

FARO TECHNOLOGIES INC
Form 10-Q
July 31, 2012
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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 June 30, 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 16,946,323 shares of the registrant's common stock outstanding as of July 27, 2012.

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FARO TECHNOLOGIES, INC.

Quarterly Report on Form 10-Q

Quarter Ended June 30, 2012

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

(in thousands, except share data)	June 30, 2012 (Unaudited)	December 31, 2011
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 74,748	\$ 64,540
Short-term investments	64,989	64,997
Accounts receivable, net	53,246	57,512
Inventories, net	54,057	49,934
Deferred income taxes, net	6,190	5,297
Prepaid expenses and other current assets	10,617	9,207
Total current assets	263,847	251,487
Property and Equipment:		
Machinery and equipment	30,587	29,171
Furniture and fixtures	6,197	5,963
Leasehold improvements	10,728	10,233
Property and equipment at cost	47,512	45,367
Less: accumulated depreciation and amortization	(31,373)	(29,134)
Property and equipment, net	16,139	16,233
Goodwill	18,339	18,610
Intangible assets, net	6,670	6,849
Service inventory	18,160	17,316
Deferred income taxes, net	2,240	2,296
Total Assets	\$ 325,395	\$ 312,791
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	\$ 9,295	\$ 13,396
Accrued liabilities	15,674	18,076
Income taxes payable	2,448	2,682
Current portion of unearned service revenues	16,751	15,638
Customer deposits	4,339	4,072
Current portion of obligations under capital leases	38	84
Total current liabilities	48,545	53,948
Unearned service revenues - less current portion	9,232	9,540
Deferred tax liability, net	1,279	1,148
Obligations under capital leases - less current portion	65	257

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Total Liabilities	59,121	64,893
Commitments and contingencies - See Note Q		
Shareholders' Equity:		
Common stock - par value \$.001, 50,000,000 shares authorized; 17,626,558 and 17,381,110 issued; 16,946,323 and 16,700,875 outstanding, respectively	18	17
Additional paid-in capital	178,361	169,780
Retained earnings	92,844	81,360
Accumulated other comprehensive income	4,126	5,816
Common stock in treasury, at cost - 680,235 shares	(9,075)	(9,075)
Total Shareholders' Equity	266,274	247,898
Total Liabilities and Shareholders' Equity	\$ 325,395	\$ 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		Six Months Ended	
	June 30, 2012	July 2, 2011	June 30, 2012	July 2, 2011
SALES				
Product	\$ 55,432	\$ 49,692	\$ 109,856	\$ 92,650
Service	11,330	10,019	22,135	19,627
Total Sales	66,762	59,711	131,991	112,277
COST OF SALES				
Product	22,320	19,349	42,826	34,922
Service	7,382	6,846	14,919	13,567
Total Cost of Sales (exclusive of depreciation and amortization, shown separately below)	29,702	26,195	57,745	48,489
GROSS PROFIT	37,060	33,516	74,246	63,788
OPERATING EXPENSES:				
Selling	15,841	15,309	31,879	29,461
General and administrative	8,134	6,917	14,762	13,507
Depreciation and amortization	1,689	1,722	3,368	3,336
Research and development	4,525	3,814	8,933	7,446
Total operating expenses	30,189	27,762	58,942	53,750
INCOME FROM OPERATIONS	6,871	5,754	15,304	10,038
OTHER (INCOME) EXPENSE				
Interest income	(20)	(39)	(121)	(65)
Other (income) expense, net	401	124	261	(5)
Interest expense	7	2	20	31
INCOME BEFORE INCOME TAX EXPENSE	6,483	5,667	15,144	10,077
INCOME TAX EXPENSE	1,749	1,434	3,660	2,601
NET INCOME	\$ 4,734	\$ 4,233	\$ 11,484	\$ 7,476
NET INCOME PER SHARE - BASIC	\$ 0.28	\$ 0.26	\$ 0.68	\$ 0.46
NET INCOME PER SHARE - DILUTED	\$ 0.28	\$ 0.25	\$ 0.67	\$ 0.45

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Weighted average shares - Basic	16,921,012	16,448,229	16,861,221	16,349,190
Weighted average shares - Diluted	17,140,115	16,845,877	17,157,185	16,724,019

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		Six Months Ended	
	June 30, 2012	July 2, 2011	June 30, 2012	July 2, 2011
Net income	\$ 4,734	\$ 4,233	\$ 11,484	\$ 7,476
Currency translation adjustments	(3,022)	2,771	(1,688)	5,342
Comprehensive income	\$ 1,712	\$ 7,004	\$ 9,796	\$ 12,818

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)	Six Months Ended	
	June 30, 2012	July 2, 2011
CASH FLOWS FROM:		
OPERATING ACTIVITIES:		
Net income	\$ 11,484	\$ 7,476
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,368	3,336
Compensation for stock options and restricted stock units	1,866	1,366
Provision for (net recovery of) bad debts	(84)	1,082
Deferred income tax benefit	(744)	(16)
Change in operating assets and liabilities:		
Decrease (increase) in:		
Accounts receivable	3,535	5,920
Inventories, net	(6,173)	(14,773)
Prepaid expenses and other current assets	(1,569)	(2,032)
Income tax benefit from exercise of stock options	(1,114)	(1,013)
Increase (decrease) in:		
Accounts payable and accrued liabilities	(6,313)	44
Income taxes payable	933	197
Customer deposits	317	(1,723)
Unearned service revenues	1,191	2,200
Net cash provided by operating activities	6,697	2,064
INVESTING ACTIVITIES:		
Purchases of property and equipment	(2,533)	(2,534)
Payments for intangible assets	(443)	(425)
Net cash used in investing activities	(2,976)	(2,959)
FINANCING ACTIVITIES:		
Payments on capital leases	(98)	(117)
Income tax benefit from exercise of stock options	1,114	1,013
Proceeds from issuance of stock, net	5,601	6,875
Net cash provided by financing activities	6,617	7,771
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	(130)	(259)
INCREASE IN CASH AND CASH EQUIVALENTS	10,208	6,617
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	64,540	50,722
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 74,748	\$ 57,339

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

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FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Unaudited for the Six Months Ended June 30, 2012 and July 2, 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 ION, 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 six months ended June 30, 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 prior period 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 will require 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 is 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, which is typically the same as 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 six months ended June 30, 2012 and July 2, 2011:

	For the Six Months Ended	
	June 30, 2012	July 2, 2011
Risk-free interest rate	0.61% - 0.66%	1.12% - 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%

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.

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The Company recorded total share-based compensation expense of \$1,093 and \$723 for the three months ended June 30, 2012 and July 2, 2011, respectively, and \$1,929 and \$1,394 for the six months ended June 30, 2012 and July 2, 2011, respectively.

A summary of stock option activity and weighted average exercise prices for the six months ended June 30, 2012 follows:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value as of June 30, 2012
Outstanding at January 1, 2012	865,445	\$ 26.72		
Granted	240,866	57.00		
Forfeited	(17,557)	30.01		
Exercised	(231,109)	24.23		
Outstanding at June 30, 2012	857,645	\$ 35.84	5.0	\$ 8,944
Options exercisable at June 30, 2012	389,619	\$ 24.54	3.7	\$ 6,834

The weighted-average grant-date fair value of the stock options granted during the six months ended June 30, 2012 and July 2, 2011 was \$22.57 and \$14.17 per option, respectively. The total intrinsic value of stock options exercised during the three months ended June 30, 2012 and July 2, 2011 was \$0.4 million and \$5.2 million, respectively. The total intrinsic value of stock options exercised during the six months ended June 30, 2012 and July 2, 2011 was \$6.5 million and \$7.0 million, respectively. The fair value of stock options vested during the three months ended June 30, 2012 and July 2, 2011 was \$0.0 million and \$0.0 million, respectively. The total fair value of stock options vested during the six months ended June 30, 2012 and July 2, 2011 was \$1.7 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 six months ended June 30, 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	(17,160)	35.45
Non-vested at June 30, 2012	37,467	\$ 40.85

As of June 30, 2012, there was \$8.5 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 2.2 years.

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NOTE G SUPPLEMENTAL CASH FLOW INFORMATION

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

	Six Months Ended	
	June 30, 2012	July 2, 2011
Cash paid for interest	\$ 20	\$ 30
Cash paid for income taxes	\$ 2,767	\$ 2,095

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 June 30, 2012 and December 31, 2011 include U.S. Treasury Bills totaling \$65.0 million that mature through December 13, 2012. 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 June 30, 2012 approximated cost.

NOTE J ACCOUNTS RECEIVABLE

Accounts receivable consist of the following:

	As of June 30, 2012	As of December 31, 2011
Accounts receivable	\$ 57,579	\$ 62,097
Allowance for doubtful accounts	(4,333)	(4,585)
Total	\$ 53,246	\$ 57,512

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NOTE K INVENTORIES

Inventories consist of the following:

	As of June 30, 2012	As of December 31, 2011
Raw materials	\$ 32,152	\$ 28,675
Finished goods	8,472	7,251
Sales demonstration inventory	16,504	16,794
Reserve for excess and obsolete	(3,071)	(2,786)
Inventory	\$ 54,057	\$ 49,934
 Service inventory	 \$ 18,160	 \$ 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				Six Months Ended			
	June 30, 2012		July 2, 2011		June 30, 2012		July 2, 2011	
	Shares	Per-Share Amount	Shares	Per-Share Amount	Shares	Per-Share Amount	Shares	Per-Share Amount
Basic EPS	16,921,012	\$ 0.28	16,448,229	\$ 0.26	16,861,221	\$ 0.68	16,349,190	\$ 0.46
Effect of dilutive securities	219,103		397,648	(0.01)	295,964	(0.01)	374,829	(0.01)
Diluted EPS	17,140,115	\$ 0.28	16,845,877	\$ 0.25	17,157,185	\$ 0.67	16,724,019	\$ 0.45

The effect of 240,616 and 240,116 securities were not included for the three months and six months ended June 30, 2012, as they were antidilutive. There were no antidilutive securities for the three months and six months ended July 2, 2011, as a result of outstanding stock options being in-the-money.

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NOTE M ACCRUED LIABILITIES

Accrued liabilities consist of the following:

	As of June 30, 2012	As of December 31, 2011
Accrued compensation and benefits	\$ 7,888	\$ 10,665
Accrued warranties	2,445	2,365
Professional and legal fees	1,478	966
Other accrued liabilities	3,863	4,080
	\$ 15,674	\$ 18,076

Activity related to accrued warranties was as follows:

	Six Months Ended	
	June 30, 2012	July 2, 2011
Beginning Balance	\$ 2,365	\$ 1,857
Provision for warranty expense	1,457	1,170
Warranty expired	(1,377)	(811)
Ending Balance	\$ 2,445	\$ 2,216

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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 June 30, 2012 and December 31, 2011, respectively. The related valuation allowance was \$11.9 million and \$11.8 million at June 30, 2012 and December 31, 2011, respectively. The Company's effective tax rate decreased to 24.2% for the six months ended June 30, 2012 from 25.8% for the six months ended July 2, 2011 and included a reduction in the income tax rates of 2.8% and 4.2%, respectively, 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. 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 \$0.5 million, or \$0.03 per share, in the six month period ended June 30, 2012, and \$0.0 million, or \$0.0 per share, in the six month period ended July 2, 2011.

In 2005, the Company opened a regional headquarters and began to manufacture its products in Singapore. In the third quarter of 2006, the Company received confirmation of a tax holiday for its operations from the Singapore Economic Development Board for a period of four years commencing January 1, 2006 and an additional six year extension at favorable tax rates subject to certain terms and conditions including employment, spending, and capital investment. The aggregate dollar effect of this favorable tax rate was approximately \$0.2 million, or \$0.01 per share, during the six month period ended June 30, 2012, and \$0.2 million, or \$0.01 per share, in the six month period ended July 2, 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 accruals. The carrying amounts of such financial instruments approximate their fair value due to the short-term nature of these instruments.

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NOTE P SEGMENT REPORTING

The Company has three reportable segments based 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.

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

	Three Months Ended		Six Months Ended	
	June 30, 2012	July 2, 2011	June 30, 2012	July 2, 2011
Americas Region				
Net sales to external customers	\$ 25,714	\$ 21,911	\$ 50,773	\$ 41,238
Operating (loss) income	(489)	137	49	604
Long-lived assets	22,379	22,723	22,379	22,723
Capital expenditures	332	849	894	1,734
Total assets	171,081	148,395	171,081	148,395
Europe/Africa Region				
Net sales to external customers	\$ 23,200	\$ 23,932	\$ 46,246	\$ 42,954
Operating income	1,613	1,215	3,917	907
Long-lived assets	16,146	18,820	16,146	18,820
Capital expenditures	580	739	762	1,009
Total assets	94,777	93,660	94,777	93,660
Asia Pacific Region				
Net sales to external customers	\$ 17,848	\$ 13,868	\$ 34,972	\$ 28,085
Operating income	5,747	4,402	11,338	8,527
Long-lived assets	2,623	2,038	2,623	2,038
Capital expenditures	791	116	1,045	403
Total assets	59,537	47,577	59,537	47,577
Totals				
Net sales to external customers	\$ 66,762	\$ 59,711	\$ 131,991	\$ 112,277
Operating income	6,871	5,754	15,304	10,038
Long-lived assets	41,148	43,581	41,148	43,581
Capital expenditures	1,703	1,704	2,701	3,146
Total assets	325,395	289,632	325,395	289,632

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.

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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 June 30, 2012, the Company does not have any long-term commitments for these 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 January 29, 2010, the Company filed a motion for summary judgment that the patents-in-suit are unenforceable due to inequitable conduct during patent prosecution. On July 14, 2010, the Company filed a motion for summary judgment of non-infringement of both patents-in-suit. In addition, during the first quarter of 2010, Nikon served a supplemental interrogatory answer revising its alleged date of conception of the patents-in-suit to an earlier date. The Company filed a motion to strike the supplemental interrogatory answer. On August 31, 2010, Nikon filed a motion for summary judgment against the Company s counterclaims for antitrust violations and unfair trade practices. The Company filed its opposition on October 12, 2010.

A mediation hearing held on February 18, 2011 to settle the matter was unsuccessful. On February 22, 2011, the Massachusetts Court denied Nikon s motion for summary judgment on the Company s counterclaims for antitrust violations and unfair trade practices without prejudice. On February 24, 2011, the Massachusetts Court denied the Company s motion for summary judgment of non-infringement without prejudice. On May 4, 2011, the Massachusetts Court found that, with respect to U.S. Patent No. 6,611,617, Nikon s patent is unenforceable due to inequitable conduct.

On May 26, 2011, the Company renewed its motion for summary judgment of non-infringement. On June 28, 2011, the Massachusetts Court heard oral arguments on the Company s motion, as well as on Nikon s renewed motion for summary judgment on the Company s counterclaims for anti-trust violations and unfair trade practices. The Massachusetts Court also heard oral arguments regarding an intervening change in the law of inequitable conduct and whether it changes the Massachusetts Court s May 4, 2011 finding that Nikon s U.S. Patent No. 6,611,617 is unenforceable due to inequitable conduct.

On September 19, 2011, as a result of these changes in the law of inequitable conduct, the Massachusetts Court vacated its May 4, 2011 decision that U.S. Patent No. 6,611,617 is unenforceable. However, in the same order, 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

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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 is 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 remains ongoing. A pre-trial conference was held on June 6, 2012 and a jury trial on the remaining claims is scheduled to begin on July 30, 2012. The Company believes it does not infringe U.S. Patent No. 7,313,264 and that the patent is invalid and unenforceable, and the Company will continue to vigorously defend itself against these claims.

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

Other than the litigation mentioned above, the Company is not involved in any 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 - LINES 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 effective 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 the Company's fiscal quarters. As of June 30, 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, extends to March 31, 2015. The Company has not drawn on this line of credit.

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

The following information should be read in conjunction with the 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 imposition of penalties against the Company for failure to comply with its continuing obligations with respect to the Foreign Corrupt Practices Act ("FCPA") Matter.

Forward-looking statements are not guarantees of future performance and are subject to a number of known and unknown risks, uncertainties, and other factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements. Consequently, undue reliance should not be placed on these forward-looking statements. The Company does not intend to update any forward-looking statements, whether as a result of new information, future events, or otherwise, unless otherwise required by law. Important

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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;

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

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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, (xxi) the ultimate costs of the Company's monitoring obligations in respect of the FCPA matter; and (xxii) 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;

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

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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;

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

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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 ION, 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 June 30, 2012, the Company's products have been purchased by approximately 13,000 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 ION 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 ION 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 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 six months ended June 30, 2012, 38.5% of the Company's sales were in the Americas compared to 36.7% in the first of six months of 2011, 35.0% were in the Europe/Africa region compared to 38.3% in the first six months of 2011, and 26.5% were in the Asia/Pacific region compared to 25.0% in the same prior year period. In the second quarter of 2012, new order bookings increased \$8.5 million, or 13.6%, to \$71.0 million from \$62.5 million in the prior year period. New orders in the second quarter of 2012 increased \$4.0 million, or 17.1%, in the Americas to \$27.4 million from \$23.4 million in the prior year period. New orders in the second quarter of 2012 increased \$1.1 million, or 4.5%, to \$25.8 million in Europe/Africa from \$24.7 million in the second quarter of 2011. In Asia/Pacific, new orders in the second quarter of 2012 increased \$3.4 million, or 23.6%, to \$17.8 million from \$14.4 million in the second quarter of 2011.

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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 six months ended June 30, 2012.

The Company 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 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 effect 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 expects that the monitoring period will not be extended beyond submission of the final report, but the Company has not yet received any response from either the SEC or the DOJ to the final report. Either or both of them could require additional steps, including extension of the monitorship, under the terms of the agreements that the Company entered into with the SEC and the DOJ. The Company does not anticipate incurring any further material expenses related to the FCPA Matter. Failure to comply with any continuing obligations with respect to the FCPA Matter could result in the SEC and the DOJ seeking to impose penalties against the Company in the future.

Results of Operations

Three Months Ended June 30, 2012 Compared to the Three Months Ended July 2, 2011

Sales increased by \$7.1 million, or 11.8%, to \$66.8 million in the three months ended June 30, 2012 from \$59.7 million for the three months ended July 2, 2011. This increase resulted primarily due 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 \$3.0 million, as sales denominated in Euros were translated into U.S. Dollars in the three months ended June 30, 2012. Product sales increased by \$5.8 million, or 11.6%, to \$55.5 million for the three months ended June 30, 2012 from \$49.7 million for the second quarter of 2011. Service revenue increased by \$1.3 million, or 13.1%, to \$11.3 million for the three months ended June 30, 2012 from \$10.0 million in the same period during the prior year primarily due to an increase in warranty revenue.

Sales in the Americas region increased by \$3.8 million, or 17.4%, to \$25.7 million for the three months ended June 30, 2012 from \$21.9 million in the three months ended July 2, 2011. Product sales in the Americas region increased by \$3.7 million, or 21.5%, to \$20.9 million for the three months ended June 30,

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2012 from \$17.2 million in the second quarter of the prior year. Service revenue in the Americas region increased by \$0.1 million, or 2.1%, to \$4.8 million for the three months ended June 30, 2012 from \$4.7 million in the same period during the prior year primarily due to an increase in warranty revenue.

Sales in the Europe/Africa region decreased by \$0.7 million, or 2.9%, to \$23.2 million for the three months ended June 30, 2012 from \$23.9 million in the three months ended July 2, 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 \$1.2 million, or 5.9%, to \$19.1 million for the three months ended June 30, 2012 from \$20.3 million in the second quarter of the prior year. Service revenue in the Europe/Africa region increased by \$0.5 million, or 13.9%, to \$4.1 million for the three months ended June 30, 2012 from \$3.6 million in the same period during the prior year.

Sales in the Asia/Pacific region increased by \$4.0 million, or 28.8%, to \$17.9 million for the three months ended June 30, 2012 from \$13.9 million in the three months ended July 2, 2011. Product sales in the Asia/Pacific region increased by \$3.4 million, or 27.9%, to \$15.6 million for the three months ended June 30, 2012 from \$12.2 million in the second quarter of the prior year. Service revenue in the Asia/Pacific region increased by \$0.6 million, or 35.2%, to \$2.3 million for the three months ended June 30, 2012 from \$1.7 million in the same period during the prior year.

Gross profit increased by \$3.6 million, or 10.6%, to \$37.1 million for the three months ended June 30, 2012 from \$33.5 million for the three months ended July 2, 2011. Gross margin decreased to 55.5% for the three months ended June 30, 2012 from 56.1% for the three months ended July 2, 2011. The decrease in gross margin is primarily due to a decrease in gross margin from product sales to 59.7% in the three months ended June 30, 2012 from 61.1% for the three months ended July 2, 2011, primarily as a result of lower average selling prices due to promotions in preparing for new product introductions and an increase in the sales mix of the Laser Scanner product sold to Distributors. Gross margin from service revenues increased to 34.8% in the three months ended June 30, 2012 from 31.7% for the three months ended July 2, 2011, primarily due to an increase in warranty revenue.

Selling expenses increased by \$0.5 million, or 3.5%, to \$15.8 million for the three months ended June 30, 2012 from \$15.3 million for three months ended July 2, 2011. This increase was primarily due to an increase in compensation and commissions expense of \$0.3 million and an increase in marketing and advertising costs of \$0.2 million.

Worldwide sales and marketing headcount increased by 34, or 10.5%, to 357 at June 30, 2012 from 323 at July 2, 2011. Regionally, the Company's sales and marketing headcount increased by 15, or 17.0%, to 103 from 88 for the Americas; increased by 3, or 2.6%, in Europe/Africa to 120 from 117; and increased by 16, or 13.6%, in Asia/Pacific to 134 from 118.

As a percentage of sales, selling expenses decreased to 23.7% of sales in the three months ended June 30, 2012 from 25.6% in the three months ended July 2, 2011. Regionally, selling expenses were 20.3% of sales in the Americas for the quarter, compared to 21.4% of sales in the second quarter of 2011; 28.8% of sales for Europe/Africa for the quarter compared to 29.8% of sales from the same period in the prior year; and 22.0% of sales for the quarter compared to 25.2% of sales for Asia/Pacific from the same period in the prior year.

General and administrative expenses increased by \$1.2 million, or 17.6%, to \$8.1 million for the three months ended June 30, 2012 from \$6.9 million for the three months ended July 2, 2011, primarily due to an increase in professional fees of \$1.2 million related to the FCPA Matter and \$0.4 million related to the patent litigation, offset by a reduction in bad debt expenses of \$0.4 million.

Depreciation and amortization expense remained at \$1.7 million for the three months ended June 30, 2012 and July 2, 2011.

Research and development expenses increased to \$4.5 million for the three months ended June 30, 2012 from \$3.8 million for the three months ended July 2, 2011, primarily as a result of an increase in compensation expense of \$0.4 million, subcontractors expense of \$0.4 million, and an increase in materials expense of \$0.2 million, offset by \$0.3 million incurred in the three months ended July 2, 2011 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 6.8% for the three months ended June 30, 2012 from 6.4% for the three months ended July 2, 2011.

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Other expense (income), net increased by \$0.3 million to \$0.4 million of expense for the three months ended June 30, 2012, from \$0.1 million of expense for the three months ended July 2, 2011, primarily as a result of an increase in foreign currency transaction losses resulting from 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 increased by \$0.3 million to \$1.7 million for the three months ended June 30, 2012 from \$1.4 million for the three months ended July 2, 2011. This increase was primarily due to an increase in pretax income. The Company's effective tax rate increased to 27.0% for the three months ended June 30, 2012 from 25.3% in the prior year period, primarily as a result of a reduction in the income tax rate of 4.7%, related to the tax benefit of the exercise of employee stock options in the prior year period. The Company's tax rate continues to be lower than the statutory tax rate in the United States primarily as a result of favorable tax rates in foreign jurisdictions. However, the Company's tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of its products and the resulting effect on taxable income in each jurisdiction.

Net income increased by \$0.5 million to \$4.7 million for the three months ended June 30, 2012 from \$4.2 million for the three months ended July 2, 2011 as a result of the factors described above.

Six Months Ended June 30, 2012 Compared to the Six Months Ended July 2, 2011

Total sales increased by \$19.7 million, or 17.6%, to \$132.0 million in the six months ended June 30, 2012 from \$112.3 million for the six months ended July 2, 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 \$3.9 million, as sales denominated in Euros were translated into U.S. Dollars in the six months ended June 30, 2012. Product sales increased by \$17.2 million, or 18.6%, to \$109.9 million for the six months ended June 30, 2012 from \$92.7 million for the six months ended July 2, 2011. Service revenue increased by \$2.5 million, or 12.8%, to \$22.1 million for the six months ended June 30, 2012 from \$19.6 million in the same period during the prior year primarily due to an increase in warranty revenue.

Sales in the Americas region increased by \$9.6 million, or 23.3%, to \$50.8 million for the six months ended June 30, 2012 from \$41.2 million in the six months ended July 2, 2011. Product sales in the Americas region increased by \$9.0 million, or 27.8%, to \$41.4 million for the six months ended June 30, 2012 from \$32.4 million in the prior year period. Service revenue in the Americas region increased by \$0.6 million, or 6.8%, to \$9.4 million for the six months ended June 30, 2012 from \$8.8 million in the same period during the prior year, due primarily to an increase in warranty revenue.

Sales in the Europe/Africa region increased by \$3.2 million, or 7.4%, to \$46.2 million for the six months ended June 30, 2012 from \$43.0 million in the six months ended July 2, 2011. The weaker Euro relative to the U.S. Dollar contributed to this decline, as discussed above. Product sales in the Europe/Africa region increased by \$2.3 million, or 6.5%, to \$37.9 million for the six months ended June 30, 2012 from \$35.6 million in the prior year period. Service revenue in the Europe/Africa region increased by \$0.9 million, or 12.2%, to \$8.3 million for the six months ended June 30, 2012 from \$7.4 million in the same period during the prior year.

Sales in the Asia/Pacific region increased by \$6.9 million, or 24.6%, to \$35.0 million for the six months ended June 30, 2012 from \$28.1 million in the six months ended July 2, 2011. Product sales in the Asia/Pacific region increased by \$5.9 million, or 24.0%, to \$30.5 million for the six months ended June 30, 2012 from \$24.6 million in the prior year period. Service revenue in the Asia/Pacific region increased by \$1.1 million, or 32.4%, to \$4.5 million for the six months ended June 30, 2012 from \$3.4 million in the same period during the prior year, due primarily to an increase in warranty revenue.

Gross profit increased by \$10.4 million, or 16.4%, to \$74.2 million for the six months ended June 30, 2012 from \$63.8 million for the six months ended July 2, 2011. Gross margin decreased to 56.3% for the six months ended June 30, 2012 from 56.8% for the six months ended July 2, 2011. The decrease in gross margin is primarily due to a decrease in gross margin from product sales to 61.0% in the six months ended June 30,

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2012 from 62.3% for the six months ended July 2, 2011 primarily as a result of lower average selling prices due to promotions in preparation for new product introductions, an increase in the sales mix of the Laser Scanner product sold to Distributors, and a change in the historical product sales mix caused by the increase in sales of the new Laser Scanner product which currently has a lower gross margin. Gross margin from service revenues increased to 32.6% in the six months ended June 30, 2012 from 30.9% for the six months ended July 2, 2011.

Selling expenses increased by \$2.4 million, or 8.2%, to \$31.9 million for the six months ended June 30, 2012 from \$29.5 million for the six months ended July 2, 2011, primarily due to an increase in commission and compensation expense of \$1.2 million, an increase in marketing and advertising expenses of \$0.7 million, and an increase in travel related expenses of \$0.3 million.

Worldwide sales and marketing headcount increased by 34, or 10.5%, to 357 at June 30, 2012 from 323 at July 2, 2011. Regionally, the Company's sales and marketing headcount increased by 15, or 17.0%, to 103 from 88 for the Americas; increased by 3, or 2.6%, in Europe/Africa to 120 from 117; and increased by 16, or 13.6%, in Asia/Pacific, to 134 from 118.

As a percentage of sales, selling expenses decreased to 24.2% of sales in the six months ended June 30, 2012 from 26.2% in the six months ended July 2, 2011. Regionally, selling expenses were 21.3% of sales in the Americas for the six months ended June 30, 2012 compared to 22.1% of sales in the prior year period; 28.3% of sales for Europe/Africa for the six months ended June 30, 2012 compared to 30.9% of sales from the same period in the prior year; and 22.8% of sales for the six months ended June 30, 2012 compared to 25.1% of sales for Asia/Pacific from the same period in the prior year.

General and administrative expenses increased by \$1.2 million, or 9.3%, to \$14.7 million for the six months ended June 30, 2012 from \$13.5 million for the six months ended July 2, 2011, primarily due to an increase in professional fees related to the FCPA Matter of \$1.2 million and legal fees primarily related to patent litigation of \$0.5 million, offset by a reduction in bad debt expenses of \$0.5 million.

Depreciation and amortization expenses remained at \$3.3 million for the six months ended June 30, 2012 and July 2, 2011.

Research and development expenses increased to \$8.9 million for the six months ended June 30, 2012 from \$7.4 million for the six months ended July 2, 2011, primarily as a result of an increase in compensation expenses of \$0.9 million, subcontractors expense of \$0.7 million, and an increase in materials expense of \$0.2 million, offset by \$0.3 million incurred 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 6.8% for the six months ended June 30, 2012 from 6.6% for the six months ended July 2, 2011.

Other expense (income), net increased by \$0.2 million to \$0.2 million for the six months ended June 30, 2012 from \$0.0 million of expense for the six months ended July 2, 2011, primarily as a result of an increase in foreign exchange transaction losses resulting from 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 increased by \$1.1 million to \$3.7 million for the six months ended June 30, 2012 from \$2.6 million for the six months ended July 2, 2011. This change was primarily due to an increase in pretax income. The Company's effective tax rate decreased to 24.2% for the six months ended June 30, 2012 from 25.8% in the prior year period, primarily as a result of a decrease in taxable income in jurisdictions with higher tax rates and included a reduction in the income tax rates of 2.8% and 4.2%, respectively, 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.

Net income increased by \$4.0 million to \$11.5 million for the six months ended June 30, 2012 from \$7.5 million for the six months ended July 2, 2011 as a result of the factors described above.

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Liquidity and Capital Resources

Cash and cash equivalents increased by \$10.2 million to \$74.7 million at June 30, 2012, from \$64.5 million at December 31, 2011. The increase was primarily attributable to net income and non-cash expenses of \$15.9 million, proceeds from stock option exercises of \$5.6 million, partially offset by a decrease in working capital of \$8.1 million and \$3.0 million in purchases of equipment and intangible assets for the six months ended June 30, 2012.

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 effective 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 the Company's fiscal quarters. As of June 30, 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, extends to 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 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 calculation, in addition to any inherent uncertainties pertaining to the possible effects on its financial condition. The critical policies discussed below are the Company's processes of recognizing revenue, the reserve for excess and obsolete inventory, income taxes, the reserve for warranties and goodwill impairment. These policies affect current assets and operating results and are therefore critical in assessing the Company's financial and operating status. These policies involve certain assumptions that, if incorrect, could have an adverse impact on the Company's operations and financial position.

Revenue Recognition

Revenue related to the Company's measurement equipment and related software is generally recognized upon shipment, as the Company considers the earnings process substantially complete as of the shipping date. Revenue from sales of software 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

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such services are performed. Extended maintenance plan revenues are recognized on a straight-line basis over the life of the plan. The Company warrants its products against defects in design, materials and workmanship for one year. A provision for estimated future costs relating to warranty expense is recorded when products are shipped. Costs relating to extended maintenance plans are recognized as incurred. Revenue from the licensing agreements for the use of the Company's 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 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 Accounting Standards Codification 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

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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.

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 Accounting Standards Update 2011-08 at the beginning of its fourth quarter of 2011 on a prospective basis for goodwill impairment tests, and performed a qualitative assessment at that time.

If the Company believes, as a result of its qualitative assessment, that it is more-likely-than-not that the fair value of a reporting unit is less than its carrying amount, the resultant annual 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 concluded there was no goodwill impairment in 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. At present, 61.5% of its revenues are invoiced, and a significant portion of its operating expenses are paid, in foreign currencies. Fluctuations in exchange rates between the U.S. dollar and such foreign currencies may have a material adverse effect on the 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).

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures 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 of 1934, as amended, or 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.

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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 June 30, 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 June 30, 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.

On January 29, 2010, the Company filed a motion for summary judgment that the patents-in-suit are unenforceable due to inequitable conduct during patent prosecution. Evidentiary hearings on the issue of inequitable conduct commenced on July 19, 2010, and concluded on October 22, 2010. Post-trial briefing concluded on December 10, 2010. On July 14, 2010, the Company filed a motion for summary judgment of non-infringement of both patents-in-suit. In addition, during the first quarter of 2010, Nikon served a supplemental interrogatory answer revising its alleged date of conception of the patents-in-suit to an earlier date. The Company filed a motion to strike the supplemental interrogatory answer, and the parties are waiting for the hearing date on the motion. On August 31, 2010, Nikon filed a motion for summary judgment against the Company's counterclaims for antitrust violations and unfair trade practices. The Company filed its opposition on October 12, 2010.

On February 22, 2011, the Court denied Nikon's Motion for Summary Judgment on the Company's counterclaims for anti-trust violations and unfair trade practices without prejudice. On February 24, 2011, the Court denied the Company's Motion for Summary Judgment of non-infringement without prejudice. The parties may renew their respective motions for summary judgment after the Court issues a decision on inequitable conduct, if necessary. No further motions for summary judgment are expected to be filed. A mediation hearing held on February 18, 2011 to settle the matter was unsuccessful.

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On May 4, 2011, the U.S. District Court for the District of Massachusetts found that with respect to U.S. Patent No. 6,611,617, Nikon's patent is unenforceable due to inequitable conduct. The patent dispute with respect to U.S. Patent No. 7,313,264 remains ongoing, and the Company believes it does not infringe patent 7,313,264 and that it is invalid and unenforceable.

On May 26, 2011 the Company renewed its Motion for Summary Judgment of non-infringement. On June 28, 2011, the Court heard oral arguments on the Company's motion, as well as on Nikon's Renewed Motion for Summary Judgment on the Company's counterclaims for anti-trust violations and unfair trade practices. The Court also heard oral arguments regarding an intervening change in the law of inequitable conduct and whether it changes the Court's May 4, 2011 finding that Nikon's U.S. Patent No. 6,611,617 is unenforceable due to inequitable conduct. The Court took all matters under advisement, and has not issued any decisions.

On September 19, 2011, as a result of these changes in the law of inequitable conduct, the Massachusetts Court vacated its May 4, 2011 decision that U.S. Patent No. 6,611,617 is unenforceable. However, in the same order, 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 is 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 remains ongoing. A pre-trial conference was held on June 6, 2012 and a jury trial on the remaining claims is scheduled to begin in the Massachusetts Court on July 30, 2012. The Company believes it does not infringe U.S. Patent No. 7,313,264 and that the patent is invalid and unenforceable, and the Company will continue to vigorously defend itself against these claims.

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

Other than the litigation mentioned above, the Company is not involved in any 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 Securities and Exchange Commission. 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.

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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 first half of fiscal 2012 under this program.

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Item 6. Exhibits

3.1	Articles of Incorporation, as amended (Filed as Exhibit 3.1 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)
3.2	Amended and Restated Bylaws (Filed as Exhibit 3.1 to current Report on Form 8-K, dated January 28, 2010 and incorporated herein by reference)
4.1	Specimen Stock Certificate (Filed as Exhibit 4.1 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)
10.1	Termination Agreement, dated June 18, 2012, by and among Siggi Buss and FARO Europe GmbH & Co. KG, FARO Verwaltungs GmbH, and FARO Deutschland Holding GmbH.*
10.2	Termination Agreement, dated June 18, 2012, by and between Siggi Buss and FARO Swiss Holding GmbH.*
31-A	Certification of the President and Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31-B	Certification of the Principal Financial and Accounting Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32-A	Certification of the President and Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32-B	Certification of the Principal Financial and Accounting Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
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

* Filed herewith.

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SIGNATURES

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

FARO Technologies, Inc.
(Registrant)

Date: July 31, 2012

By: /s/ Keith S. Bair
Keith S. Bair
Senior Vice President and Chief Financial Officer

(Duly Authorized Officer and Principal Financial Officer)