FARO TECHNOLOGIES INC
Form 10-Q
November 03, 2008
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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 September 27, 2008

OR

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

For the transition period from ______ to ______

Commission File Number: 0-23081

FARO TECHNOLOGIES, INC.

(Exact name of Registrant as specified in its charter)

Florida	**59-3157093**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
125 Technology Park, Lake Mary, Florida	**32746**
(Address of Principal Executive Offices)	**(Zip Code)**

Registrant s Telephone Number, including area code: (407) 333-9911

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 **x** NO ¨

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨ 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 x

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 16,694,995 shares of the registrant s common stock as of October 24, 2008.

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FARO TECHNOLOGIES, INC.

Quarterly Report on Form 10-Q

Quarter Ended September 27, 2008

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

(in thousands, except share data)	September 27, 2008	December 31, 2007
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 20,160	$ 25,798
Short-term investments	82,370	77,375
Accounts receivable, net	45,354	54,767
Inventories	37,237	29,100
Deferred income taxes, net	6,034	2,841
Prepaid expenses and other current assets	9,097	6,719
Total current assets	200,252	196,600
Property and Equipment:		
Machinery and equipment	18,145	12,895
Furniture and fixtures	3,909	5,008
Leasehold improvements	3,523	3,296
Property and equipment at cost	25,577	21,199
Less: accumulated depreciation and amortization	(16,068)	(13,672)
Property and equipment, net	9,509	7,527
Goodwill	19,544	19,117
Intangible assets, net	8,869	5,970
Service inventory	12,682	10,865
Deferred income taxes, net	1,931	3,460
Total Assets	$ 252,787	$ 243,539
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 9,526	$ 12,450
Accrued liabilities	13,290	17,989
Income taxes payable	1,470	2,266
Current portion of unearned service revenues	10,846	8,594
Customer deposits	334	337
Current portion of obligations under capital leases	15	18
Total current liabilities	35,481	41,654
Unearned service revenues - less current portion	6,597	6,091
Deferred tax liability, net	1,157	1,073
Obligations under capital leases - less current portion	159	222

Total Liabilities	43,394	49,040
Commitments and contingencies - See Note O		
Shareholders Equity:		
Common stock - par value $.001, 50,000,000 shares authorized; 16,733,554 and 16,700,966 issued; 16,653,859 and 16,604,052 outstanding, respectively	17	17
Additional paid-in-capital	148,782	146,489
Retained earnings	55,299	43,545
Accumulated other comprehensive income	5,446	4,599
Common stock in treasury, at cost - 40,000 shares	(151)	(151)
Total Shareholders Equity	209,393	194,499
Total Liabilities and Shareholders Equity	$ 252,787	$ 243,539

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

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FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

	Three Months Ended		Nine Months Ended	
(in thousands, except per share data)	**Sep 27, 2008**	**Sep 29, 2007**	**Sep 27, 2008**	**Sep 29, 2007**
SALES	$ 49,095	$ 44,521	$ 152,934	$ 132,389
COST OF SALES (exclusive of depreciation and amortization, shown separately below)	20,086	18,065	59,980	52,873
GROSS PROFIT	29,009	26,456	92,954	79,516
OPERATING EXPENSES:				
Selling	15,382	13,625	46,886	39,951
General and administrative	6,614	7,978	19,274	18,496
Depreciation and amortization	1,158	971	3,293	3,013
Research and development	3,237	2,881	9,122	7,129
Total operating expenses	26,391	25,455	78,575	68,589
INCOME FROM OPERATIONS	2,618	1,001	14,379	10,927
OTHER (INCOME) EXPENSE				
Interest income	(547)	(590)	(1,624)	(1,182)
Other (income) expense, net	652	(720)	834	(1,427)
Interest expense	2	3	450	7
INCOME BEFORE INCOME TAX	2,511	2,308	14,719	13,529
INCOME TAX EXPENSE	500	1,603	2,965	3,840
NET INCOME	$ 2,011	$ 705	$ 11,754	$ 9,689
NET INCOME PER SHARE - BASIC	$ 0.12	$ 0.04	$ 0.71	$ 0.64
NET INCOME PER SHARE - DILUTED	$ 0.12	$ 0.04	$ 0.70	$ 0.63
Weighted average shares - Basic	16,637,497	15,726,009	16,624,784	15,037,745
Weighted average shares - Diluted	16,731,064	15,988,788	16,751,679	15,315,996

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

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FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Nine Months Ended	
(in thousands)	**Sep 27, 2008**	**Sep 29, 2007**
CASH FLOWS FROM:		
OPERATING ACTIVITIES:		
Net income	$ 11,754	$ 9,689
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,293	3,013
Amortization of stock options and restricted stock units	1,686	956
Provision for bad debts	446	223
Deferred income tax benefit	(1,575)	(542)
Change in operating assets and liabilities:		
Decrease (increase) in:		
Accounts receivable	9,198	(218)
Inventories	(9,681)	(4,798)
Prepaid expenses and other current assets	(2,369)	(695)
Income tax benefit from exercise of stock options	(45)	(2,993)
Increase (decrease) in:		
Accounts payable and accrued liabilities	(7,654)	2,499
Income taxes payable	(771)	(785)
Customer deposits	(11)	(314)
Unearned service revenues	2,671	5,064
Net cash provided by operating activities	6,942	11,099
INVESTING ACTIVITIES:		
Purchases of property and equipment	(4,377)	(1,807)
Payments for intangible assets	(3,584)	(264)
Purchases of short-term investments	(4,995)	(56,990)
Net cash used in investing activities	(12,956)	(59,061)
FINANCING ACTIVITIES:		
Payments of capital leases	(68)	(60)
Income tax benefit from exercise of stock options	45	2,993
Proceeds from issuance of stock, net	128	58,409
Net cash provided by financing activities	105	61,342
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	271	(3,660)
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(5,638)	9,720
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	25,798	15,689
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 20,160	$ 25,409

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

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the Nine Months Ended September 27, 2008 and September 29, 2007

(Unaudited)

(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 Scan Arm and FARO Gage, all articulated electromechanical measuring devices, and the FARO Laser Tracker and the FARO Laser Scanner LS, both laser-based measuring devices. Primary markets for the Company s products include automobile, aerospace, heavy equipment, and law enforcement agencies. The Company sells the vast majority of its products though a direct sales force located in many of the world s largest industrialized countries.

NOTE B PRINCIPLES OF CONSOLIDATION

The consolidated financial statements of the Company include the accounts of FARO Technologies, Inc. and all its subsidiaries. All intercompany transactions and balances have been eliminated. The financial statements of the 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 adjustments of a normal recurring nature considered necessary by management for their fair presentation in conformity with accounting principles generally accepted in the United States of America. 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 from those estimates. The consolidated results of operations for the three and nine months ended September 27, 2008 are not necessarily indicative of results that may be expected for the year ending December 31, 2008 or any future period.

The information included in this Form 10-Q, including the interim consolidated financial statements and notes that accompany these financial statements, should be read in conjunction with the audited consolidated financial statements and related notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

NOTE D RECLASSIFICATIONS

From time to time the Company may reclassify certain amounts to conform to the current period presentation. No amounts have been reclassified in the periods presented herein.

NOTE E IMPACT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

As of January 1, 2008, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 permits entities to choose to measure certain financial instruments and other eligible items at fair value when the items are not otherwise currently required to be measured at fair value. Under SFAS 159, the decision to measure items at fair value is made at specified election dates on an irrevocable instrument-by-instrument basis. Entities electing the fair value option would be required to recognize changes in fair value in earnings and to expense upfront costs and fees associated with the item for which the fair value option is elected. Entities electing the fair value option are required to distinguish, on the face of the statement of financial

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position, the fair value of assets and liabilities for which the fair value option has been elected and similar assets and liabilities measured using another measurement attribute. The adoption of SFAS 159 had no impact on the Company s consolidated financial statements.

As of January 1, 2008, the Company adopted SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements; rather, it applies to other accounting pronouncements that require or permit fair value measurements. The Company does not believe that any of its assets or liabilities are subject to the quarterly recurring measurement provisions of SFAS 157. The Company will make the disclosures necessary for any assets and liabilities measured on a recurring basis subject to the annual disclosure requirements of SFAS 157 at year-end. The disclosure requirements for assets and liabilities assessed on a non-recurring basis have been deferred by FASB Staff Position 157-2, *Effective Date of FASB Statement No. 157* until fiscal years beginning after November 15, 2008.

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141 (revised 2007), *Business Combinations* (SFAS 141 (revised)). SFAS 141 (revised) requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date. The statement also requires the acquirer in a business combination achieved in stages to recognize the identifiable assets and liabilities, as well as the noncontrolling interest in the acquiree, at the full amounts of their fair values. The provisions of SFAS 141 (revised) are effective prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company has not determined the effect, if any, that the adoption of this statement will have on its financial condition or results of operations.

In December 2007, the FASB issued SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment to ARB No. 51*. This statement establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This statement is effective prospectively, except for certain retrospective disclosure requirements, for fiscal years beginning after December 15, 2008. The Company has not determined the effect, if any, that the adoption of this statement will have on its financial condition or results of operations.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133* (SFAS 161). This statement requires enhanced disclosures about an entity s derivative and hedging activities. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company does not expect SFAS 161 to have a material impact on its 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 usually the vesting period, which 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 27, 2008 and September 29, 2007:

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	For the Nine Months Ended	
	September 27, 2008	September 29, 2007
Risk-free interest rate	2.15-3.04%	4.50%
Expected dividend yield	0%	0%
Expected option life	4 years	4 years
Expected volatility	54.7% and 58%	60.1% and 62.8%

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 $0.6 million and $0.4 million for the three months ended September 27, 2008 and September 29, 2007, respectively and $1.7 million and $1.0 million for the nine months ended September 27, 2008 and September 29, 2007, respectively.

A summary of stock option activity and weighted average exercise prices follows for the nine months ended September 27, 2008:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value as of September 27, 2008
Outstanding at beginning of period	785,864	$ 20.34		
Granted	201,300	30.41		
Forfeited	(3,667)	24.02		
Exercised	(10,785)	17.41		
Outstanding at September 27, 2008	972,712	$ 22.44	6.39	$ 2,110
Options exercisable at September 27, 2008	645,376	$ 19.51	5.91	$ 2,103

The weighted-average grant-date fair value of the stock options granted during the nine months ended September 27, 2008 and September 29, 2007 was $14.06 and $12.80 per option, respectively. The total intrinsic value of stock options exercised during the three months ended September 27, 2008 and September 29, 2007 was $0.0 million and $2.0 million, respectively. The total intrinsic value of stock options exercised during the nine months ended September 27, 2008 and September 29, 2007 was $0.1 million and $8.0 million, respectively. The total fair value of stock options vested during the three months ended September 27, 2008 and September 29, 2007 was $0.0 million and $0.02 million, respectively. The total fair value of stock options vested during the nine months ended September 27, 2008 and September 29, 2007 was $0.8 million and $0.05 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 27, 2008:

	Shares	Weighted-Average Grant Date Fair Value
Non-vested at beginning of period	47,941	$ 24.03
Granted	33,200	27.10
Forfeited	(907)	21.79
Vested	(17,140)	24.64
Non-vested at September 27, 2008	63,094	$ 25.51

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As of September 27, 2008, there was $4.6 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.

NOTE G SUPPLEMENTAL CASH FLOW INFORMATION

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

	Nine Months Ended	
	September 27, 2008	September 29, 2007
Cash paid for interest	$ 4	$ 8
Cash paid for income taxes	6,600	2,519
Non-Cash Activity:		
Value of shares issued for acquisition of iQvolution	433	430

NOTE H ACCOUNTS RECEIVABLE

Accounts receivable consist of the following:

	As of September 27, 2008	As of December 31, 2007
Accounts receivable	$ 46,691	$ 55,506
Allowance for doubtful accounts	(1,337)	(739)
Total	$ 45,354	$ 54,767

NOTE I INVENTORIES

Inventories consist of the following:

	As of September 27, 2008	As of December 31, 2007
Raw materials	$ 14,730	$ 12,614
Finished goods	8,113	4,903
Sales demonstration inventory	16,076	13,448
Reserve for excess and obsolete	(1,682)	(1,865)
Inventory	$ 37,237	$ 29,100
Service inventory	$ 12,682	$ 10,865

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NOTE J 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 27, 2008		September 29, 2007		September 27, 2008		September 29, 2007	
	Shares	Per-Share Amount	Shares	Per-Share Amount	Shares	Per-Share Amount	Shares	Per-Share Amount
Basic EPS	16,637,497	$ 0.12	15,726,009	$ 0.04	16,624,784	$ 0.71	15,037,745	$ 0.64
Effect of dilutive securities	93,567		262,779		126,895	(0.01)	278,251	(0.01)
Diluted EPS	16,731,064	$ 0.12	15,988,788	$ 0.04	16,751,679	$ 0.70	15,315,996	$ 0.63

As of September 27, 2008, options to purchase 293,402 shares of common stock were not included in the computation of diluted EPS during the three month period then ended because the options exercise price was greater than the average market price of the common stock. As of September 27, 2008 and September 29, 2007, options to purchase 285,936 and 10,000 shares of common stock, respectively, were not included in the computation of diluted EPS during the nine month periods then ended because the exercise price was greater than the average market price of the common stock.

NOTE K ACCRUED LIABILITIES

Accrued liabilities consist of the following:

	As of September 27, 2008	As of December 31, 2007
Accrued compensation and benefits	$ 8,024	$ 10,689
Accrued warranties	1,911	1,980
Professional and legal fees	1,023	1,140
Accrued penalties		2,650
Other accrued liabilities	2,332	1,530
	$ 13,290	$ 17,989

NOTE L INCOME TAXES

Total deferred tax assets for the Company s foreign subsidiaries relating to net operating loss carryforwards were $10.0 million and $7.7 million at September 27, 2008 and December 31, 2007, respectively. The related valuation allowance was $8.5 million and $6.3 million at September 27, 2008 and December 31, 2007, respectively. As a result of a decrease in non-deductible expenses for U.S. income tax purposes of $2.65 million related to an accrual for penalties in connection with the resolution of the FCPA matter, the Company s effective tax rate was 20.1% for the nine months ended September 27, 2008 and 28.4% for the nine months ended September 29, 2007. The Company s effective income tax rate, excluding this effect, would have been 19.9% for the nine months ended September 29, 2007. The Company currently estimates the effective tax rate will approximate 18%-22% for the remainder of 2008. 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.

The effective income tax rate for 2008 and 2007 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 $1.8 million, or $0.11 per share, in the nine month period ended September 27, 2008, and $1.7 million, or $0.11 per share, in the nine month period ended September 29, 2007.

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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 a favorable tax rate subject to certain terms and conditions including employment, spending, and capital investment. The aggregate dollar effect of this favorable tax rate was approximately $1.2 million, or $0.07 per share, during the nine month period ended September 27, 2008, and $1.3 million, or $0.09 per share, in the nine months ended September 29, 2007.

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

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

	Three Months Ended		Nine Months Ended	
	Sept 27, 2008	**Sept. 29, 2007**	**Sept 27, 2008**	**Sept. 29, 2007**
Americas Region				
Net sales to external customers	$ 18,386	$ 19,053	$ 57,721	$ 58,092
Operating (loss)	(2,913)	(4,466)	(3,134)	(2,280)
Long-lived assets	17,677	12,302	17,677	12,302
Capital expenditures	1,899	424	3,034	1,234
Total assets	153,948	136,114	153,948	136,114
Europe/Africa Region				
Net sales to external customers	$ 21,530	$ 16,949	$ 67,411	$ 51,044
Operating income	3,294	3,001	10,841	6,928
Long-lived assets	18,846	17,633	18,846	17,633
Capital expenditures	424	254	1,297	673
Total assets	72,670	64,981	72,670	64,981
Asia Pacific Region				
Net sales to external customers	$ 9,179	$ 8,519	$ 27,802	$ 23,253
Operating income	2,237	2,466	6,672	6,279
Long-lived assets	1,399	1,590	1,399	1,590
Capital expenditures	158	138	246	302
Total assets	26,169	23,519	26,169	23,519
Totals				
Net sales to external customers	$ 49,095	$ 44,521	$ 152,934	$ 132,389
Operating income	2,618	1,001	14,379	10,927
Long-lived assets	37,922	31,525	37,922	31,525
Capital expenditures	2,481	816	4,577	2,209
Total assets	252,787	224,614	252,787	224,614

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NOTE N COMPREHENSIVE INCOME

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

	Three Months Ended		Nine Months Ended	
	Sep 27, 2008	Sep 29, 2007	Sep 27, 2008	Sep 29, 2007
NET INCOME	$ 2,011	$ 705	$ 11,754	$ 9,689
OTHER COMPREHENSIVE (LOSS) INCOME:				
Currency translation adjustments	(3,621)	2,430	847	2,747
COMPREHENSIVE INCOME	$ (1,610)	$ 3,135	$ 12,601	$ 12,436

NOTE O COMMITMENTS AND CONTINGENCIES

Leases The Company is a party to leases arising in the normal course of business which expire on or before 2011. Total obligations under these leases will be approximately $4.4 million for 2008.

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 27, 2008, the Company does not have any long-term commitments for purchases.

Securities Litigation On December 6, 2005, the first of four essentially identical class action securities fraud lawsuits were filed against the Company and certain officers of the Company (the Securities Litigation) in the U.S. District Court for the Middle District of Florida. On April 19, 2006, the four lawsuits were consolidated, and Kornitzer Capital Management, Inc. (the Lead Plaintiff) was appointed as the lead plaintiff. The Lead Plaintiff sought to include in the class all persons who purchased or otherwise acquired the Company s common stock between April 15, 2004 and March 15, 2006 (the Class), and sought an unspecified amount of damages, premised on allegations that each defendant made misrepresentations and omissions of material fact during the class period in violation of the Securities Exchange Act of 1934.

On February 26, 2008, the parties to the Securities Litigation entered into a Memorandum of Understanding stating the principal terms of their agreement to settle the Securities Litigation. On April 9, 2008, the parties filed a detailed Stipulation of Settlement with the court seeking the court s preliminary and final approval of the terms of the proposed settlement. Pursuant to those terms, the issuer of the Company s Executive Liability and Entity Securities Liability insurance policy applicable to the Securities Litigation will pay $6.875 million into a settlement fund for the Securities Litigation. That sum is within the coverage limit of the policy and accordingly has no effect on the Company s financial results. On October 3, 2008, the court entered a Final Judgment and Order of Dismissal With Prejudice, whereby the court certified the Class for purposes of the settlement, approved the settlement, and dismissed the Securities Litigation, with prejudice, as against each defendant.

Derivative Action On January 10, 2008, a Verified Shareholder Derivative Complaint (the Derivative Complaint) was filed by an alleged shareholder of the Company in the U.S. District Court for the Middle District of Florida against six of the Company s current and former directors, as defendants, and against the Company, as a nominal defendant (the Derivative Action). The Derivative Complaint alleges breach of fiduciary duty and other claims against the individual defendants principally in connection with the alleged acts and omissions asserted in the Securities Litigation. The plaintiff alleges that the individual defendants caused the Company s stock price to be falsely inflated, and subjected the Company to costs, fines and other damages, as well as a loss of goodwill. The plaintiff purports to seek an unspecified amount of damages, together with other relief, on behalf of the Company and against the individual defendants. Prior to filing the Derivative Complaint, the plaintiff had requested that the Company assert certain of such claims against some of the individual defendants. In April 2008, the Company received another demand by another

alleged shareholder that the Company assert substantially the same claims as set forth in the Derivative Complaint against seven of the Company s current and former directors. A similar demand received by the Company in February 2008 was subsequently withdrawn.

The Company has formed a committee of independent directors to review and investigate the shareholder demands, and the allegations made in the Derivative Complaint. The committee has not yet made a recommendation with respect to those matters. On July 7, 2008, the Company was served with the Derivative Complaint. On September 15, 2008, the parties to the Derivative Action filed a Joint Motion to Stay Proceedings with the court, reporting that the plaintiff to the Derivative Action and the Company had reached an agreement in principle to settle the Derivative Action, and that the individual defendants were reviewing the terms of the proposed settlement agreement. On September 17, 2008, the Court granted the Motion to Stay, and directed the parties to file a Stipulation of Settlement by November 18, 2008.

Settlement of Foreign Corrupt Practices Act Matter with the Securities and Exchange Commission and Department of Justice. As previously reported by the Company, the Company learned that its China subsidiary had made payments to certain customers in China that may have violated the Foreign Corrupt Practices Act (FCPA) and other applicable laws. The Company s Audit Committee instituted an internal investigation into this matter in February 2006, and the Company voluntarily notified the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) of this matter in March 2006. The Company s internal investigation into the matter, which has been completed, identified certain improper payments made in China and deficiencies in its controls with respect to its operations in China in possible violation of the FCPA.

Results of the investigation revealed that referral fee payments in possible violation of the FCPA were $165,000 and $265,000 in 2004 and 2005, respectively, which were recorded in selling expenses in its statements of income. The related sales to customers to which payment of these referral fees had been made totaled approximately $1.3 million and $3.24 million in 2004 and 2005, respectively. Additional improper referral fee payments of $122,000 were made in January and February 2006 related to sales contracts in 2005. The Company had sales in China of $9.0 million in 2005 and $4.2 million in 2004, approximately 7% and 4% of total sales, respectively. The Company incurred expenses of $3.8 million in 2006, $3.1 million in 2007, and $0.3 million in the nine months ended September 27, 2008, relating to the FCPA matter, including $2.95 million for fines, penalties and interest to the DOJ and SEC.

The Company has entered into settlement agreements and documents with the SEC and DOJ concerning the FCPA matter, pursuant to which the Company paid an aggregate of $2.95 million in fines, disgorgement of associated profit, and interest. The Company also has a two-year monitoring obligation and other continuing obligations with the SEC and the DOJ with respect to compliance with the FCPA and other laws, full cooperation with the government, and the adoption of a compliance code containing specific provisions intended to prevent violations of the FCPA. Failure to comply with any such continuing obligations could result in the SEC and the DOJ seeking to impose penalties against the Company in the future.

Patent Matters On July 11, 2008, a complaint for patent infringement was filed against the Company in the U.S. District Court for the District of Massachusetts by Metris USA, Inc. and certain of its affiliates concerning U.S. Patent Nos. 6,611,617 and 7,313,264. The complaint has not been served on the Company. The patents generally are directed to laser scanning devices, and the lawsuit concerns only the Company s LaserScan Arm products and no other Company products. The Company believes that it does not infringe the asserted patents and/or that the patents are invalid. The Company currently does not believe this lawsuit will have a material impact on the Company or its business.

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

NOTE P LINE OF CREDIT

On July 11, 2006, the Company entered into a loan agreement providing for an available line of credit of $30.0 million. Loans under the loan agreement bear interest at the rate of LIBOR plus 1.75% and require the Company to maintain certain ratios with respect to a debt covenant agreement, including current ratio, consolidated EBITDA, and senior funded debt to EBITDA. As of September 27, 2008, the Company is in compliance with all of the covenants under the Amended Loan Agreement. The term of the Amended Loan Agreement extends to April 30, 2009. The Company has not drawn on this line of credit.

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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 the Management s Discussion and Analysis of Financial Condition and Results of Operations included in the Company s 2007 Annual Report, Form 10-K, for the year ended December 31, 2007.

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

Forward-looking statements are not guarantees of future performance and are subject to a number of known and unknown risks, uncertainties, and other factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements. Consequently, undue reliance should not be placed on these forward-looking statements. 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 a material difference in the actual results from those contemplated in such forward-looking statements include, among others, and those elsewhere in this report and the following:

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

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

- the 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 the financial condition of its customers;

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

- 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

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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 Foreign Corrupt Practices Act (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;

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

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

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

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

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

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

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

Overview

The Company designs, develops, manufactures, markets and supports portable, software driven, 3-D measurement systems that are used in a broad range of manufacturing, industrial, building construction and forensic applications. The Company s FaroArm, FARO Scan Arm and FARO Gage articulated measuring devices, the FARO Laser Scanner LS, the FARO Laser Tracker, and their companion CAM2 software, provide for Computer-Aided Design (CAD)-based inspection and/or factory-level statistical process control, and high-density surveying. Together, these products integrate the measurement, quality inspection, and reverse engineering functions with CAD software to improve productivity, enhance product quality and decrease rework and scrap in the manufacturing process. The Company uses the acronym CAM2 for this process, which stands for computer-aided measurement. As of September 2008, the Company s products have been purchased by approximately 8,600 customers worldwide, ranging from small machine shops to such large manufacturing and industrial companies as Audi, Bell Helicopter, Boeing, British Aerospace, Caterpillar, Daimler Chrysler, General Electric, General Motors, Honda, Johnson Controls, Komatsu Dresser, Lockheed Martin, Nissan, Siemens and Volkswagen, among many others.

The Company operates in international markets throughout the world. It maintains sales offices in France, Germany, Great Britain, Japan, Spain, Italy, China, India, Poland, Netherlands, Malaysia and Vietnam. The Company added a new regional headquarters in Singapore in the third quarter of 2005 along with a new manufacturing and service facility there in the fourth quarter of 2005. In 2006 the Company closed its South Korean office and established a third party distributor relationship for serving that market, and in December 2006, the Company established a sales office in Thailand.

The Company derives revenues primarily from the sale of its FaroArm, FARO Scan Arm, FARO Gage, FARO Laser Tracker and FARO Laser Scanner LS 3-D measurement equipment, and their related multi-faceted software. Revenue related to these products is generally recognized upon shipment. In addition,

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 the sale of the technology by the licensees.

The Company manufactures its FaroArm, FARO Gage, and FARO Laser Tracker products 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 FaroArm, FARO Gage, and FARO Laser Tracker products in the Company s manufacturing facilities located in Florida and Pennsylvania for customer orders from the Americas. The Company manufactures its FARO Laser Scanner LS product in its facility located in Stuttgart, Germany. The Company expects all its existing plants to have the production capacity necessary to support its growth through 2008.

The Company manages and reports its global sales in three regions: the Americas, Europe/Africa and Asia/Pacific. In the nine months ended September 27, 2008, 37.7% of the Company s sales were in the Americas compared to 43.9% in the first nine months of 2007, 44.1% were in the Europe/Africa region compared to 38.5% in the first nine months of 2007 and 18.2% were in the Asia/Pacific region, compared to 17.6% in the same prior year period (see also Note M- Segment Reporting, to the financial statements above). In the third quarter of 2008, new order bookings increased $5.4 million, or 12.3%, to $49.2 million from $43.8 million in the prior year period. New orders decreased $2.6 million, or 12.9%, in the Americas to $17.6 million, from $20.2 million in the prior year period. New orders increased $5.7 million, or 35.4% to $21.8 million in Europe/Africa from $16.1 in the third quarter of 2007. In Asia/Pacific new orders increased $2.3 million, or 30.7% to $9.8 million, from $7.5 million in the third quarter of 2007.

The Company s effective tax rate decreased to 20.1% in the nine months ended September 27, 2008, from 28.4% for the nine months ended September 29, 2007 as a result of a decrease in non-deductible expenses for U.S. income tax purposes of $2.65 million related to an accrual in 2007 for penalties in connection with the resolution of the FCPA matter. The Company s effective income tax rate, excluding this effect, would have been 19.9% for the nine months ended September 29, 2007. The Company currently estimates that its effective tax rate will approximate 18% to 22% for the remainder of 2008. The Company s tax rate continues to be lower than the statutory tax rate in the United States primarily as a result of favorable tax rates in foreign jurisdictions. However, the Company s tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of its products. The Company has received a favorable income tax rate commitment from the Swiss government as an incentive to establish a manufacturing plant in Switzerland. In 2006, the Company received approval from the Singapore Economic Development Board for a favorable multi-year income tax holiday for its Singapore headquarters and manufacturing operations subject to certain terms and conditions including employment, spending and capital investment.

Accounting for wholly-owned foreign subsidiaries is maintained in the currency of the respective foreign jurisdiction. Inter-company transactions are eliminated in consolidation. Fluctuations in exchange rates may have an impact in the Company s consolidated financial statements upon the expected settlement of these inter-company accounts. 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 2007 or the nine months ended September 27, 2008.

The Company has had twenty-five consecutive profitable quarters through September 27, 2008. Its sales and earnings growth have been the result of a number of factors, including: continuing market demand for and acceptance of the Company s products; increased sales activity in part through additional sales staff worldwide, new products and product enhancements such as the FARO Gage and Laser Scanner; and the effect of acquisitions.

FCPA Update

As previously reported by the Company, the Company learned that its China subsidiary had made payments to certain customers in China that may have violated the FCPA and other applicable laws. The Company s Audit Committee instituted an internal investigation into this matter in February 2006, and the

Company voluntarily notified the SEC and the DOJ of this matter in March 2006. The Company s internal investigation into this matter, which has been completed, identified certain improper payments made in China and deficiencies in its controls with respect to its operations in China in possible violation of the FCPA.

Results of the investigation revealed that referral fee payments in possible violation of the FCPA were $165,000 and $265,000 in 2004 and 2005, respectively, which were recorded in selling expenses in its statements of income. The related sales to customers to which payment of these referral fees had been made totaled approximately $1.3 million and $3.24 million in 2004 and 2005, respectively. Additional improper referral fee payments of $122,000 were made in January and February 2006 related to sales contracts in 2005. The Company had sales in China of $9.0 million in 2005 and $4.2 million in 2004, approximately 7% and 4% of total sales, respectively. The Company incurred expenses of $3.8 million in 2006, $3.1 million in 2007 and $0.3 million in the nine months ended September 27, 2008, including $2.95 million in fines, penalties, and interest to the DOJ and SEC, relating to the FCPA matter.

The Company has entered into settlement agreements and documents with the SEC and DOJ concerning the FCPA matter, pursuant to which the Company has paid an aggregate of $2.95 million in fines, disgorgement of associated profit, and interest. The Company also has a two-year monitoring obligation and other continuing obligations with the SEC and the DOJ with respect to compliance with the FCPA and other laws, full cooperation with the government, and the adoption of a compliance code containing specific provisions intended to prevent violations of the FCPA. Failure to comply with any such continuing obligations could result in the SEC and the DOJ seeking to impose penalties against the Company in the future.

Results of Operations

Three Months Ended September 27, 2008 Compared to the Three Months Ended September 29, 2007

Sales increased by $4.6 million or 10.3% to $49.1 million in the three months ended September 27, 2008 from $44.5 million for the three months ended September 29, 2007. This increase resulted primarily from an increase in unit sales and an increase in average selling prices. The effect of changes in foreign exchange rates on sales was an increase of $2.2 million in the three months ended September 27, 2008. Sales in the Americas region decreased $0.7 million or 3.7% to $18.4 million for the three months ended September 27, 2008 from $19.1 million in the three months ended September 29, 2007. Sales in the Europe/Africa region increased $4.6 million or 27.2%, to $21.5 million for the three months ended September 27, 2008 from $16.9 million in the three months ended September 29, 2007. Sales in the Asia/Pacific region increased $0.7 million or 8.2% to $9.2 million for the three months ended September 27, 2008 from $8.5 million in the three months ended September 29, 2007.

Gross profit increased by $2.5 million or 9.6% to $29.0 million for the three months ended September 27, 2008 from $26.5 million for the three months ended September 29, 2007. Gross margin decreased to 59.1% for the three months ended September 27, 2008 from 59.4% for the three months ended September 29, 2007 primarily due to an increase in service costs as a percentage of sales.

Selling expenses increased by $1.8 million or 12.9% to $15.4 million for the three months ended September 27, 2008 from $13.6 million for three months ended September 29, 2007. This increase was primarily due to an increase in commission and compensation expense of $1.2 million, and higher travel related costs of $0.6 million. Worldwide sales and marketing headcount increased by 57 or 18.3% to 369 from 312 between September 27, 2008 and September 29, 2007. Regionally, the Company s sales and marketing headcount increased by 21 or 18.9% in the Americas, to 132 from 111; increased by 10, or 8.3% to 131 from 121 in Europe/Africa; and increased by 26 or 32.5% in Asia/Pacific, to 106 from 80 between September 27, 2008 and September 29, 2007. The Company intends to continue to selectively increase its sales and marketing headcount as the market demands. As a percentage of sales, selling expenses increased to 31.3% of sales in the three months ended September 27, 2008 from 30.6% in the three months ended September 29, 2007. Regionally, selling expenses were 32.2% of sales in the Americas for the quarter, compared to 28.7% of sales in the year-ago quarter, 31.7% of sales for Europe/Africa compared to 34.0% of sales, and 28.8% of sales compared to 28.2% of sales for Asia/Pacific.

General and administrative expenses decreased by $1.4 million or 17.1%, to $6.6 million for the three months ended September 27, 2008 from $8.0 million for the three months ended September 29, 2007, primarily due to a reduction of $2.65 million for estimated fines and penalties related to the settlement of the FCPA matter included in the three months ended September 29, 2007, offset by an increase in compensation costs of $0.8 million, and increased costs related to the additional leased space to expand the Company s corporate offices of $0.4 million

Depreciation and amortization expenses increased by $0.2 million to $1.2 million for the three months ended September 27, 2008 from $1.0 million for the three months ended September 29, 2007.

Research and development expenses increased to $3.2 million for the three months ended September 27, 2008 from $2.9 million for the three months ended September 29, 2007 primarily as a result of an increase in compensation expense. Research and development expenses as a percentage of sales increased to 6.6% for the three months ended September 27, 2008 from 6.5% for the three months ended September 29, 2007.

Interest income remained flat at $0.6 million for the three months ended September 27, 2008 compared to the three months ended September 29, 2007.

Other (income) expense, net decreased by $1.4 million to $0.7 million of expense for the three months ended September 27, 2008, from income of $0.7 million for the three months ended September 29, 2007, primarily as a result of foreign exchange transaction losses.

Income tax expense decreased by $1.1 million to $0.5 million for the three months ended September 27, 2008 from $1.6 million for the three months ended September 29, 2007. This decrease was primarily a result of a reduction in the effective tax rate to 19.9% for the three months ended September 27, 2008, from 69.5% for the three months ended September 29, 2007. The Company s effective tax rate was 69.5% in the three months ended September 29, 2007 as a result of an increase in expenses that are non-deductible for U.S. income tax purposes of $2.65 million related to an accrual for penalties in connection with the resolution of the FCPA matter. The Company s effective income tax rate, excluding this effect, would have been 19.9% for the three months ended September 29, 2007. Total deferred taxes for the Company s foreign subsidiaries relating to net operating loss carryforwards were $10.0 million and $7.7 million at September 27, 2008 and December 31, 2007, respectively. The related valuation allowance was $8.5 million and $6.3 million at September 27, 2008 and December 31, 2007, respectively. The Company currently estimates its effective tax rate will approximate 18% to 22% for the remainder of 2008. 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 $1.3 million to $2.0 million for the three months ended September 27, 2008 from $0.7 million for the three months ended September 29, 2007 as a result of the factors described above.

Nine Months Ended September 27, 2008 Compared to the Nine Months Ended September 29, 2007

Sales increased by $20.5 million or 15.5% to $152.9 million in the nine months ended September 27, 2008 from $132.4 million for the nine months ended September 29, 2007. This increase resulted primarily from an increase in unit sales and an increase in average selling prices. The effect of changes in foreign exchange rates on sales was an increase of $9.7 million in the nine months ended September 27, 2008. Sales in the Americas region decreased $0.4 million or 0.6% to $57.7 million for the nine months ended September 27, 2008 from $58.1 million in the nine months ended September 29, 2007. Sales in the Europe/Africa region increased $16.4 million or 32.1%, to $67.4 million for the nine months ended September 27, 2008 from $51.0 million in the nine months ended September 29, 2007. Sales in the Asia/Pacific region increased $4.5 million or 19.6% to $27.8 million for the nine months ended September 27, 2008 from $23.3 million in the nine months ended September 29, 2007.

Gross profit increased by $13.5 million or 16.9% to $93.0 million for the nine months ended September 27, 2008 from $79.5 million for the nine months ended September 29, 2007. Gross margin

increased to 60.8% for the nine months ended September 27, 2008 from 60.1% for the nine months ended September 29, 2007. The increase in gross margin is primarily due to a change in the sales mix resulting from an increase in unit sales in product lines with higher margins than the prior year period.

Selling expenses increased by $6.9 million or 17.4% to $46.9 million for the nine months ended September 27, 2008 from $40.0 million for nine months ended September 29, 2007. This increase was primarily due to an increase in commission and compensation expense of $4.7 million and an increase in travel expense of $1.7 million. Worldwide sales and marketing headcount increased by 57 or 18.3% to 369 from 312 between September 27, 2008 and September 29, 2007. Regionally, the Company s sales and marketing headcount increased by 21 or 18.9% in the Americas, to 132 from 111; increased by 10 or 8.3% to 131 from 121 in Europe/Africa; and increased by 26 or 32.5% in Asia/Pacific, to 106 from 80 between September 27, 2008 and September 29, 2007. The Company intends to continue to selectively increase its sales and marketing headcount as the market demands. As a percentage of sales, selling expenses increased to 30.7% of sales in the nine months ended September 27, 2008 from 30.2% in the nine months ended September 29, 2007. Regionally, selling expenses were 30.2% of sales in the Americas for the nine months ended September 27, 2008, compared to 26.4% of sales in the year-ago period, 31.5% of sales for Europe/Africa compared to 34.7% of sales and 29.6% of sales compared to 29.6% of sales for Asia/Pacific.

General and administrative expenses increased by $0.8 million or 0.4%, to $19.3 million for the nine months ended September 27, 2008 from $18.5 million for the nine months ended September 29, 2007 primarily due to an increase in compensation expense of $2.1 million, increased costs related to the additional leased space to expand the Company s corporate offices of $1.1 million, an increase in the allowance for doubtful accounts of $0.4 million, and higher travel related costs of $0.3 million, offset by a reduction of $0.8 million in professional fees and $2.65 million for estimated fines and penalties related to the settlement of the FCPA matter included in the nine months ended September 29, 2007. General and administrative expenses as a percentage of sales decreased to 12.6% for the nine months ended September 27, 2008 from 14.0% for the nine months ended September 29, 2007.

Depreciation and amortization expenses increased by $0.3 million to $3.3 million for the nine months ended September 27, 2008 from $3.0 million for the nine months ended September 29, 2007 as a result of an increase in purchases of property and equipment.

Research and development expenses increased to $9.1 million for the nine months ended September 27, 2008 from $7.1 million for the nine months ended September 29, 2007 primarily as a result of an increase in compensation expense. Research and development expenses as a percentage of sales increased to 6.0% for the nine months ended September 27, 2008 from 5.4% for the nine months ended September 29, 2007.

Interest income increased by $0.4 million to $1.6 million for the nine months ended September 27, 2008 from $1.2 million for the nine months ended September 29, 2007, due to an increase in short term investments.

Interest expense increased by $0.5 million to $0.5 million for the nine months ended September 27, 2008 from $0.0 million for the nine months ended September 29, 2007, due to interest accrued on the estimated fines and penalties to the SEC and DOJ related to the FCPA matter.

Other (income) expense, net, decreased by $2.2 million to $0.8 million of expense for the nine months ended September 27, 2008, from income of $1.4 million for the nine months ended September 29, 2007, primarily as a result of foreign exchange transaction losses.

Income tax expense decreased by $0.8 million to $3.0 million for the nine months ended September 27, 2008 from $3.8 million for the nine months ended September 29, 2007. The Company s effective tax rate decreased to 20.1% in the nine months ended September 27, 2008, from 28.4% for the nine months ended September 29, 2007 as a result of a decrease in expenses that are non-deductible for U.S. income tax purposes of $2.65 million related to an accrual for penalties in connection with the resolution of the FCPA matter. The Company s effective income tax rate, excluding this effect, would have been 19.9% for the nine months ended September 29, 2007. Total deferred taxes for the Company s foreign subsidiaries relating to net operating loss carryforwards were $10.0 million and $7.7 million at September 27, 2008 and December 31, 2007, respectively. The related valuation allowance was $8.5 million and $6.3 million at September 27, 2008 and December 31, 2007, respectively. The Company currently estimates its effective tax rate will

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approximate 18% to 22% for the remainder of 2008. 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 $2.1 million to $11.8 million for the nine months ended September 27, 2008 from $9.7 million for the nine months ended September 29, 2007 as a result of the factors described above.

Liquidity and Capital Resources

On January 10, 2005, the Company filed a Registration Statement on Form S-3 with the Securities and Exchange Commission allowing it to raise proceeds of up to $125 million. The proceeds from any offerings with respect to this registration statement, if any, would be used for either repayment or refinancing of debt, acquisition of additional businesses or technologies or for working capital and general corporate purposes.

On August 14, 2007, the Company sold 1,650,000 shares of common stock in a registered direct offering pursuant to its Form S-3 Registration Statement to certain institutional investors at $34.00 per share. The net proceeds after deducting placement fees and other offering expenses were approximately $53.0 million.

Cash and cash equivalents decreased by $5.6 million to $20.2 million at September 27, 2008 from $25.8 million at December 31, 2007. The decrease was primarily attributable to purchases of equipment and intangible assets of $8.0 million and short term investments of $5.0 million, offset by an increase in net income and non-cash expenses of $6.9 million. The Company s short term investments increased to $82.4 million at September 27, 2008 from $77.4 million at December 31, 2007.

On July 11, 2006, the Company entered into a loan agreement providing for an available line of credit of $30.0 million. Loans under the agreement bear interest at the rate of LIBOR plus 1.75% and require the Company to maintain certain ratios with respect to a debt covenant agreement, including current ratio, consolidated EBITDA, and senior funded debt to EBITDA. As of September 27, 2008, the Company was in compliance with all of the covenants under the Amended Loan Agreement. The term of the Amended Loan Agreement extends to April 30, 2009. The Company has not drawn on this line of credit.

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.

Critical Accounting Policies

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 the 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, and the reserve for warranties. 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 create an adverse impact on the Company s operations and financial position.

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

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

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

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

The Company operates in a number of different countries around the world and considers the statutory rates within each jurisdiction to determine the overall effective tax rate. In 2003, the Company began to manufacture its products in Switzerland, where it has received a favorable income tax rate commitment from the Swiss government as an incentive to establish a manufacturing plant there. The aggregate dollar effect of this favorable tax rate was approximately $1.8 million, or $0.11 per share for the nine months ended September 27, 2008 and $1.7 million, or $0.11 per share for the nine months ended September 29, 2007.

In 2005, the Company opened a regional headquarters and began to manufacture its products in Singapore, where it received approval for a four year tax holiday from the Singapore Economic Development Board as an incentive to establish a manufacturing plant and regional headquarters. The aggregate dollar effect of this favorable tax rate was approximately $1.2 million, or $0.07 per share for the nine months ended September 27, 2008, and $1.3 million, or $0.09 per share for the nine months ended September 29, 2007.

The Company is subject to certain terms and conditions including employment, spending, and capital investment in each of these countries in order to receive these favorable tax rates or be subject to the statutory rates. Significant judgment is required in determining the Company s worldwide provision for income taxes. In the ordinary course of global business, there are many transactions for which the ultimate tax outcome is uncertain. The Company has appropriately reserved for its tax uncertainties based on the criteria established by Interpretation No. 48. *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109* .

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

Foreign Exchange Exposure

The Company conducts a significant portion of its business outside the United States. At present, 62% of its revenues are invoiced, and a significant portion of its operating expenses paid, in foreign currencies. Fluctuations in exchange rates between the U.S. dollar and such foreign currencies may have a material adverse effect on the 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 3. Quantitative and Qualitative Disclosures about Market Risk

The information required by this item is incorporated by reference herein from the section of this Report in Part I, Item 2, under the caption Foreign Exchange Exposure , above.

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934, as amended (the Exchange Act), the Company s management, with the participation of its Principal Executive Officer and Principal Financial Officer, has carried out an evaluation of the effectiveness of the Company s disclosure controls and procedures (as defined under Rule 13a-15(e) under the Exchange Act) as of the end of the period covered by this report. Based upon that evaluation, the Company s Principal Executive Officer and Principal Financial Officer have concluded that its disclosure controls and procedures were effective as of the end of the period covered by this report.

Changes in Internal Control Over Financial Reporting

There have been 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 27, 2008 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

Securities Litigation On December 6, 2005, the first of four essentially identical class action securities fraud lawsuits were filed against the Company and certain officers of the Company (the Securities Litigation) in the U.S. District Court for the Middle District of Florida. On April 19, 2006, the four lawsuits were consolidated, and Kornitzer Capital Management, Inc. (the Lead Plaintiff) was appointed as the lead plaintiff. The Lead Plaintiff sought to include in the class all persons who purchased or otherwise acquired the Company s common stock between April 15, 2004 and March 15, 2006 (the Class), and sought an unspecified amount of damages, premised on allegations that each defendant made misrepresentations and omissions of material fact during the class period in violation of the Securities Exchange Act of 1934.

On February 26, 2008, the parties to the Securities Litigation entered into a Memorandum of Understanding stating the principal terms of their agreement to settle the Securities Litigation. On April 9, 2008, the parties filed a detailed Stipulation of Settlement with the court seeking the court s preliminary and final approval of the terms of the proposed settlement. Pursuant to those terms, the issuer of the Company s Executive Liability and Entity Securities Liability insurance policy applicable to the Securities Litigation will pay $6.875 million into a settlement fund for the Securities Litigation. That sum is within the coverage limit of the policy and accordingly has no effect on the Company s financial results. On October 3, 2008, the court entered a Final Judgment and Order of Dismissal With Prejudice, whereby the court certified the Class for purposes of the settlement, approved the settlement, and dismissed the Securities Litigation, with prejudice, as against each defendant.

Derivative Action On January 10, 2008, a Verified Shareholder Derivative Complaint (the Derivative Complaint) was filed by an alleged shareholder of the Company in the U.S. District Court for the Middle District of Florida against six of the Company s current and former directors, as defendants, and against the Company, as a nominal defendant (the Derivative Action). The Derivative Complaint alleges breach of fiduciary duty and other claims against the individual defendants principally in connection with the alleged acts and omissions asserted in the Securities Litigation. The plaintiff alleges that the individual defendants caused the Company s stock price to be falsely inflated, and subjected the Company to costs, fines and other damages, as well as a loss of goodwill. The plaintiff purports to seek an unspecified amount of damages, together with other relief, on behalf of the Company and against the individual defendants. Prior to filing the Derivative Complaint, the plaintiff had requested that the Company assert certain of such claims against some of the individual defendants. In April 2008, the Company received another demand by another alleged shareholder that the Company assert substantially the same claims as set forth in the Derivative Complaint against seven of the Company s current and former directors. A similar demand received by the Company in February 2008 was subsequently withdrawn.

The Company has formed a committee of independent directors to review and investigate the shareholder demands, and the allegations made in the Derivative Complaint. The committee has not yet made a recommendation with respect to those matters. On July 7, 2008, the Company was served with the Derivative Complaint. On September 15, 2008, the parties to the Derivative Action filed a Joint Motion to Stay Proceedings with the court, reporting that the plaintiff to the Derivative Action and the Company had reached an agreement in principle to settle the Derivative Action, and that the individual defendants were reviewing the terms of the proposed settlement agreement. On September 17, 2008, the Court granted the Motion to Stay, and directed the parties to file a Stipulation of Settlement by November 18, 2008.

Settlement of Foreign Corrupt Practices Act Matter with the Securities and Exchange Commission and Department of Justice. As previously reported by the Company, the Company learned that its China subsidiary had made payments to certain customers in China that may have violated the Foreign Corrupt Practices Act (FCPA) and other applicable laws. The Company s Audit Committee instituted an internal investigation into this matter in February 2006, and the Company voluntarily notified the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) of this matter in March 2006. The Company s internal investigation into the matter, which has been completed, identified certain improper payments made in China and deficiencies in its controls with respect to its operations in China in possible violation of the FCPA.

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Results of the investigation revealed that referral fee payments in possible violation of the FCPA were $165,000 and $265,000 in 2004 and 2005, respectively, which were recorded in selling expenses in its statements of income. The related sales to customers to which payment of these referral fees had been made totaled approximately $1.3 million and $3.24 million in 2004 and 2005, respectively. Additional improper referral fee payments of $122,000 were made in January and February 2006 related to sales contracts in 2005. The Company had sales in China of $9.0 million in 2005 and $4.2 million in 2004, approximately 7% and 4% of total sales, respectively. The Company incurred expenses of $3.8 million in 2006, $3.1 million in 2007, and $0.3 million in the six months ended September 27, 2008, relating to the FCPA matter, including $2.95 million for fines, penalties and interest to the DOJ and SEC.

The Company has entered into settlement agreements and documents with the SEC and DOJ concerning the FCPA matter, pursuant to which the Company paid an aggregate of $2.95 million in fines, disgorgement of associated profit, and interest. The Company also has a two-year monitoring obligation and other continuing obligations with the SEC and the DOJ with respect to compliance with the FCPA and other laws, full cooperation with the government, and the adoption of a compliance code containing specific provisions intended to prevent violations of the FCPA. Failure to comply with any such continuing obligations could result in the SEC and the DOJ seeking to impose penalties against the Company in the future.

Patent Matters On July 11, 2008, a complaint for patent infringement was filed against the Company in the U.S. District Court for the District of Massachusetts by Metris USA, Inc. and certain of its affiliates concerning U.S. Patent Nos. 6,611,617 and 7,313,264. The complaint has not been served on the Company. The patents generally are directed to laser scanning devices, and the lawsuit concerns only the Company s LaserScan Arm products and no other Company products. The Company believes that it does not infringe the asserted patents and/or that the patents are invalid. The Company currently does not believe this lawsuit will have a material impact on the Company or its business.

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

Item 1A. Risk Factors

In addition to the other information set forth in this Form 10-Q, you should carefully consider the factors discussed under Risk Factors in the Company s Form 10-K for the year ended December 31, 2007 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, 2007 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.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

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Item 6. Exhibits

10.16	Lease Agreement dated July 8, 2008, by and between the Company and James W. Hickman Revocable Trust
10.17	Lease Agreement dated September 15, 2008, by and between the Company and NB MS NEBC LLC
31-A	Certification of the President and Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31-B	Certification of the Principal Financial and Accounting Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32-A	Certification of the President and Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32-B	Certification of the Principal Financial and Accounting Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

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

FARO Technologies, Inc.
(Registrant)

Date: November 3, 2008

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

(Duly Authorized Officer and Principal Financial

Officer)