, General Motors, Honda, Johnson Controls, Komatsu America International, Lockheed Martin, Nissan, Siemens and Volkswagen, among many others.

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

The Company manufactures its FaroArm, FARO Gage, FARO 3D Imager AMP, and FARO Laser Tracker Vantage products in the Company's manufacturing facilities located in Florida and Pennsylvania for customer orders from the Americas, in its manufacturing facility located in Switzerland for customer orders from the Europe/Africa region and in its manufacturing facility located in Singapore for customer orders from the Asia/Pacific region. The Company manufactures its FARO Focus^{3D} product in its facility located in Stuttgart, Germany. The Company expects all of its existing plants to have the production capacity necessary to support its volume requirements through 2012.

The Company operates in international markets throughout the world. It maintains sales offices in the United States, Brazil, Mexico, France, Germany, Great Britain, Italy, Netherlands, Poland, Spain, China, India, Japan, Malaysia, Singapore, Thailand, and Vietnam. The Company manages and reports its global sales in three regions: the Americas, Europe/Africa and Asia/Pacific.

In the nine months ended September 29, 2012, 39.2% of the Company's sales were in the Americas compared to 36.7% in the first of nine months of 2011, 34.9% were in the Europe/Africa region compared to 38.3% in the first nine months of 2011, and 25.9% were in the Asia/Pacific region compared to 25.0% in the same prior year period. In the third quarter of 2012, new order bookings increased \$0.8 million, or 1.3%, to \$61.0 million from \$60.2 million in the prior year period. New orders in the third quarter of 2012 increased \$3.6 million, or 15.6%, in the Americas to \$26.7 million from \$23.1 million in the prior year period. New orders in the third quarter of 2012 decreased \$4.7 million, or 20.2%, to \$18.6 million in Europe/Africa from \$23.3 million in the third quarter of 2011. In Asia/Pacific, new orders in the third quarter of 2012 increased \$1.9 million, or 13.8%, to \$15.7 million from \$13.8 million in the third quarter of 2011.

Table of Contents

The Company accounts for wholly owned foreign subsidiaries in the currency of the respective foreign jurisdiction; therefore, fluctuations in exchange rates may have an impact on inter-company accounts reflected in the Company's consolidated financial statements. The Company is aware of the availability of off-balance sheet financial instruments to hedge exposure to foreign currency exchange rates, including cross-currency swaps, forward contracts and foreign currency options (see Foreign Exchange Exposure below). However, it does not regularly use such instruments, and none were utilized in 2011 or the nine months ended September 29, 2012.

The Company has been profitable in the first three quarters of 2012 and was profitable in each quarter in the years ended December 31, 2011 and December 31, 2010. The Company incurred a net loss in the year ended December 31, 2009, primarily as a result of a decrease in product sales. The Company attributes the decrease in product sales principally to the decline of the global economy. Prior to 2009, the Company had a history of sales and earnings growth and had 26 consecutive profitable quarters through December 31, 2008. Its historical sales and earnings growth were the result of a number of factors, including: continuing market demand for and acceptance of the Company's products; increased sales activity in part through additional sales staff worldwide, new products and product enhancements such as the FARO Edge Arm and FARO Focus^{3D}, and the effects of acquisitions. However, the Company's historical financial performance is not indicative of its future financial performance.

FCPA Update

As previously reported by the Company, the Company conducted an internal investigation in 2006 into certain payments made by its China subsidiary that may have violated the Foreign Corrupt Practices Act, or the FCPA, and other applicable laws, which we refer to as the FCPA Matter, and entered into settlement agreements and related documents with the SEC and the U.S. Department of Justice, or the DOJ, in 2008 related to the FCPA Matter. Under the terms of the agreements with the SEC and the DOJ, the Company assumed a two-year monitoring obligation and other continuing obligations with respect to compliance with the FCPA and other laws, including full cooperation with the U.S. government and the adoption of a compliance code containing specific provisions intended to prevent violations of the FCPA. During the second quarter of 2010, the Company, in conjunction with the SEC and the DOJ, completed the selection of the FCPA monitor. The monitor completed its follow-up review and submitted its final report to the SEC and the DOJ on June 29, 2012. The Company was notified on October 5, 2012 by the monitor that the SEC and DOJ have ended the monitorship. The Company does not anticipate incurring any further material expenses related to the FCPA Matter.

Results of Operations

Three Months Ended September 29, 2012 Compared to the Three Months Ended October 1, 2011

Sales decreased by \$4.1 million, or 6.3%, to \$60.7 million in the three months ended September 29, 2012 from \$64.8 million for the three months ended October 1, 2011. This decrease resulted primarily from a decline in sales of the Laser Scanner product compared to the quarter ended October 1, 2011, when the Company had expanded its manufacturing capacity to meet product demand which allowed it to increase shipments of the Laser Scanner to reduce the build-up in the backlog of orders for Laser Scanners at that time. A weaker Euro relative to the U.S. Dollar, on average, resulted in lower sales of approximately \$2.2 million in the three months ended September 29, 2012, as sales denominated in Euros were translated into U.S. Dollars. Product sales decreased by \$4.7 million, or 8.8%, to \$49.3 million for the three months ended September 29, 2012 from \$54.0 million for the third quarter of 2011. Service revenue increased by \$0.6 million, or 6.4%, to \$11.4 million for the three months ended September 29, 2012 from \$10.8 million in the same period during the prior year, primarily due to an increase in Warranty revenue.

Sales in the Americas region decreased by \$0.2 million, or 0.6%, to \$24.8 million for the three months ended September 29, 2012 from \$25.0 million in the three months ended October 1, 2011. Product sales in the Americas region decreased by \$0.9 million, or 4.0%, to \$19.7 million for the three months ended September 29, 2012 from \$20.6 million in the third quarter of the prior year. Service revenue in the Americas region increased by \$0.7 million, or 15.5%, to \$5.1 million for the three months ended September 29, 2012 from \$4.4 million in the same period during the prior year, primarily due to an increase in Customer Service and Warranty revenue.

Table of Contents

Sales in the Europe/Africa region decreased by \$4.4 million, or 17.3%, to \$21.0 million for the three months ended September 29, 2012 from \$25.4 million in the three months ended October 1, 2011. The weaker Euro relative to the U.S. Dollar contributed to this decline, as discussed above. Product sales in the Europe/Africa region decreased by \$4.1 million, or 19.5%, to \$16.8 million for the three months ended September 29, 2012 from \$20.9 million in the third quarter of the prior year. Service revenue in the Europe/Africa region decreased by \$0.3 million, or 7.1%, to \$4.2 million for the three months ended September 29, 2012 from \$4.5 million in the same period during the prior year, primarily due to a decrease in Customer Service revenue.

Sales in the Asia/Pacific region increased by \$0.5 million, or 3.2%, to \$14.9 million for the three months ended September 29, 2012 from \$14.4 million in the three months ended October 1, 2011. Product sales in the Asia/Pacific region increased by \$0.3 million, or 1.1%, to \$12.7 million for the three months ended September 29, 2012 from \$12.5 million in the third quarter of the prior year. Service revenue in the Asia/Pacific region increased by \$0.3 million, or 17.0%, to \$2.2 million for the three months ended September 29, 2012 from \$1.9 million in the same period during the prior year primarily due to an increase in Warranty revenue.

Gross profit decreased by \$4.1 million, or 11.2%, to \$32.3 million for the three months ended September 29, 2012 from \$36.4 million for the three months ended October 1, 2011. Gross margin decreased to 53.2% for the three months ended September 29, 2012 from 56.1% for the three months ended October 1, 2011. The decrease in gross margin is primarily due to a decrease in gross margin from product sales to 57.2% in the three months ended September 29, 2012 from 60.0% for the three months ended October 1, 2011, as a result of lower average selling prices across the Company's major product lines, sales promotions for older model products, and additional manufacturing costs related to the introduction of the new Vantage Laser Tracker. Gross margin from service revenues decreased to 36.1% in the three months ended September 29, 2012 from 36.8% for the three months ended October 1, 2011, primarily due to an increase in Customer Service costs.

Selling expenses decreased by \$0.5 million, or 3.7%, to \$14.2 million for the three months ended September 29, 2012 from \$14.7 million for three months ended October 1, 2011. This decrease was primarily due to a decrease in compensation and commissions expense of \$0.5 million.

Worldwide sales and marketing headcount increased by 40, or 12.2%, to 368 at September 29, 2012 from 328 at October 1, 2011. Regionally, the Company's sales and marketing headcount increased by 12, or 13.2%, to 103 from 91 for the Americas; increased by 10, or 8.7%, in Europe/Africa to 125 from 115; and increased by 18, or 14.8%, in Asia/Pacific to 140 from 122.

As a percentage of sales, selling expenses increased to 23.3% of sales in the three months ended September 29, 2012 from 22.7% in the three months ended October 1, 2011. Regionally, selling expenses were 18.8% of sales in the Americas for the quarter, compared to 18.5% of sales in the third quarter of 2011; 25.7% of sales for Europe/Africa for the quarter, compared to 26.4% of sales from the same period in the prior year; and 27.5% of sales in Asia/Pacific for the quarter, compared to 23.3% of sales for Asia/Pacific from the same period in the prior year.

General and administrative expenses increased by \$0.8 million, or 13.1%, to \$7.2 million for the three months ended September 29, 2012 from \$6.4 million for the three months ended October 1, 2011, primarily due to an increase in legal fees of \$0.7 million related to patent litigation.

Research and development expenses increased to \$4.1 million for the three months ended September 29, 2012 from \$3.6 million for the three months ended October 1, 2011, primarily as a result of an increase in compensation expense of \$0.4 million and professional fees of \$0.1 million. Research and development expenses as a percentage of sales increased to 6.7% for the three months ended September 29, 2012 from 5.5% for the three months ended October 1, 2011.

Table of Contents

Other (income) expense, net decreased by \$0.8 million to \$0.1 million of income for the three months ended September 29, 2012, from \$0.7 million of expense for the three months ended October 1, 2011, primarily as a result of an increase in foreign currency transaction gains due to changes in foreign exchange rates on the value of current intercompany account balances of the Company's subsidiaries denominated in different currencies.

Income tax expense decreased by \$1.4 million to \$1.4 million for the three months ended September 29, 2012 from \$2.8 million for the three months ended October 1, 2011. This decrease was primarily due to a decrease in pretax income. The Company's effective tax rate decreased to 27.8% for the three months ended September 29, 2012 from 30.1% in the prior year period, primarily as a result of a decrease in taxable income in jurisdictions with higher tax rates. The Company's tax rate continues to be lower than the statutory tax rate in the United States primarily as a result of favorable tax rates in foreign jurisdictions. However, the Company's tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of its products and the resulting effect on taxable income in each jurisdiction.

Net income decreased by \$2.7 million to \$3.7 million for the three months ended September 29, 2012 from \$6.4 million for the three months ended October 1, 2011 as a result of the factors described above.

Nine Months Ended September 29, 2012 Compared to the Nine Months Ended October 1, 2011

Total sales increased by \$15.6 million, or 8.8%, to \$192.7 million in the nine months ended September 29, 2012 from \$177.1 million for the nine months ended October 1, 2011. This increase is attributable primarily to an increase in demand for the Company's products. A weaker Euro relative to the U.S. Dollar, on average, resulted in lower sales of approximately \$6.0 million in the nine months ended September 29, 2012, as sales denominated in Euros were translated into U.S. Dollars. Product sales increased by \$12.4 million, or 8.5%, to \$159.1 million for the nine months ended September 29, 2012 from \$146.7 million for the nine months ended October 1, 2011. Service revenue increased by \$3.2 million, or 10.5%, to \$33.6 million for the nine months ended September 29, 2012 from \$30.4 million in the same period during the prior year, primarily due to an increase in Customer Service and Warranty revenue.

Sales in the Americas region increased by \$9.4 million, or 14.2%, to \$75.6 million for the nine months ended September 29, 2012 from \$66.2 million in the nine months ended October 1, 2011. Product sales in the Americas region increased by \$8.1 million, or 15.3%, to \$61.1 million for the nine months ended September 29, 2012 from \$53.0 million in the prior year period. Service revenue in the Americas region increased by \$1.3 million, or 9.6%, to \$14.5 million for the nine months ended September 29, 2012 from \$13.2 million in the same period during the prior year, due primarily to an increase in Customer Service and Warranty revenue.

Sales in the Europe/Africa region decreased by \$1.1 million, or 1.6%, to \$67.3 million for the nine months ended September 29, 2012 from \$68.4 million in the nine months ended October 1, 2011. The weaker Euro relative to the U.S. Dollar contributed to this decline, as discussed above. Product sales in the Europe/Africa region decreased by \$1.7 million, or 3.2%, to \$54.8 million for the nine months ended September 29, 2012 from \$56.6 million in the prior year period. Service revenue in the Europe/Africa region increased by \$0.7 million, or 5.4%, to \$12.5 million for the nine months ended September 29, 2012 from \$11.8 million in the same period during the prior year, primarily due to an increase in Customer Service and Warranty revenue.

Sales in the Asia/Pacific region increased by \$7.3 million, or 17.3%, to \$49.8 million for the nine months ended September 29, 2012 from \$42.5 million in the nine months ended October 1, 2011. Product sales in the Asia/Pacific region increased by \$6.1 million, or 16.3%, to \$43.2 million for the nine months ended September 29, 2012 from \$37.1 million in the prior year period. Service revenue in the Asia/Pacific region increased by \$1.2 million, or 24.1%, to \$6.6 million for the nine months ended September 29, 2012 from \$5.4 million in the same period during the prior year, due primarily to an increase in Customer Service and warranty revenue.

Table of Contents

Gross profit increased by \$6.3 million, or 6.4%, to \$106.6 million for the nine months ended September 29, 2012 from \$100.2 million for the nine months ended October 1, 2011. Gross margin decreased to 55.3% for the nine months ended September 29, 2012 from 56.6% for the nine months ended October 1, 2011. The decrease in gross margin is primarily due to a decrease in gross margin from product sales to 59.8% in the nine months ended September 29, 2012 from 61.5% for the nine months ended October 1, 2011, as a result of lower average selling prices, sales promotions for older model products, and an increase in the sales mix of the Laser Scanner product sold to Distributors. Gross margin from service revenues increased to 33.8% in the nine months ended September 29, 2012 from 33.0% in the nine months ended October 1, 2011, primarily due to an increase in Customer Service and Warranty revenue.

Selling expenses increased by \$1.8 million, or 4.2%, to \$46.0 million for the nine months ended September 29, 2012 from \$44.2 million for nine months ended October 1, 2011, primarily due to an increase in commission and compensation expense of \$0.8 million, an increase in marketing and advertising expenses of \$0.5 million, and an increase in travel related expenses of \$0.3 million.

As a percentage of sales, selling expenses decreased to 23.9% of sales in the nine months ended September 29, 2012 from 24.9% in the nine months ended October 1, 2011. Regionally, selling expenses were 20.5% of sales in the Americas for the nine months ended September 29, 2012, compared to 20.8% of sales in the prior year period; 27.5% of sales for Europe/Africa for the nine months ended September 29, 2012, compared to 29.2% of sales from the same period in the prior year; and 24.2% of sales for Asia/Pacific for the nine months ended September 29, 2012, compared to 24.5% of sales for Asia/Pacific from the same period in the prior year.

General and administrative expenses increased by \$2.1 million, or 10.5%, to \$22.0 million for the nine months ended September 29, 2012 from \$19.9 million for the nine months ended October 1, 2011, primarily due to increases in compensation expenses of \$0.8 million, an increase of \$1.1 million in legal and professional fees related to the cost of the FCPA monitor in connection with the DOJ and SEC settlement, and an increase in expenses related to patent litigation of \$1.2 million, offset by a decrease in bad debt expense of \$0.8 million.

Depreciation and amortization expenses increased by \$0.1 million to \$5.1 million for the nine months ended September 29, 2012 from \$5.0 million for the nine months ended October 1, 2011, primarily due to an increase in property and equipment.

Research and development expenses increased to \$13.0 million for the nine months ended September 29, 2012 from \$11.0 million for the nine months ended October 1, 2011, primarily as a result of an increase in compensation expenses of \$1.3 million, subcontractors and professional fees of \$0.8 million, and materials expense of \$0.1 million, offset by costs of \$0.3 million in the prior year period related to the closing and relocation of the R&D facility in Andover, MA to our existing facility in Kennett Square, PA. Research and development expenses as a percentage of sales increased to 6.7% for the nine months ended September 29, 2012 from 6.2% for the nine months ended October 1, 2011.

Other expense (income), net decreased by \$0.6 million to \$0.1 million of expense for the nine months ended September 29, 2012 from \$0.7 million of expense for the nine months ended October 1, 2011, primarily as a result of a decrease in foreign currency transaction losses due to changes in foreign exchange rates on the value of current intercompany account balances of the Company's subsidiaries denominated in different currencies.

Income tax expense decreased by \$0.3 million to \$5.1 million for the nine months ended September 29, 2012 from \$5.4 million for the nine months ended October 1, 2011. The Company's effective tax rate decreased to 25.1% for the nine months ended September 29, 2012 from 27.9% in the prior year period, primarily as a result of a decrease in taxable income in jurisdictions with higher tax rates, which included a reduction in the income tax rates of 2.2% in both periods related to the tax benefit of the exercise of employee stock options. The Company's tax rate continues to be lower than the statutory tax rate in the United States primarily as a result of favorable tax rates in foreign jurisdictions. However, the Company's tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of its products and the resulting effect on taxable income in each jurisdiction.

Table of Contents

Net income increased by \$1.3 million to \$15.2 million for the nine months ended September 29, 2012 from \$13.9 million for the nine months ended October 1, 2011 as a result of the factors described above.

Liquidity and Capital Resources

Cash and cash equivalents increased by \$16.0 million to \$80.5 million at September 29, 2012, from \$64.5 million at December 31, 2011. The increase was primarily attributable to net income and non-cash expenses of \$22.5 million, and proceeds from stock option exercises of \$6.1 million, partially offset by an increase in working capital of \$8.0 million and \$3.9 million in purchases of equipment and intangible assets.

On July 11, 2006, the Company entered into a loan agreement providing for an available line of credit of \$30.0 million, which was most recently amended on March 15, 2012. Loans under the Amended and Restated Loan Agreement, as amended, bear interest at the rate of LIBOR plus a fixed percentage between 1.50% and 2.00% and require the Company to maintain a minimum cash balance and tangible net worth measured at the end of each of the Company's fiscal quarters. As of September 29, 2012, the Company was in compliance with all of the covenants under the Amended and Restated Loan Agreement, as amended. The term of the Amended and Restated Loan Agreement, as amended, expires on March 31, 2015. The Company has not drawn on this line of credit.

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

The Company has no off balance sheet arrangements.

Critical Accounting Policies

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

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

Table of Contents

Revenue Recognition

Revenue related to the Company's measurement equipment and related software is generally recognized upon shipment, as the Company considers the earnings process substantially complete as of the shipping date. Revenue from sales of software only is recognized when no further significant production, modification or customization of the software is required and where persuasive evidence of a sales agreement exists, delivery has occurred, and the sales price is fixed or determinable and deemed collectible. Revenues resulting from sales of comprehensive support, training and technology consulting services are recognized as such services are performed. Extended maintenance plan revenues are recognized on a straight-line basis over the life of the plan. Revenue from the licensing agreements for the use of the Company's historical technology for medical applications is recognized when the technology is sold by the licensees.

Reserve for Excess and Obsolete Inventory

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

Income Taxes

The Company reviews its deferred tax assets on a regular basis to evaluate their recoverability based upon expected future reversals of deferred tax liabilities, projections of future taxable income over a two-year period, and tax planning strategies that it might employ to utilize such assets, including net operating loss carryforwards. Based on the positive and negative evidence of recoverability, the Company establishes a valuation allowance against the net deferred assets of a taxing jurisdiction in which it operates unless it is more likely than not that it will recover such assets through the above means. In the future, the Company's evaluation of the need for the valuation allowance will be significantly influenced by its ability to achieve profitability and its ability to predict and achieve future projections of taxable income.

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

Reserve for Warranties

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

Table of Contents

Goodwill Impairment

Goodwill represents the excess cost of a business acquisition over the fair value of the net assets acquired. Indefinite-life identifiable intangible assets and goodwill are not amortized but are tested for impairment. The Company performs an annual review in the fourth quarter of each year, or more frequently if indicators of potential impairment exist, to determine if the carrying value of the recorded goodwill is impaired. If an asset is impaired, the difference between the value of the asset reflected on the financial statements and its current fair value is recognized as an expense in the period in which the impairment occurs.

The Company first performs a qualitative assessment to determine whether it is necessary to perform the two-step goodwill impairment test. If the Company believes, as a result of its qualitative assessment, that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then the first and second steps of the goodwill impairment test are unnecessary. The Company elected to early adopt this accounting guidance at the beginning of its fourth quarter 2011 on a prospective basis for goodwill impairment tests.

The goodwill impairment test is applied using a two-step approach. In performing the first step, the Company calculates the fair values of the reporting units using discounted cash flows (DCF) of each reporting unit. If the carrying amount of the reporting unit exceeds the fair value, the second step is performed to measure the amount of the impairment loss, if any. In the second step, the implied fair value of the goodwill is estimated as the fair value of the reporting unit as calculated in the first step, less the fair values of the net tangible and intangible assets of the reporting unit other than goodwill. If the carrying amount of goodwill exceeds its implied fair value, an impairment loss is recognized in an amount equal to that excess, not to exceed the carrying amount of the goodwill. Management has concluded there was no goodwill impairment in the nine month period ended September 29, 2012 or the year ended December 31, 2011.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Foreign Exchange Exposure

The Company conducts a significant portion of its business outside the United States. As of September 29, 2012, 60.8% of its revenues were invoiced, and a significant portion of its operating expenses paid, in foreign currencies. Fluctuations in exchange rates between the U.S. dollar and such foreign currencies may have a material adverse effect on the Company's business, results of operations and financial condition, and could specifically result in foreign exchange gains and losses. The impact of future exchange rate fluctuations on the results of the Company's operations cannot be accurately predicted. To the extent that the percentage of its non-U.S. dollar revenues derived from international sales increases (or decreases) in the future, the Company's exposure to risks associated with fluctuations in foreign exchange rates may increase (or decrease).

Table of Contents

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) that are designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

As of the end of the period covered by this report, the Company's management carried out an evaluation, under the supervision and with the participation of its Chief Executive Officer and its Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures, as defined by Rule 13a-15(e) under the Exchange Act, were effective as of September 29, 2012.

Changes in Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 29, 2012 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

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

Table of Contents

On July 14, 2010, the Company filed a motion for summary judgment of non-infringement of both patents-in-suit. On August 31, 2010, Nikon filed a motion for summary judgment against the Company's counterclaims for antitrust violations and unfair trade practices.

On September 19, 2011, the Massachusetts Court ruled that the Company did not infringe U.S. Patent No. 6,611,617. The Massachusetts Court also granted Nikon's motion for summary judgment on the Company's counterclaims for anti-trust violations and unfair trade practices. The Massachusetts Court denied the Company's motion for summary judgment of non-infringement of U.S. Patent No. 7,313,264. The effect of the ruling was to reduce or eliminate the Company's exposure with respect to claims associated with U.S. Patent No. 6,611,617, while the patent dispute with respect to U.S. Patent No. 7,313,264 continued.

On August 10, 2012, following a two-week jury trial on the remaining claims related to U.S. Patent No. 7,313,264, the jury determined the asserted patent claims were invalid, and on August 13, 2012, the Massachusetts Court entered judgment for the Company.

Post-trial motions were filed with the Massachusetts Court on September 21, 2012. The Company filed three motions, including a request for attorneys' fees, a renewed request for judgment as a matter of law and a renewed request for judgment that U.S. Patent No. 6,611,617 is unenforceable. Nikon filed a renewed motion for judgment as a matter of law, or alternatively for a new trial, requesting that the Massachusetts Court reverse the jury's verdict and uphold the validity of U.S. Patent No. 7,313,264. Briefing on these motions is scheduled to be completed by November 16, 2012.

While it is not possible to predict the outcome of this lawsuit, we believe an adverse determination of the patent infringement claims could have a material impact on the Company's business, financial condition or results of operations.

Other than the litigation mentioned above, the Company is not involved in any legal proceedings other than routine litigation arising in the normal course of business, none of which the Company believes will have a material adverse effect on the Company's business, financial condition or results of operations.

Item 1A. Risk Factors

In addition to the other information set forth in this Form 10-Q, you should carefully consider the factors discussed under "Risk Factors" in the Company's Form 10-K for the year ended December 31, 2011, as filed with the SEC. These risks could materially and adversely affect the Company's business, financial condition, and results of operations. The risks described in the Company's Form 10-K for the year ended December 31, 2011 are not the only risks it faces. The Company's operations could also be affected by additional factors that are not presently known to the Company or by factors that it currently considers immaterial to its business.

Table of Contents**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****Purchases of Equity Securities by the Issuer**

On November 24, 2008, the Company's Board of Directors approved a \$30 million share repurchase program. Acquisitions for the share repurchase program will be made from time to time at prevailing prices as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The share repurchase program may be discontinued at any time. There is no restriction date or other restriction governing the period over which the Company can repurchase shares under the program. The Company made no stock repurchases during the nine month period ended September 29, 2012 under this program.

Item 6. Exhibits

- 3.1 Articles of Incorporation, as amended (Filed as Exhibit 3.1 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)
- 3.2 Amended and Restated Bylaws (Filed as Exhibit 3.1 to current Report on Form 8-K, dated January 28, 2010 and incorporated herein by reference)
- 4.1 Specimen Stock Certificate (Filed as Exhibit 4.1 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)
- 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 and Accounting 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 and Accounting 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 Schema Document
- 101.CAL XBRL Calculation Linkbase Document
- 101.DEF XBRL Definition Linkbase Document
- 101.LAB XBRL Label Linkbase Document
- 101.PRE XBRL Presentation Linkbase Document

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: October 31, 2012

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