

FARO TECHNOLOGIES INC
Form 10-Q
July 25, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2018

OR

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

For the transition period from _____ to _____

Commission File Number: 0-23081

FARO TECHNOLOGIES, INC.
(Exact Name of Registrant as Specified in Its Charter)

Florida 59-3157093
(State or other Jurisdiction of Incorporation or Organization) (I.R.S. Employer Identification No.)

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

(407) 333-9911
(Registrant's Telephone Number, including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

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

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

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

Smaller reporting
company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. "

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 16,978,758 shares of the registrant's common stock outstanding as of July 23, 2018.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)	June 30, 2018 (unaudited)	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 133,554	\$ 140,960
Short-term investments	10,998	10,997
Accounts receivable, net	71,641	72,105
Inventories, net	60,349	53,786
Prepaid expenses and other current assets	21,086	16,311
Total current assets	297,628	294,159
Property and equipment:		
Machinery and equipment	70,332	66,514
Furniture and fixtures	6,650	6,945
Leasehold improvements	20,039	19,872
Property and equipment at cost	97,021	93,331
Less: accumulated depreciation and amortization	(66,321)	(61,452)
Property and equipment, net	30,700	31,879
Goodwill	53,584	52,750
Intangible assets, net	23,842	22,540
Service and sales demonstration inventory, net	38,346	39,614
Deferred income tax assets, net	15,691	15,606
Other long-term assets	4,678	2,030
Total assets	\$ 464,469	\$ 458,578
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 11,764	\$ 11,569
Accrued liabilities	24,950	27,362
Income taxes payable	1,672	4,676
Current portion of unearned service revenues	30,179	29,674
Customer deposits	2,944	2,604
Total current liabilities	71,509	75,885
Unearned service revenues - less current portion	13,291	11,815
Deferred income tax liabilities	590	695
Income taxes payable - less current portion	14,578	15,952
Other long-term liabilities	1,798	2,165
Total liabilities	101,766	106,512
Commitments and contingencies - See Note 16		
Shareholders' equity:		
Common stock - par value \$.001, 50,000,000 shares authorized; 18,440,073 and 18,277,142 issued, respectively; 16,978,758 and 16,796,884 outstanding, respectively	18	18
Additional paid-in capital	233,755	223,055
Retained earnings	172,649	168,624
Accumulated other comprehensive loss	(11,985)	(7,822)
Common stock in treasury, at cost; 1,461,315 and 1,480,258 shares, respectively	(31,734)	(31,809)

Total shareholders' equity	362,703	352,066
Total liabilities and shareholders' equity	\$ 464,469	\$ 458,578

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

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

(in thousands, except share and per share data)	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Sales				
Product	\$75,720	\$ 62,533	\$146,301	\$124,913
Service	22,524	20,149	44,777	39,331
Total sales	98,244	82,682	191,078	164,244
Cost of Sales				
Product	27,878	24,455	54,762	51,513
Service	12,675	11,467	24,839	22,222
Total cost of sales (exclusive of depreciation and amortization, shown separately below)	40,553	35,922	79,601	73,735
Gross Profit	57,691	46,760	111,477	90,509
Operating Expenses				
Selling and marketing	30,084	26,022	58,355	48,894
General and administrative	11,320	11,877	22,393	22,576
Depreciation and amortization	4,377	3,989	8,720	7,707
Research and development	9,983	9,045	19,389	17,511
Total operating expenses	55,764	50,933	108,857	96,688
Income (loss) from operations	1,927	(4,173)	) 2,620	(6,179)
Other expense (income)				
Interest income, net	(87)	) (89)	) (160)	) (171)
Other expense, net	509	459	693	467
Income (loss) before income tax expense (benefit)	1,505	(4,543)	) 2,087	(6,475)
Income tax expense (benefit)	300	(918)	) 427	(1,389)
Net income (loss)	\$1,205	\$ (3,625)	) \$1,660	\$ (5,086)
Net income (loss) per share - Basic	\$0.07	\$ (0.22)	) \$0.10	\$ (0.30)
Net income (loss) per share - Diluted	\$0.07	\$ (0.22)	) \$0.10	\$ (0.30)
Weighted average shares - Basic	16,966,928	16,700,718	16,902,390	16,692,500
Weighted average shares - Diluted	17,264,642	16,700,718	17,210,054	16,692,500

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

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

	Three Months		Six Months Ended	
	Ended			Ended
(in thousands)	June 30,	June 30,	June 30,	June 30,
	2018	2017	2018	2017
Net income (loss)	\$1,205	\$(3,625)	\$1,660	\$(5,086)
Currency translation adjustments, net of income tax	(9,377)	7,140	(4,163)	11,299
Comprehensive (loss) income	\$(8,172)	\$3,515	\$(2,503)	\$6,213

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

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

(in thousands)	Six Months Ended	
	June 30, 2018	June 30, 2017
Cash flows from:		
Operating activities:		
Net income (loss)	\$1,660	\$(5,086)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	8,720	7,707
Stock-based compensation	3,400	3,195
Provision for bad debts	211	230
Loss on disposal of assets	165	122
Provision for excess and obsolete inventory	504	736
Deferred income tax (benefit) expense	(190)	168
Change in operating assets and liabilities:		
Decrease (increase) in:		
Accounts receivable	252	4,771
Inventories	(6,664)	(10,107)
Prepaid expenses and other current assets	(3,526)	(6,489)
(Decrease) increase in:		
Accounts payable and accrued liabilities	(2,901)	1,610
Income taxes payable	(4,378)	(590)
Customer deposits	382	(163)
Unearned service revenues	2,372	(472)
Net cash provided by (used in) operating activities	7	(4,368)
Investing activities:		
Proceeds from sale of investments	—	21,000
Purchases of property and equipment	(5,164)	(3,669)
Payments for intangible assets	(1,186)	(645)
Acquisition of businesses	(3,965)	(5,496)
Equity investments and advances to affiliates	(1,786)	—
Net cash (used in) provided by investing activities	(12,101)	11,190
Financing activities:		
Payments on capital leases	(46)	(4)
Proceeds from issuance of stock related to stock option exercises	7,133	284
Net cash provided by financing activities	7,087	280
Effect of exchange rate changes on cash and cash equivalents	(2,399)	4,323
(Decrease) increase in cash and cash equivalents	(7,406)	11,425
Cash and cash equivalents, beginning of period	140,960	106,169
Cash and cash equivalents, end of period	\$133,554	\$117,594
The accompanying notes are an integral part of these condensed consolidated financial statements.		

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FARO TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

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

NOTE 1 – DESCRIPTION OF BUSINESS

FARO Technologies, Inc. and its subsidiaries (collectively “FARO,” the “Company,” “us,” “we” or “our”) is a global technology company that designs, develops, manufactures, markets and supports software driven, three-dimensional (“3D”) measurement, imaging and realization systems. This technology permits high-precision 3D measurement, imaging and comparison of parts and complex structures within production and quality assurance processes. Our devices are used for inspection of components and assemblies, rapid prototyping, reverse engineering, documenting large volume or structures in 3D, surveying and construction, as well as for investigation and reconstruction of accident sites or crime scenes. We sell the majority of our products through a direct sales force across a broad number of customers in a range of manufacturing, industrial, architecture, surveying, building information modeling, construction, public safety forensics, cultural heritage and other applications. Our FaroArm[®], FARO ScanArm[®], FARO Gage[®], FARO Laser Tracker[™], FARO Cobalt Array Imager, FARO Laser Projector, and their companion CAM2[®], BuildIT, and RayTracer[™] software solutions, provide for Computer-Aided Design (“CAD”) based inspection, factory-level statistical process control, high-density surveying and laser-guided assembly and production. Together, these products integrate the measurement, quality inspection, and reverse engineering functions with CAD and 3D software to improve productivity, enhance product quality, and decrease rework and scrap in the manufacturing process, mainly supporting applications in our Factory Metrology vertical. Our FARO Focus and FARO Scanner Freestyle^{3DX} laser scanners, and their companion FARO SCENE, FARO PointSense, and FARO Zone public safety forensics software offerings, are utilized for a wide variety of 3D modeling, documentation and high-density surveying applications in our Construction Building Information Modeling (“Construction BIM” and formerly known as “Construction BIM-CIM”) and Public Safety Forensics verticals. Our FARO ScanArm[®], FARO Cobalt Array Imager, FARO Scanner Freestyle^{3DX} laser scanners and their companion SCENE software also enable a fully digital workflow used to capture real world geometry for the purpose of empowering design, enabling innovation, and speeding up the design cycle, supporting our Product Design vertical. Our line of galvanometer-based scan heads and laser scan controllers are used in a variety of laser applications and are integrated into larger components and systems.

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We report our segment information in accordance with the provisions of Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 280, Segment Reporting (“FASB ASC Topic 280”). We evaluate business performance based upon several metrics, using segment profit as the primary financial measure. In the first quarter of 2018, we combined our historical Factory Metrology and 3D Machine Vision verticals under a single reporting segment, 3D Factory, which replaced our Factory Metrology reporting segment, due to the linkage between the two historical verticals related to the type or class of customers served, the nature of the products and services provided, and the nature of the production processes. The 3D Machine Vision vertical was historically reported within the former Other reporting segment. There has been no change in our total consolidated financial condition or results of operations previously reported as a result of the change in our reportable segments. The amounts related to our reporting segment information for the three and six months ended June 30, 2017 have been restated throughout this Quarterly Report on Form 10-Q to reflect the change in reporting segments. Each of our reporting segments continue to employ consistent accounting policies. As a result of this assessment, we now report our activities in the following three reportable segments:

The 3D Factory reporting segment includes our Factory Metrology and 3D Machine Vision verticals and provides both standardized and customized solutions for 3D measurement and inspection in an industrial or manufacturing environment. Applications include alignment, part inspection, dimensional analysis, first article inspection, incoming and in-process inspection, machine calibration, non-contact inspection, robot calibration, tool building and set-up, and assembly guidance.

The Construction BIM reporting segment contains solely our Construction BIM vertical and provides solutions for as-built data capturing and 3D visualization in building information modeling applications, allowing our customers in the architecture, engineering and construction markets to quickly and accurately extract two-dimensional (“2D”) and 3D measurement points. Applications include as-built documentation, construction monitoring, surveying, asset and facility management, and heritage preservation.

The Emerging Verticals reporting segment (formerly known as "Other") includes our Product Design and Public Safety Forensics verticals. Our Product Design vertical provides advanced 3D solutions to assist in the engineering or design of a movable object, enabling a full digital workflow for applications that include reverse engineering and virtual simulation. Our Public Safety Forensics vertical provides solutions to public safety officials and professionals to capture environmental or situational scenes in 2D and 3D for crime, crash and fire scene investigations and environmental safety evaluations.

All operating segments that do not meet the criteria to be reportable segments are aggregated in the Emerging Verticals reporting segment and have been combined based on the aggregation criteria and quantitative thresholds in accordance with the provisions of FASB ASC Topic 280. See Note 15 – Segment Reporting for further information.

NOTE 2 – PRINCIPLES OF CONSOLIDATION

Our condensed consolidated financial statements include the accounts of FARO Technologies, Inc. and its subsidiaries, all of which are wholly-owned. All intercompany transactions and balances have been eliminated. The financial statements of our foreign subsidiaries are translated into U.S. dollars using exchange rates in effect at period-end for assets and liabilities and average exchange rates during each reporting period for results of operations. Adjustments resulting from financial statement translations are reflected as a separate component of accumulated other comprehensive loss. Foreign currency transaction gains and losses are included in net income (loss).

NOTE 3 – BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements and notes thereto have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) for interim financial information and with the instructions of Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These condensed consolidated financial statements include all normal recurring accruals and adjustments considered necessary by management for a fair presentation in conformity with U.S. GAAP. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates. The

condensed consolidated results of operations for the three or six months ended June 30, 2018 are not necessarily indicative of results that may be expected for the year ending December 31, 2018 or any future interim period.

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The information included in this Quarterly Report on Form 10-Q, including the interim condensed consolidated financial statements and the accompanying notes, should be read in conjunction with the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017. The accompanying December 31, 2017 condensed consolidated balance sheet has been derived from those audited consolidated financial statements.

As described in Note 1 – Description of Business, in the first quarter of 2018, we changed our reporting segment structure. Amounts related to our reporting segment information for the three and six months ended June 30, 2017 have been restated throughout this Quarterly Report on Form 10-Q to reflect the change in reporting segments.

NOTE 4 – IMPACT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

Impact of Recently Adopted Accounting Standards -

In January 2017, the FASB issued Accounting Standards Update (“ASU”) No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business (“ASU 2017-01”) in order to clarify the definition of a business and provide additional guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. ASC Topic 805 recognizes three elements of a business: inputs, processes, and outputs. While an integrated set of assets and activities (collectively referred to as a “set”) that is a business usually has outputs, outputs are not required to be present. Additionally, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs. ASU 2017-01 provides a screen to determine when a set is not a business. The screen requires that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. If the screen is not met, the new guidance (1) requires that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output and (2) removes the evaluation of whether a market participant could replace missing elements. The new guidance provides a framework to assist entities in evaluating whether both an input and a substantive process are present. This framework includes two sets of criteria to consider that depend on whether a set has outputs. Although outputs are not required for a set to be a business, outputs generally are a key element of a business. ASU 2017-01 provides more stringent criteria for sets without outputs and more narrowly defines the term output. ASU 2017-01 became effective for us on January 1, 2018 and was applied prospectively. Our adoption of the new guidance did not have a material impact on our consolidated financial statements.

In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory (“ASU 2016-16”), which removes the prohibition in ASC Topic 740 against the immediate recognition of the current and deferred income tax effects of intra-entity transfers of assets other than inventory. This ASU requires the tax effects of intercompany transactions, other than sales of inventory, to be recognized when the transfer occurs, instead of deferred until the transferred asset is sold to a third party or otherwise recovered through use of the asset. The new guidance must be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. ASU 2016-16 became effective for us on January 1, 2018 and was applied on a modified retrospective basis. Our adoption of the new guidance did not have a material impact on our consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (“ASU 2016-15”), which clarifies how companies present and classify certain cash receipts and cash payments in the statement of cash flows. ASU 2016-15 became effective for us on January 1, 2018 and was applied on a modified retrospective basis. Our adoption of the new guidance did not have a material impact on our consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers: (Topic 606) (“ASU 2014-09”), amending its accounting guidance related to revenue recognition. Under this ASU and subsequently issued amendments, revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Additional

disclosures are required to provide the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. The following represents the impact of our adoption by significant revenue stream:

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Measurement equipment and related software: Under the prior accounting guidance, sales of measurement, imaging and realization equipment and related software sales were generally recognized upon shipment, as we considered the earnings process complete as of the shipping date. The related software sold with our measurement, imaging and realization equipment functions together with such equipment to deliver the tangible product's essential functionality. Customers frequently purchase extended warranties when purchasing measurement equipment and related software. Under the new guidance, we allocate the contract price to performance obligations based on our best estimate of the standalone selling price, utilizing data from the sale of our applicable products and services to customers separately in similar circumstances, with the exception of software licenses. We use the residual method for allocating the contract price to performance obligations relating to software licenses. Our adoption of the new guidance did not result in material changes to our accounting for revenue related to our measurement, imaging and realization equipment and related software.

Extended warranties: Under the prior accounting guidance, extended warranty sales were recognized on a straight-line basis over the term of the warranty. Extended warranty sales include contract periods that extend between one month and three years. The unearned service revenues reported in current and noncurrent liabilities on our condensed consolidated balance sheets appropriately reflect the remaining performance obligations related to these contracts. Our adoption of the new guidance did not result in material changes to our accounting for revenue related to extended warranties.

Software: Under the prior accounting guidance, software only sales were recognized when no further significant production, modification or customization of the software was required and when the following criteria were met: persuasive evidence of a sales agreement existed, delivery had occurred, and the sales price was fixed or determinable and deemed collectible. These software arrangements generally include short-term maintenance that is considered post-contract support. Maintenance renewals, when sold, were recognized on a straight-line basis over the term of the maintenance agreement. Our adoption of the new guidance did not result in material changes to our accounting for revenue related to software only sales and maintenance renewals.

The unearned service revenue liabilities reported on our condensed consolidated balance sheets reflect the contract liabilities to satisfy the remaining performance obligations for extended warranties and software maintenance. The current portion of unearned service revenues on our condensed consolidated balance sheets is what we expect to recognize to revenue within twelve months after the applicable balance sheet date relating to extended warranty and software maintenance contract liabilities. The unearned service revenues - less current portion on our condensed consolidated balance sheets is what we expect to recognize to revenue extending beyond twelve months after the applicable balance sheet date relating to extended warranty and software maintenance contract liabilities. Customer deposits on our condensed consolidated balance sheets represent customer prepayments on contracts for performance obligations that we must satisfy in the future to recognize the related contract revenue. During the three months ended June 30, 2018, we recognized \$7.2 million of service revenue that was deferred on our consolidated balance sheet as of December 31, 2017. During the six months ended June 30, 2018, we recognized \$16.2 million of service revenue that was deferred on our consolidated balance sheet as of December 31, 2017.

Under the prior accounting guidance, we recognized sales commission expense as incurred. Under the new guidance, we must capitalize commission expense and amortize such costs ratably over the term of the contract. In accordance with the modified retrospective method of adoption, we recorded a net increase to opening retained earnings as of January 1, 2018 of \$2.4 million and recognized an associated \$2.4 million deferred cost asset due to the cumulative impact of adopting the new guidance. As of June 30, 2018, the deferred cost asset related to deferred commissions was approximately \$2.5 million. For classification purposes, \$1.8 million and \$0.7 million are comprised within the Prepaid expenses and other current assets and Other long-term assets, respectively, on our condensed consolidated balance sheet. The impact of adopting the new guidance was not material to the consolidated operating results for the six months ended June 30, 2018.

We have elected to account for shipping and handling as activities to fulfill the promise to transfer the good. As such, shipping and handling fees billed to customers in a sales transaction are recorded in Sales and shipping and handling costs incurred are recorded in Cost of Sales. Additionally, we have elected to exclude from Sales any value add, sales and other taxes that we collect concurrent with revenue-producing activities. These accounting policy elections are consistent with the manner in which we have historically recorded shipping and handling fees and taxes.

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The nature of certain of our contracts gives rise to variable consideration, which may be constrained, primarily related to an allowance for sales returns. In accordance with the adoption of the new guidance, we are required to estimate the contract asset related to sales returns and record a corresponding adjustment to Cost of Sales. Historically, our allowance for sales returns has not been material and was approximately \$0.1 million as of June 30, 2018. As such, our adoption of the new guidance did not result in material changes to our accounting for variable consideration related to sales returns, and the corresponding contract asset related to such returns. See Note 5, "Revenues," for further information.

Impact of Recently Issued Accounting Standards -

In January 2017, the FASB issued ASU No. 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment ("ASU 2017-04"), which is intended to simplify the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Under the current guidance, performance of Step 2 requires us to calculate the implied fair value of goodwill by following procedures that would be required to determine the fair value of assets acquired and liabilities assumed in a business combination. Under the new guidance, we will perform our goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge will be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value up to the amount of the goodwill allocated to the reporting unit. The new guidance also eliminates the requirements for any reporting unit with a zero or negative carrying amount to perform Step 2 of the goodwill impairment test if it fails the qualitative assessment. As a result, all reporting units will be subject to the same impairment assessment. We will still have the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. ASU 2017-04 becomes effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019, with early adoption permitted for annual or any interim goodwill impairment tests after January 1, 2017. The amendments in this ASU will be applied on a prospective basis. Disclosure of the nature and reason for the change in accounting principle is required upon transition. This disclosure is required in the first annual period and in the interim period within the first annual period when we initially adopt the amendments in this ASU. We plan to adopt this guidance for our fiscal year ending December 31, 2020. We do not expect that the adoption of this guidance will have a material impact on our consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) ("ASU 2016-02"), which is intended to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. ASU 2016-02 must be applied on a modified retrospective basis and is effective for fiscal years beginning after December 15, 2018, and interim periods within those years, with early adoption permitted. We plan to adopt ASU 2016-02 in the first quarter of 2019. Although we are in the process of evaluating the impact of adoption of this ASU on our consolidated financial statements, we currently believe the most significant changes will be related to the recognition of new right-of-use assets and lease liabilities on our balance sheet for operating leases.

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NOTE 5 – REVENUES

The following tables present our revenues by Sales type as presented in our condensed consolidated statements of operations disaggregated by the timing of transfer of goods or services (in thousands, unaudited):

	For the Three Months Ended June 30, 2018 2017	
Product sales		
Product transferred to customers at a point in time	\$75,720	\$62,533
Product transferred to customers over time	—	—
	\$75,720	\$62,533
	For the Six Months Ended June 30, 2018 2017	
Product sales		
Product transferred to customers at a point in time	\$146,301	\$124,913
Product transferred to customers over time	—	—
	\$146,301	\$124,913
	For the Three Months Ended June 30, 2018 2017	
Service sales		
Service transferred to customers at a point in time	\$9,907	\$8,530
Service transferred to customers over time	12,617	11,619
	\$22,524	\$20,149
	For the Six Months Ended June 30, 2018 2017	
Service sales		
Service transferred to customers at a point in time	\$19,359	\$17,172
Service transferred to customers over time	25,418	22,159
	\$44,777	\$39,331

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The following table presents our revenues disaggregated by geography, based on the billing addresses of our customers (in thousands, unaudited):

	For the Three Months Ended June 30, 2018 2017	
Net sales to external customers		
United States	\$40,278	\$32,143
EMEA ⁽¹⁾	29,601	24,320
APAC ⁽¹⁾	24,944	22,882
Other Americas ⁽¹⁾	3,421	3,337
	\$98,244	\$82,682

	For the Six Months Ended June 30, 2018 2017	
Net sales to external customers		
United States	\$77,580	\$63,913
EMEA ⁽¹⁾	59,281	49,280
APAC ⁽¹⁾	47,533	44,142
Other Americas ⁽¹⁾	6,684	6,909
	\$191,078	\$164,244

⁽¹⁾ Regions represent Europe, the Middle East, and Africa (EMEA); Asia-Pacific (APAC); and Canada, Mexico, and Brazil (Other Americas)

NOTE 6 – STOCK-BASED COMPENSATION

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

We have two compensation plans that provide for the granting of stock options and other share-based awards to key employees and non-employee members of the Board of Directors (the “Board”). The 2009 Equity Incentive Plan (the “2009 Plan”) and the 2014 Equity Incentive Plan (the “2014 Plan”) provide for granting options, restricted stock, restricted stock units or stock appreciation rights to employees and non-employee directors. In May 2018, our shareholders approved an amendment to the 2014 Plan, which increased the number of shares available for issuance under the 2014 Plan by 1,000,000 shares. A maximum of 2,974,543 shares are available for issuance under the 2014 Plan, as amended, plus the number of shares (not to exceed 891,960) underlying awards outstanding under the 2004 Equity Incentive Plan (the “2004 Plan”) and the 2009 Plan as of May 29, 2014 that thereafter terminate or expire unexercised or are canceled, forfeited or lapse for any reason. No awards were outstanding under the 2004 Plan as of June 30, 2018, and no further grants will be made under the 2004 Plan or the 2009 Plan.

Upon election to the Board, each non-employee director receives an initial equity grant of shares of restricted common stock with a value equal to \$100,000, calculated using the closing share price on the date of the non-employee director’s election to the Board. The initial restricted stock grant vests on the third anniversary of the grant date, subject to the non-employee director’s continued membership on the Board. Annually, the non-employee directors are granted restricted shares with a value equal to \$100,000 on the first business day following the annual meeting of shareholders, calculated using the closing price of our common stock on that day. In addition, the Lead Director is annually granted restricted shares with a value equal to \$40,000 on the first business day following the annual meeting of shareholders, calculated using the closing price of our common stock on that day. The shares of restricted stock granted annually to our non-employee directors and our Lead Director vest on the day prior to the following year’s

annual meeting date, subject to the non-employee director's continued membership on the Board. We record compensation cost associated with our restricted stock grants on a straight-line basis over the vesting term.

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

Our annual grants in March 2018 and March 2017 consisted of stock options and restricted stock units that are subject to only time-based vesting. The number of stock options and/or restricted stock units granted was based on the employee's individual objectives, performance against operational metrics assigned to the employee and overall contribution to FARO. The stock options vest in three equal annual installments beginning one year after the grant date. The restricted stock unit awards vest in full on the three-year anniversary of the grant date. The fair value of these stock-based awards is determined by using (a) the Black-Scholes option valuation model in the case of stock options or (b) the current market price of our common stock on the grant date in the case of restricted stock units. In 2015, we granted performance-based stock options and restricted stock units to certain executives. These awards vested in three annual installments beginning one year after the grant date if the applicable performance measures or strategic objectives were achieved. The related stock-based compensation expense was recognized over the requisite service period, taking into account the probability that we would satisfy the performance measures or strategic objectives. In addition to certain strategic objectives, the performance-based stock options and restricted stock units granted in 2015 were earned and vested based upon (1) our achievement of specified revenue and earnings per share targets, and (2) our total shareholder return ("TSR") relative to the TSR attained by companies within our defined peer group.

Due to the TSR presence in certain performance-based grants, the fair value of these awards was determined using the Monte Carlo Simulation valuation model. We expensed these market condition awards over the three-year vesting period regardless of the value the award recipients ultimately received. In March 2018, our Compensation Committee determined that 7,743 performance-based stock options and 266 restricted stock units were earned for the 2017 performance period and 17,160 stock options and 640 restricted stock units were unearned, as the required metrics were not achieved. As of June 30, 2018, all performance-based stock options and restricted stock units granted in 2015 were either vested or were forfeited because they were not earned.

The Black-Scholes option valuation model incorporates assumptions as to stock price volatility, the expected life of options or awards, a risk-free interest rate and dividend yield. The weighted-average grant-date fair value of the stock options that were granted during the six months ended June 30, 2018 and June 30, 2017 and valued using the Black-Scholes option valuation model was \$23.43 and \$14.51 per option, respectively. For stock options granted during the six months ended June 30, 2018 and June 30, 2017 valued using the Black-Scholes option valuation model, we used the following assumptions:

	Six Months Ended		
	June 30,	June 30,	
	2018	2017	
Risk-free interest rate	2.65	% 1.88% - 2.02%	
Expected dividend yield	—	% —	%
Expected term of option	4 years	5 years	
Expected volatility	45.0	% 45.2	%
Weighted-average expected volatility	45.0	% 45.2	%

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

A summary of stock option activity and weighted-average exercise prices during the six months ended June 30, 2018 follows:

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	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value as of June 30, 2018
Outstanding at January 1, 2018	1,156,763	\$ 45.93		
Granted	174,439	61.30		
Forfeited or expired	(60,448)	50.21		
Exercised	(162,594)	43.41		
Unearned performance-based options (17,160)		59.97		
Outstanding at June 30, 2018	1,091,000	\$ 48.19	4.4	\$ 9,585
Options exercisable at June 30, 2018	918,462	\$ 42.24	2.4	\$ 4,689

The total intrinsic value of stock options exercised during each of the three months ended June 30, 2018 and June 30, 2017 was less than \$0.1 million. For the six months ended June 30, 2018 and June 30, 2017, the total intrinsic value of the stock options exercised in the respective period was \$2.7 million and \$0.1 million.

The fair value of stock options vested during each of the three months ended June 30, 2018 and June 30, 2017 was less than \$0.1 million. The fair value of stock options vested during the six months ended June 30, 2018 and June 30, 2017 was \$3.1 million and \$2.9 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, 2018:

	Shares	Weighted-Average Grant Date Fair Value
Non-vested at January 1, 2018	257,492	\$ 34.75
Granted	98,448	60.29
Forfeited	(17,748)	37.59
Vested	(18,618)	35.03
Unearned performance-based awards (640)		51.15
Non-vested at June 30, 2018	318,934	\$ 42.41

We recorded total stock-based compensation expense of \$1.8 million for each of the three months ended June 30, 2018 and June 30, 2017, and \$3.4 million and \$3.2 million for the six months ended June 30, 2018 and June 30, 2017, respectively.

As of June 30, 2018, there was \$14.8 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 7 – SHORT TERM INVESTMENTS

Short-term investments at June 30, 2018 consisted of U.S Treasury Bills totaling \$11.0 million that matured on July 5, 2018. Short-term investments at December 31, 2017 consisted of U.S. Treasury Bills totaling \$11.0 million that matured on January 11, 2018. The interest rate on the U.S. Treasury Bills held on June 30, 2018 was 1.45% and was less than one percent for the U.S. Treasury Bills held as of December 31, 2017. The investments are classified as held-to-maturity and recorded at cost plus accrued interest, which approximates fair value. The fair value of the U.S. Treasury Bills at June 30, 2018 and December 31, 2017 were classed as Level 1, as they are traded with sufficient frequency and volume to enable us to obtain pricing information on an ongoing basis. For further discussion of fair value, refer to Note 13 – Fair Value of Financial Instruments.

NOTE 8 – ACCOUNTS RECEIVABLE

Accounts receivable consist of the following:

	As of June 30, 2018	As of December 31, 2017
Accounts receivable	\$73,708	\$ 74,062

Allowance for doubtful accounts	(2,067)	(1,957)
Total	\$71,641	\$ 72,105

NOTE 9 – INVENTORIES

Inventories are stated at the lower of cost or net realizable value using the first-in first-out (FIFO) method. We have four principal categories of inventory: 1) raw materials; 2) manufactured product to be sold; 3) sales demonstration inventory - completed product used to support our sales force and demonstrations; and 4) service inventory - completed product and parts used to support our service department. Shipping and handling costs associated with third party sales transactions are classified as a component of cost of sales in our condensed consolidated statements of operations.

Sales demonstration inventory is held by our sales representatives for up to three years, at which time it would be refurbished and transferred to finished goods as used equipment, stated at the lower of cost or net realizable value. Management expects these refurbished units to remain in finished goods inventory and to be sold within 12 months at prices that may produce reduced gross margins.

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Service inventory is used to provide a temporary replacement product to a customer covered by a premium warranty when the customer's unit requires service or repair and as training equipment. Service inventory is available for sale; however, management does not expect service inventory to be sold within 12 months and, as such, classifies this inventory as a long-term asset. Service inventory that we utilize for training or repairs and which we deem as no longer available for sale is transferred to fixed assets at the lower of cost or net realizable value and depreciated over the remaining life, typically three years.

Inventories consist of the following:

	As of June 30, 2018	As of December 31, 2017
Raw materials	\$37,348	\$ 36,328
Finished goods	23,001	17,458
Inventories, net	\$60,349	\$ 53,786
Service and sales demonstration inventory, net	\$38,346	\$ 39,614

NOTE 10 – EARNINGS (LOSS) PER SHARE

Basic earnings (loss) per share is computed by dividing net income or (loss) by the weighted average number of shares outstanding. Diluted earnings per share is computed by also considering the impact of potential common stock on both net income and the weighted average number of shares outstanding. Our potential common stock consists of employee stock options, restricted stock units and performance-based awards. Our potential common stock is included in the diluted earnings per share calculation, when adding such potential common stock would not be anti-dilutive.

Performance-based awards are included in the computation of diluted earnings per share only to the extent that the underlying performance conditions (and any applicable market condition) (i) are satisfied as of the end of the reporting period or (ii) would be considered satisfied if the end of the reporting period were the end of the related contingency period and the result would be dilutive under the treasury stock method. When we report a net loss, which we did for the three and six months ended June 30, 2017, the calculation of diluted net loss per share excludes our potential common stock, as the effect would be anti-dilutive.

For the three and six months ended June 30, 2018, there were approximately 565,398 shares issuable upon the exercise of options that were excluded from the dilutive calculations, as they were anti-dilutive. For the three and six months ended June 30, 2017, there were approximately 1,265,885 and 1,221,308 shares, respectively, issuable upon the exercise of options and the contingent vesting of performance-based awards that were excluded from the dilutive calculations, as they were anti-dilutive.

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

	Three Months Ended June 30, 2018		June 30, 2017	
	Shares	Per-Share Amount	Shares	Per-Share Amount
Basic earnings (loss) per share	16,966,928	\$ 0.07	16,700,718	\$ (0.22)
Effect of dilutive securities	297,714	—	—	—
Diluted earnings (loss) per share	17,264,642	\$ 0.07	16,700,718	\$ (0.22)

	Six Months Ended June 30, 2018		June 30, 2017	
	Shares	Per-Share Amount	Shares	Per-Share Amount
Basic earnings (loss) per share	16,902,390	\$ 0.10	16,692,500	\$ (0.30)
Effect of dilutive securities	307,664	—	—	—

Diluted earnings (loss) per share 17,210,054 \$ 0.10 16,692,500 \$ (0.30)

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NOTE 11 – ACCRUED LIABILITIES

Accrued liabilities consist of the following:

	As of June 30, 2018	As of December 31, 2017
Accrued compensation and benefits	\$14,763	\$ 16,144
Accrued warranties	2,562	2,628
Professional and legal fees	1,837	1,541
Taxes other than income	2,858	3,787
Other accrued liabilities	2,930	3,262
	\$24,950	\$ 27,362

Activity related to accrued warranties was as follows:

	Six Months Ended	
	June 30, 2018	June 30, 2017
Balance, beginning of period	\$2,628	\$2,594
Provision for warranty expense	1,980	1,824
Fulfillment of warranty obligations	(2,046)	(1,848)
Balance, end of period	\$2,562	\$2,570

NOTE 12 – INCOME TAXES

For the three months ended June 30, 2018, we recorded income tax expense of \$0.3 million compared with an income tax benefit of \$0.9 million for the three months ended June 30, 2017. Our effective tax rate was 19.9% for the three months ended June 30, 2018 compared with (20.2)% in the prior year period. The change in our income tax expense (benefit) was primarily due to pretax income during the three months ended June 30, 2018 compared to a pretax loss during the three months ended June 30, 2017.

For the six months ended June 30, 2018, we recorded income tax expense of \$0.4 million compared with an income tax benefit of \$1.4 million for the six months ended June 30, 2017. Our effective tax rate was 20.5% for the six months ended June 30, 2018 compared with (21.5)% in the prior year period. The change in our income tax expense (benefit) was primarily due to pretax income during the six months ended June 30, 2018 compared to a pretax loss during the six months ended June 30, 2017.

On December 22, 2017, the United States enacted the U.S. Tax Cuts and Jobs Act (the “Tax Cuts Act”), resulting in significant modifications to existing tax law. We are following the guidance in SEC Staff Accounting Bulletin 118 (“SAB 118”), which provides additional clarification regarding the application of ASC Topic 740 in situations where a company does not have the necessary information available, prepared, or analyzed in reasonable detail to complete the accounting for certain income tax effects of the Tax Cuts Act for the reporting period in which the Tax Cuts Act was enacted. SAB 118 provides for a measurement period beginning in the reporting period that includes the Tax Cuts Act’s December 2017 enactment date and ending when we have obtained, prepared, and analyzed the information needed in order to complete the accounting for such income tax effects, but in no circumstances will the measurement period extend beyond one year from the enactment date.

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Under the Tax Cuts Act, changes include lowering the statutory corporate tax rate from 35% to 21%, eliminating certain deductions, imposing a mandatory tax on accumulated earnings in foreign subsidiaries, introducing new tax regimes, and changing how foreign earnings are subject to United States taxation. The statutory corporate tax rate reduction is effective for tax years beginning on or after January 1, 2018. Based on our best estimate, we have calculated the impact of the Tax Cuts Act in our current tax provision in accordance with our understanding of the Tax Cuts Act and available guidance. The portion of the provisional amount that related to the transition tax on the mandatory deemed repatriation of foreign earnings was \$17.4 million based on our best estimate and guidance available as of the date of this filing, which was recorded in the fourth quarter of 2017. The provisional amount related to the transition tax on the mandatory deemed repatriation of foreign earnings has not changed as of June 30, 2018 when compared to December 31, 2017. Additional work is necessary to finalize our analysis of historical foreign earnings. Upon gathering all necessary data, interpreting any additional guidance from tax authorities, and completing the analysis, our provisional amount will be adjusted in the measurement period allowable in accordance with SAB 118. Our provisional amount relating to the transition tax may materially differ upon completing the analysis compared to the amount accrued as of June 30, 2018. We expect our analysis to be completed when our 2017 United States tax return is filed in the fourth quarter of 2018.

Additionally, the Tax Cuts Act included a new provision designed to impose a tax on global intangible low-taxed income (“GILTI”) of foreign subsidiaries but allows the possibility of using foreign tax credits to offset the tax liability, subject to some limitations. For the three and six months ended June 30, 2018, our income tax expense included an estimate of the current GILTI impact on our tax provision, which we currently estimate would result in a tax liability of approximately \$1.6 million for the year ended December 31, 2018. Based on our current forecast of taxable income for the United States and foreign tax jurisdictions, the estimated \$1.6 million GILTI tax liability would be fully offset by the utilization of foreign tax credits and have an immaterial impact on our income tax expense for the year ended December 31, 2018. Our amount relating to GILTI may materially differ if the geographical mix of taxable earnings or total taxable earnings change compared to the assumptions used in our forecast.

NOTE 13 – FAIR VALUE OF FINANCIAL INSTRUMENTS

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

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

	As of June 30, 2018		
	Level 1	Level 2	Level 3
Assets:			
Short-term investments (1)	\$10,998	\$	—\$
Total	\$10,998	\$	—\$
Liabilities:			
Contingent consideration (2)	\$—	\$	—\$1,019
Total	\$—	\$	—\$1,019
	As of December 31, 2017		
	Level 1	Level 2	Level 3
Assets:			
Short-term investments (1)	\$10,997	\$	—\$
Total	\$10,997	\$	—\$
Liabilities:			

Contingent consideration (2)	\$—	\$	—\$412
Total	\$—	\$	—\$412

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

(2) Contingent consideration liability represents arrangements to pay the former owners of certain companies we acquired. The remaining undiscounted maximum payment under the arrangements is \$1.1 million. We did not pay any amounts as part of these arrangements during the six months ended June 30, 2018. The change in the fair value of the contingent consideration from December 31, 2017 to June 30, 2018 is primarily related to our acquisition of Laser Control Systems Limited on March 9, 2018. See Note 17 – Business Combinations for further information regarding that acquisition.

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NOTE 14 – VARIABLE INTEREST ENTITY

A variable interest entity (“VIE”) is an entity that has one of three characteristics: (1) it is controlled by someone other than its shareowners or partners, (2) its shareowners or partners are not economically exposed to the entity’s earnings (for example, they are protected against losses), or (3) it lacks sufficient equity to permit the entity to finance its activities without additional subordinated financial support from other parties.

On April 27, 2018, we invested \$1.8 million in Present4D GmbH (“Present4D”), a software solutions provider for professional virtual reality presentations and training environments, in the form of an equity capital contribution. This contribution represents a minority investment in Present4D.

As of our investment date, Present4D was thinly capitalized and lacked the sufficient equity to finance its activities without additional subordinated financial support and is classified as a VIE. We do not have power over decisions that significantly affect Present4D’s economic performance and do not represent its primary beneficiary. After April 27, 2020, Present4D may request additional equity financing of up to \$1.8 million from us in exchange for additional share capital. Our investment in this unconsolidated VIE at June 30, 2018 was \$1.8 million and included in Other long-term assets in our condensed consolidated balance sheet as of June 30, 2018. We had no VIE investments as of December 31, 2017.

NOTE 15 – SEGMENT REPORTING

We have three reportable segments: 3D Factory, Construction BIM, and Emerging Verticals. These segments are based upon the vertical markets that we currently serve. Business activities that do not meet the criteria to be reportable segments are aggregated in the Emerging Verticals segment.

We develop, manufacture, market, support and sell CAD-based quality assurance products integrated with CAD-based inspection and statistical process control software and three-dimensional documentation systems in each of these reportable segments. These activities represent more than 99% of consolidated sales.

Our Chief Operating Decision Maker (CODM), our Chief Executive Officer, evaluates segment performance and allocates resources based upon profitable growth. We use segment profit to evaluate the performance of our reportable segments. Segment profit is calculated as gross profit, net of selling and marketing expenses, for the reporting segment. Our definition of segment profit may not be comparable to similarly-titled measures reported by other companies.

Our segment structure presented below represents a change from the prior year as further described in Note 1 – Description of Business. The amounts for the three and six months ended June 30, 2017 have been restated to reflect the change in reporting segments. Each of our segments employs consistent accounting policies.

The following tables present information about our reportable segments, including a reconciliation of total segment profit to Income (Loss) from Operations included in the condensed consolidated statements of operations for the three and six months ended June 30, 2018 and 2017:

	3D Factory	Construction BIM	Emerging Verticals	Total
Three Months Ended June 30, 2018				
Total sales	\$64,970	\$ 23,567	\$ 9,707	\$98,244
Segment profit	\$21,042	\$ 5,865	\$ 700	\$27,607
General and administrative				11,320
Depreciation and amortization				4,377
Research and development				9,983
Income from operations				\$1,927

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	3D Factory	Construction BIM	Emerging Verticals	Total
Three Months Ended June 30, 2017				
Total sales	\$57,363	\$ 18,859	\$ 6,460	\$82,682
Segment profit (loss)	\$16,651	\$ 4,314	\$ (227)	\$20,738
General and administrative				11,877
Depreciation and amortization				3,989
Research and development				9,045
Loss from operations				\$(4,173)
	3D Factory	Construction BIM	Emerging Verticals	Total
Six Months Ended June 30, 2018				
Total sales	\$126,328	\$ 46,249	\$ 18,501	\$191,078
Segment profit	\$39,414	\$ 12,316	\$ 1,392	\$53,122
General and administrative				22,393
Depreciation and amortization				8,720
Research and development				19,389
Income from operations				\$2,620
	3D Factory	Construction BIM	Emerging Verticals	Total
Six Months Ended June 30, 2017				
Total sales	\$114,584	\$ 37,800	\$ 11,860	\$164,244
Segment profit (loss)	\$33,319	\$ 8,392	\$ (96)	\$41,615
General and administrative				22,576
Depreciation and amortization				7,707
Research and development				17,511
Loss from operations				\$(6,179)

NOTE 16 – COMMITMENTS AND CONTINGENCIES

Leases — We lease buildings and equipment in the normal course of business under non-cancellable operating leases that expire in or before 2026. Total remaining obligations under these leases are approximately \$2.6 million for 2018.

Purchase Commitments — We enter into purchase commitments for products and services in the ordinary course of business. These purchases generally cover production requirements for 60 to 120 days as well as materials necessary to service customer units through the product lifecycle and for warranty commitments. As of June 30, 2018, we had approximately \$69.0 million in purchase commitments that are expected to be delivered within the next 12 months. To ensure adequate component availability in preparation for new product introductions, as of June 30, 2018, we also had \$7.3 million in long-term commitments for purchases to be delivered after 12 months.

Legal Proceedings — We are not involved in any legal proceedings, including routine litigation arising in the normal course of business, that we believe will have a material adverse effect on our business, financial condition or results of operations.

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NOTE 17 – BUSINESS COMBINATIONS

In April 2017, we completed the acquisition of substantially all of the assets of Instrument Associates, LLC d/b/a Nutfield Technology (“Nutfield”), a component technology business located in Hudson, New Hampshire, which specializes in the design and manufacture of advanced galvanometer-based optical scanners, scan heads and laser kits, for a total purchase price of approximately \$5.5 million. This acquisition supports our long-term strategy to expand our presence in key markets and improve our existing product lines with innovative technology. The results of the acquired business’ operations as of and after the date of acquisition have been included in our condensed consolidated financial statements for the three and six months ended June 30, 2018 and June 30, 2017.

On March 9, 2018, we acquired all of the outstanding shares of Laser Control Systems Limited, a laser component technology business located in Bedfordshire, United Kingdom, which specializes in the design and manufacture of advanced digital scan heads and laser software, for a purchase price of \$1.7 million. An additional \$0.7 million in contingent consideration may be earned by the former owners if certain milestones are met. This acquisition supports our long-term strategy to expand our presence in key markets and improve our existing product lines with innovative technology. The results of the acquired business’ operations as of and after the date of acquisition have been included in our condensed consolidated financial statements as of and for the three and six months ended June 30, 2018.

On March 16, 2018, we acquired all of the outstanding shares of Photocore AG, a vision-based 3D measurement application and software developer, for a total purchase price of \$2.4 million. This acquisition supports our long-term strategy to improve our existing software offerings with innovative technology. The results of the acquired business’ operations as of and after the date of acquisition have been included in our condensed consolidated financial statements as of and for the three and six months ended June 30, 2018.

The acquisitions of Nutfield, Laser Control Systems Limited, and Photocore AG constitute business combinations as defined by ASC Topic 805. Accordingly, the assets acquired and liabilities assumed were recorded at their fair values on the date of acquisition. The purchase price allocations marked as “Preliminary” below are based on the information that was available to make estimates of the fair value and may change as further information becomes available and additional analyses are completed. While we believe such information provides a reasonable basis for estimating the fair values, we may obtain more information and evidence during the measurement period that result in changes to the estimated fair value amounts. The measurement period ends on the earlier of one year after the acquisition date or the date we received the information about the facts and circumstances that existed at the acquisition date. Subsequent adjustments, if necessary, will be recognized during the period in which the amounts are determined. These refinements include: (1) changes in the estimated fair value of certain intangible assets acquired; and (2) changes in deferred tax assets and liabilities related to the fair value estimates. The purchase price allocation marked as “Final” below represents our final determination of the fair value of the assets acquired and liabilities assumed for such acquisition.

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

	Nutfield (Final)	Laser Control Systems Limited (Preliminary)	Photocore AG (Preliminary)
Accounts receivable	\$ 160	\$ —	\$ —
Inventory	539	—	—
Other assets	96	—	—
Deferred income tax assets	131	—	—
Intangible assets	2,329	1,400	1,435

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Goodwill ⁽¹⁾	2,357	928	1,010
Accounts payable and accrued liabilities	(12)—	—
Other liabilities ⁽²⁾	(104)(579) —
Total purchase price, net of cash acquired	\$5,496	\$ 1,749	\$ 2,445

⁽¹⁾ A portion of the goodwill is expected to be tax deductible for Nutfield and Photocore AG.

⁽²⁾ For Laser Control Systems Limited, this total consists primarily of the fair value of the projected contingent consideration.

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Following are the details of the purchase price allocated to the intangible assets acquired for the acquisitions noted above:

	Nutfield (Final)		Laser Control Systems Limited (Preliminary)		Photocore AG (Preliminary)	
	Amount	Weighted Average Life (Years)	Amount	Weighted Average Life (Years)	Amount	Weighted Average Life (Years)
Trade name	\$29	1	\$—	0	\$—	0
Brand	—	0	26	1	22	1
Non-competition agreement	144	5	29	3	9	3
Technology	1,970	10	1,319	7	1,343	7
Customer relationship	95	10	26	10	61	10
Favorable in-place lease	91	12	—	0	—	0
Fair value of intangible assets acquired	\$2,329	10	\$1,400	7	\$1,435	7

The goodwill for the Nutfield acquisition has been allocated to the 3D Factory reporting segment. The goodwill for Laser Control Systems Limited will be allocated to the 3D Factory reporting segment. The goodwill for Photocore AG will be allocated to the Construction BIM reporting segment.

Pro forma financial results for Nutfield, Laser Control Systems Limited and Photocore AG have not been presented because the effects of these transactions, individually and in the aggregate, were not material to our consolidated financial results.

NOTE 18 – SUBSEQUENT EVENTS

On July 6, 2018, we acquired all of the outstanding shares of Lanmark Controls, Inc., a galvanometer-based laser marking control board and software technology business located in Acton, Massachusetts, for a purchase price of \$6.0 million. An additional \$1.0 million in contingent consideration may be earned by the former owners if certain milestones are met. This acquisition supports our long-term strategy to improve and expand upon our new galvanometer-based product lines with innovative technology.

On July 13, 2018, we acquired all of the outstanding capital of Opto-Tech SRL, a business located in Brescia, Italy, which develops, designs, manufactures, markets and sells 3D scanners and related software for dental, industrial, design and research applications, for a total purchase price of \$16.9 million. An additional \$4.7 million in contingent consideration may be earned by the former owners if certain milestones are met. This acquisition supports our long-term strategy to improve our existing product lines in our Product Design vertical with innovative technology.

Because these acquisitions occurred subsequent to the end of the second quarter of 2018, the initial accounting for these business combinations is incomplete as of the filing date of this Quarterly Report on Form 10-Q, and certain disclosures, including the preliminary allocations of purchase price, have been omitted from these condensed consolidated financial statements. We will include the required disclosures regarding these acquisitions in our Quarterly Report on Form 10-Q as of, and for the period ending, September 30, 2018. We are currently evaluating the impact of these acquisitions on our reportable segments. The operating results of these acquired businesses will be included in our condensed consolidated financial statements as of and after their respective dates of acquisition.

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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 Condensed Consolidated Financial Statements, including the notes thereto, included elsewhere in this Form 10-Q and Management’s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2017.

FARO Technologies, Inc. (“FARO,” the “Company,” “us,” “we” or “our”) has made “forward-looking statements” in this report (within the meaning of the Private Securities Litigation Reform Act of 1995). Statements that are not historical facts or that describe our plans, beliefs, goals, intentions, objectives, projections, expectations, assumptions, strategies, or future events are forward-looking statements. In addition, words such as “may,” “might,” “would,” “will,” “will be,” “future,” “strategy,” “believe,” “plan,” “should,” “could,” “seek,” “expect,” “anticipate,” “intend,” “estimate,” “goal,” “objective,” “project” and similar words identify forward-looking statements.

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

- an economic downturn in the manufacturing industry or the domestic and international economies in the regions of the world where we operate;
- our inability to further penetrate our customer base and target markets;
- development by others of new or improved products, processes or technologies that make our products less competitive or obsolete;
- our inability to maintain what we believe to be our technological advantage by developing new products and enhancing our existing products;
- risks associated with expanding international operations, such as difficulties in staffing and managing foreign operations, increased political and economic instability, compliance with potentially evolving 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;
- changes in regulation which result in rising prices of imported steel, steel byproducts, aluminum, and aluminum byproducts used as raw materials in the production of measurement devices, and our ability to pass those costs on to our customers or require our suppliers to absorb such costs;
- changes in foreign regulation which may result in rising prices of our measurement devices sold as exports to our international customers, our customers’ willingness to absorb incremental import tariffs, and the corresponding impact on our profitability;
- our inability to successfully identify and acquire target companies and achieve expected benefits from, and effectively integrate, acquisitions that are consummated;
- the cyclical nature of the industries of our customers and material adverse changes in our customers’ access to liquidity and capital;
- change in the potential for the computer-aided measurement (“CAM2”) market and the potential adoption rate for our products, which are difficult to quantify and predict;
- our inability to protect our patents and other proprietary rights in the United States and foreign countries;
- our inability to adequately establish and maintain effective internal controls over financial reporting;

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fluctuations in our annual and quarterly operating results and the inability to achieve our financial operating targets as a result of a number of factors including, without limitation (i) litigation and regulatory action brought against us, (ii) quality issues with our products, (iii) excess or obsolete inventory, shrinkage or other inventory losses due to product obsolescence, change in demand for our products, scrap or material price changes, (iv) raw material price fluctuations and other inflationary pressures, (v) expansion of our manufacturing capability, (vi) the size and timing of customer orders, (vii) the amount of time that it takes to fulfill orders and ship our products, (viii) the length of our sales cycle to new customers and the time and expense incurred in further penetrating our existing customer base, (ix) manufacturing inefficiencies associated with new product introductions, (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 inability of our sales and marketing programs to achieve their sales targets, (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) inefficiencies in the management of our inventories and fixed assets, (xvii) compliance with government regulations including health, safety, and environmental matters, and (xviii) investment costs associated with the training and ramp-up time for new sales people;

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

our inability to successfully comply with the requirements of the Restriction of Hazardous Substances Directive and the Waste Electrical and Electronic Equipment Directive in the European Union;

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

the impact of competitive products and pricing on our current offerings;

the loss of our Chief Executive Officer or other key personnel;

difficulties in recruiting research and development engineers and application engineers;

the failure to effectively manage the effects of our growth;

the impact of reductions or projected reductions in government spending, or uncertainty regarding future levels of government expenditures, particularly in the defense sector;

variations in our effective income tax rate, which makes it difficult to predict our effective income tax rate on a quarterly and annual basis, and the impact of the U.S. Tax Cuts and Jobs Act of 2017 (the "Tax Cuts Act"), including the global intangible low-taxed income ("GILTI") of foreign subsidiaries;

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

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

the sufficiency of our plants to meet manufacturing requirements;

the continuation of our share repurchase program;

the sufficiency of our working capital and cash flow from operations to fund our long-term liquidity requirements;

the impact of geographic changes in the manufacturing or sales of our products on our effective income tax rate;

our ability to comply with the requirements for favorable tax rates in foreign jurisdictions; and

other risks and uncertainties discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2017 and Part II, Item 1A. Risk Factors in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2018.

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

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Overview

We are a global technology company that designs, develops, manufactures, markets and supports software driven, three-dimensional (“3D”) measurement, imaging and realization systems. This technology permits high-precision 3D measurement, imaging and comparison of parts and complex structures within production and quality assurance processes. Our devices are used for inspection of components and assemblies, rapid prototyping, reverse engineering, documenting large volume or structures in 3D, surveying and construction, as well as for investigation and reconstruction of accident sites or crime scenes. We sell the majority of our products through a direct sales force across a broad number of customers in a range of manufacturing, industrial, architecture, surveying, building information modeling, construction, public safety forensics, cultural heritage and other applications. Our FaroArm[®], FARO ScanArm[®], FARO Gage[®], FARO Laser Tracker[™], FARO Laser Projector, FARO Cobalt Array Imager, and their companion CAM2[®], BuildIT and RayTracer[™] software solutions, provide for Computer-Aided Design (“CAD”) based inspection, factory-level statistical process control, high-density surveying and laser-guided assembly and production. Together, these products integrate the measurement, quality inspection, and reverse engineering functions with CAD and 3D software to improve productivity, enhance product quality, and decrease rework and scrap in the manufacturing process, mainly supporting applications in our Factory Metrology vertical. Our FARO Focus and FARO Scanner Freestyle^{3DX} laser scanners, and their companion FARO SCENE, FARO PointSense, and FARO Zone public safety forensics software offerings, are utilized for a wide variety of 3D modeling, documentation and high-density surveying applications in our Construction Building Information Modeling (“Construction BIM” and formerly known as “Construction BIM-CIM”) and Public Safety Forensics verticals. Our FARO ScanArm[®], FARO Cobalt Array Imager, FARO Scanner Freestyle^{3DX} laser scanners and their companion SCENE software also enable a fully digital workflow used to capture real world geometry for the purpose of empowering design, enabling innovation, and speeding up the design cycle, supporting our Product Design vertical. Our line of galvanometer-based scan heads and laser scan controllers are used in a variety of laser applications and are integrated into larger components and systems.

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

We operate in international markets throughout the world and maintain sales offices in Australia, Brazil, Canada, China, France, Germany, India, Italy, Japan, Malaysia, Mexico, the Netherlands, Poland, Portugal, Singapore, South Korea, Spain, Switzerland, Thailand, Turkey, the United Kingdom, and the United States.

We manufacture our FaroArm[®], FARO ScanArm[®], and FARO Gage products in our manufacturing facility located in Switzerland for customer orders from Europe, the Middle East and Africa, in our manufacturing facility located in Singapore for customer orders from the Asia-Pacific region, and in our manufacturing facility located in Florida for customer orders from the Americas. We manufacture our FARO Focus in our manufacturing facilities located in Germany and Switzerland for customer orders from Europe, the Middle East and Africa and the Asia-Pacific region, and in our manufacturing facility located in Pennsylvania for customer orders from the Americas. We manufacture our FARO Freestyle^{3DX} products in our facility located in Germany. We manufacture our FARO Cobalt Array Imager, FARO Laser Projector and FARO Laser Tracker[™] products in our facility located in Pennsylvania. We expect all of our existing plants to have the production capacity necessary to support our volume requirements through the remainder of 2018.

We account for wholly owned foreign subsidiaries in the currency of the respective foreign jurisdiction; therefore, fluctuations in exchange rates may have an impact on the value of the intercompany account balances denominated in different currencies and reflected in our condensed consolidated financial statements. We are aware of the availability of off-balance sheet financial instruments to hedge exposure to foreign currency exchange rates, including cross-currency swaps, forward contracts and foreign currency options. However, we have not used such instruments in the past, and none were utilized in 2017 or the six months ended June 30, 2018.

Over the past decade, we have achieved profitability on an annual basis, with the exception of a loss in 2009 that resulted primarily from the decline of the global economy that year, and a loss in 2017 that resulted primarily from the enactment and the impact of the Tax Cuts Act further described in Note 12 – Income Taxes in Part I, Item 1 of this Quarterly Report on Form 10-Q. Historically, our sales have grown as a result of continuing market demand for and acceptance of our products, increased sales activity in part through additional sales staff worldwide, new product launches or enhancements, and acquisitions. Our historical financial performance is not indicative of our future financial performance.

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In the first quarter of 2018, we renamed our reporting segments from “Construction BIM-CIM” to “Construction BIM” and from “Other” to “Emerging Verticals” and combined our historical Factory Metrology and 3D Machine Vision verticals under a single 3D Factory reporting segment, as further discussed in Note 1 – Description of Business in Part I, Item 1 of this Quarterly Report on Form 10-Q. The amounts related to our segment information for the three and six months ended June 30, 2017 have been restated throughout this Quarterly Report on Form 10-Q to reflect the change in reporting segments.

Amounts reported in millions within this Quarterly Report on Form 10-Q are computed based on the amounts in thousands. As a result, the sum of the components reported in millions may not equal the total amount reported in millions due to rounding. Certain columns and rows within the tables that follow may not add due to the use of rounded numbers. Percentages presented are calculated based on the respective amounts in thousands.

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Results of Operations

The following table sets forth, for the periods indicated, our unaudited results of operations expressed as dollar amounts and as a percentage of total sales.

(dollars in thousands)	Three months ended June 30,				Six months ended June 30,			
	2018	% of Sales	2017	% of Sales	2018	% of Sales	2017	% of Sales
Sales								
Product	\$75,720	77.1 %	\$62,533	75.6 %	\$146,301	76.6 %	\$124,913	76.1 %
Service	22,524	22.9 %	20,149	24.4 %	44,777	23.4 %	39,331	23.9 %
Total sales	98,244	100.0 %	82,682	100.0 %	191,078	100.0 %	164,244	100.0 %
Cost of Sales								
Product	27,878	28.4 %	24,455	29.6 %	54,762	28.7 %	51,513	31.4 %
Service	12,675	12.9 %	11,467	13.9 %	24,839	13.0 %	22,222	13.5 %
Total cost of sales	40,553	41.3 %	35,922	43.4 %	79,601	41.7 %	73,735	44.9 %
Gross Profit	57,691	58.7 %	46,760	56.6 %	111,477	58.3 %	90,509	55.1 %
Operating Expenses:								
Selling and marketing	30,084	30.6 %	26,022	31.5 %	58,355	30.5 %	48,894	29.8 %
General and administrative	11,320	11.5 %	11,877	14.4 %	22,393	11.7 %	22,576	13.7 %
Depreciation and amortization	4,377	4.5 %	3,989	4.8 %	8,720	4.6 %	7,707	4.7 %
Research and development	9,983	10.2 %	9,045	10.9 %	19,389	10.1 %	17,511	10.7 %
Total operating expenses	55,764	56.8 %	50,933	61.6 %	108,857	57.0 %	96,688	58.9 %
Income (loss) from operations	1,927	2.0 %	(4,173)	(5.0)%	2,620	1.4 %	(6,179)	(3.8)%
Other expense (income)								
Interest income, net	(87)	(0.1)%	(89)	(0.1)%	(160)	(0.1)%	(171)	(0.1)%
Other expense, net	509	0.5 %	459	0.6 %	693	0.4 %	467	0.3 %
Income (loss) before income tax expense (benefit)	1,505	1.5 %	(4,543)	(5.5)%	2,087	1.1 %	(6,475)	(3.9)%
Income tax expense (benefit)	300	0.3 %	(918)	(1.1)%	427	0.2 %	(1,389)	(0.8)%
Net income (loss)	\$1,205	1.2 %	\$(3,625)	(4.4)%	\$1,660	0.9 %	\$(5,086)	(3.1)%

Consolidated Results

Three Months Ended June 30, 2018 Compared to the Three Months Ended June 30, 2017

Sales. Total sales increased by \$15.5 million, or 18.8%, to \$98.2 million for the three months ended June 30, 2018 from \$82.7 million for the three months ended June 30, 2017. Total product sales increased by \$13.2 million, or 21.1%, to \$75.7 million for the three months ended June 30, 2018 from \$62.5 million for the three months ended June 30, 2017. Our product sales increased primarily due to increased unit sales across all segments and higher average selling prices in our 3D Factory segment. Service revenue increased by \$2.4 million, or 11.8%, to \$22.5 million for the three months ended June 30, 2018 from \$20.1 million for the three months ended June 30, 2017, primarily due to an increase in warranty and customer service revenue driven by the growth of our installed, serviceable base and focused sales initiatives. Foreign exchange rates had a positive impact on sales of \$2.3 million, increasing our overall sales growth rate by approximately 2.8 percentage points, primarily due to the strengthening of the Euro and Chinese Yuan relative to the U.S. dollar.

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Gross profit. Gross profit increased by \$10.9 million, or 23.4%, to \$57.7 million for the three months ended June 30, 2018 from \$46.8 million for the three months ended June 30, 2017. Gross margin increased to 58.7% for the three months ended June 30, 2018 from 56.6% in the prior year period. Gross margin from product revenue increased by 2.3 percentage points to 63.2% for the three months ended June 30, 2018 from 60.9% in the prior year period. This increase was primarily due to higher average selling prices in our 3D Factory segment and improved manufacturing efficiencies. Gross margin from service revenue increased by 0.6 percentage points to 43.7% for the three months ended June 30, 2018 from 43.1% for the prior year period, primarily as a result of higher service revenue.

Selling and Marketing Expenses. Selling and marketing expenses increased by \$4.1 million, or 15.6%, to \$30.1 million for the three months ended June 30, 2018 from \$26.0 million for the three months ended June 30, 2017. This increase was driven primarily by higher compensation expense, reflecting an increase in selling headcount as part of our strategic initiatives to drive sales growth. Selling and marketing expenses as a percentage of sales were 30.6% for the three months ended June 30, 2018, compared with 31.5% of sales for the three months ended June 30, 2017. Our worldwide period-ending selling headcount increased by 46, or 7.3%, to 673 at June 30, 2018, from 627 at June 30, 2017.

General and administrative expenses. General and administrative expenses decreased by \$0.6 million, or 4.7%, to \$11.3 million for the three months ended June 30, 2018 from \$11.9 million for the three months ended June 30, 2017. This decrease was driven primarily by active control of headcount and outside professional services spending. General and administrative expenses decreased to 11.5% of sales for the three months ended June 30, 2018 from 14.4% of sales for the three months ended June 30, 2017 primarily due to leveraging the effect of increased sales and the decrease in expenses.

Depreciation and amortization expenses. Depreciation and amortization expenses increased by \$0.4 million, or 9.7%, to \$4.4 million for the three months ended June 30, 2018 from \$4.0 million for the three months ended June 30, 2017. This increase was driven primarily by higher amortization of intangible assets related to our recent acquisitions and new production tooling for the manufacture of new products.

Research and development expenses. Research and development expenses increased by \$1.0 million, or 10.4%, to \$10.0 million for the three months ended June 30, 2018 from \$9.0 million for the three months ended June 30, 2017. This increase was mainly due to increased headcount and costs to accelerate new product development. Research and development expenses as a percentage of sales were 10.2% and 10.9% for the three months ended June 30, 2018 and June 30, 2017, respectively.

Other expense (income). For each of the three months ended June 30, 2018 and June 30, 2017, we had other expense of \$0.4 million.

Income tax expense (benefit). Income tax expense was \$0.3 million for the three months ended June 30, 2018, compared with an income tax benefit of \$0.9 million for the three months ended June 30, 2017. Our effective tax rate was 19.9% for the three months ended June 30, 2018 compared with (20.2)% in the prior year period. The change in our income tax expense (benefit) was primarily due to pretax income during the three months ended June 30, 2018 compared to a pretax loss during the three months ended June 30, 2017. Our effective tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of our products and the resulting effect on taxable income in each jurisdiction, as well as by any change in statutory tax rates in a jurisdiction.

Net income (loss). Our net income was \$1.2 million for the three months ended June 30, 2018 compared to a net loss of \$3.6 million for the prior year period, reflecting the impact of the factors described above.

Six Months Ended June 30, 2018 Compared to the Six Months Ended June 30, 2017

Sales. Total sales increased by \$26.9 million, or 16.3%, to \$191.1 million for the six months ended June 30, 2018 from \$164.2 million for the six months ended June 30, 2017. Total product sales increased by \$21.4 million, or 17.1%, to \$146.3 million for the six months ended June 30, 2018 from \$124.9 million for the six months ended June 30, 2017. Our product sales increase reflected higher unit sales in the Construction BIM and Emerging Verticals segments, and higher average selling prices in the 3D Factory segment. Service revenue increased by \$5.5 million, or 13.8%, to \$44.8 million for the six months ended June 30, 2018 from \$39.3 million for the six months ended June 30, 2017, primarily due to an increase in warranty and customer service revenue driven by the growth of our installed, serviceable base and focused sales initiatives. Foreign exchange rates had a positive impact on sales of \$7.4 million,

increasing our overall sales growth rate by approximately 4.5 percentage points, due to the strengthening of the Euro, Japanese Yen, and Chinese Yuan relative to the U.S. dollar.

Gross profit. Gross profit increased \$21.0 million, or 23.2%, to \$111.5 million for the six months ended June 30, 2018 from \$90.5 million for the six months ended June 30, 2017. Gross margin increased to 58.3% for the six months ended June 30, 2018 from 55.1% in the prior year period. Gross margin from product revenue increased by 3.8% percentage points to 62.6% for the six months ended June 30, 2018 from 58.8% in the prior year period. This increase was primarily due to higher average selling prices and improved manufacturing efficiencies. Gross margin from service revenue increased by 1.0% percentage points to 44.5% for the six months ended June 30, 2018 from 43.5% for the prior year period primarily as a result of higher warranty and customer service revenue.

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Selling and Marketing Expenses. Selling and marketing expenses increased by \$9.5 million, or 19.4% to \$58.4 million for the six months ended June 30, 2018 from \$48.9 million for the six months ended June 30, 2017. This increase was driven primarily by higher compensation expense, reflecting an increase in selling headcount as part of our strategic initiatives to drive sales growth. Selling and marketing expenses as a percentage of sales were 30.5% for the six months ended June 30, 2018, compared with 29.8% of sales for the six months ended June 30, 2017. Our worldwide period-ending selling headcount increased by 46, or 7.3%, to 673 at June 30, 2018, from 627 at June 30, 2017.

General and administrative expenses. General and administrative expenses decreased by \$0.2 million, or 0.8%, to \$22.4 million for the six months ended June 30, 2018 from \$22.6 million for the six months ended June 30, 2017. This decrease was driven primarily by fewer professional service and consulting fees. General and administrative expenses decreased to 11.7% of sales for the six months ended June 30, 2018 from 13.7% of sales for the six months ended June 30, 2017.

Depreciation and amortization expenses. Depreciation and amortization expenses increased by \$1.0 million, or 13.1%, to \$8.7 million for the six months ended June 30, 2018 from \$7.7 million for the six months ended June 30, 2017. This increase was driven primarily by higher amortization of intangible assets related to our current year acquisitions and new production tooling for the manufacture of new products.

Research and development expenses. Research and development expenses increased by \$1.9 million, or 10.7%, to \$19.4 million for the six months ended June 30, 2018 from \$17.5 million for the six months ended June 30, 2017. This increase was mainly due to higher compensation expense resulting from increased engineering headcount resulting from our acquisitions in 2018 and higher research and development headcount to accelerate our new product development. Research and development expenses as a percentage of sales decreased to 10.1% for the six months ended June 30, 2018 from 10.7% for the six months ended June 30, 2017.

Other expense (income). For the six months ended June 30, 2018, other expense increased by \$0.2 million to \$0.5 million from \$0.3 million for the six months ended June 30, 2017. This change was primarily driven by the effect of foreign exchange rates on the value of intercompany account balances of our subsidiaries denominated in other currencies.

Income tax expense (benefit). Income tax expense was \$0.4 million for the six months ended June 30, 2018, compared with income tax benefit of \$1.4 million for the six months ended June 30, 2017. This change of \$1.8 million was due to pretax income during the six months ended June 30, 2018 compared to a pretax loss in the same period of 2017. Our effective tax rate was 20.5% for the six months ended June 30, 2018 compared with (21.5)% in the prior year period. Our effective tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of our products and the resulting effect on taxable income in each jurisdiction, as well as by any change in statutory tax rates in a jurisdiction.

Net income (loss). Our net income was \$1.7 million for the six months ended June 30, 2018 compared to net loss of \$5.1 million for the prior year period, reflecting the impact of the factors described above.

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Segment Results

We use segment profit to evaluate the performance of our reportable segments, which are 3D Factory, Construction BIM and Emerging Verticals. Segment profit is calculated as gross profit, net of selling and marketing expenses, for the reporting segment. The discussion of segment results for the three and six months ended June 30, 2018 and 2017 presented below is based on segment profit, as described above, and segment profit as a percent of sales, which is calculated as segment profit divided by net sales for such reporting segment, which we believe will aid investors in understanding and analyzing our operating results. Our definition of segment profit may not be comparable to similarly-titled measures reported by other companies. For additional information, including a reconciliation of total segment profit to income (loss) from operations, see Note 15 – Segment Reporting, in Part I, Item 1 of this Quarterly Report on Form 10-Q.

Three Months Ended June 30, 2018 Compared to the Three Months Ended June 30, 2017

Total sales by segment for the three months ended June 30, 2018 and June 30, 2017 were as follows (in thousands):

	Three Months Ended			
	June 30, 2018	% of Total	June 30, 2017	% of Total
3D Factory	\$64,970	66.1%	\$57,363	69.4%
Construction BIM	23,567	24.0%	18,859	22.8%
Emerging Verticals	9,707	9.9%	6,460	7.8%
Total sales	\$98,244		\$82,682	

3D Factory

(dollars in thousands)

	Three Months Ended	
	June 30, 2018	June 30, 2017
Total sales	\$64,970	\$57,363
Segment profit	\$21,042	\$16,651
Segment profit as a % of 3D Factory segment sales	32.4%	29.0%

Sales. Total sales in our 3D Factory segment increased by \$7.6 million, or 13.3%, to \$65.0 million for the three months ended June 30, 2018 from \$57.4 million in the prior year period. This increase was principally driven by an increase in units sold, higher average selling prices, and continued growth in service revenue.

Segment profit. Segment profit in our 3D Factory segment increased by \$4.3 million, or 26.4%, to \$21.0 million for the three months ended June 30, 2018 from \$16.7 million in the prior year period. This increase was primarily due to higher average selling prices and growth in service revenue, partially offset by higher selling and marketing expenses resulting from an increase in selling headcount as part of our strategic initiatives to drive sales growth.

Construction BIM

(dollars in thousands)

	Three Months Ended	
	June 30, 2018	June 30, 2017
Total sales	\$23,567	\$18,859
Segment profit	\$5,865	\$4,314
Segment profit as a % of Construction BIM segment sales	24.9%	22.9%

Sales. Total sales in our Construction BIM segment increased by \$4.7 million, or 25.0%, to \$23.6 million for the three months ended June 30, 2018 from \$18.9 million in the prior year period, primarily reflecting a strong increase in product unit sales.

Segment profit. Segment profit in our Construction BIM segment increased by \$1.6 million, or 36.0%, to \$5.9 million for the three months ended June 30, 2018 from \$4.3 million in the prior year period, primarily driven by an increase in product unit sales, partially offset by an increase in selling headcount as part of our strategic initiatives to drive sales growth.

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Emerging Verticals

(dollars in thousands)

	Three Months	
	Ended	
	June 30,	June 30,
	2018	2017
Total sales	\$9,707	\$6,460
Segment profit (loss)	\$700	\$(227)
Segment profit (loss) as a % of Emerging Verticals segment sales	7.2	% (3.5)%

Sales. Total sales in our Emerging Verticals segment increased by \$3.2 million, or 50.3%, to \$9.7 million for the three months ended June 30, 2018 from \$6.5 million in the prior year period, primarily due to higher product unit sales in our Public Safety Forensics and Product Design verticals as we continue to strategically invest in new markets.

Segment profit (loss). Segment profit in our Emerging Verticals segment was \$0.7 million for the three months ended June 30, 2018 compared to segment loss of \$0.2 million in the prior year period. This increase of \$0.9 million was primarily due to higher product sales resulting from the increase in selling headcount as part of our strategic initiatives to staff these verticals with a dedicated sales force to drive sales growth.

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Six Months Ended June 30, 2018 Compared to the Six Months Ended June 30, 2017

Total sales by segment for the six months ended June 30, 2018 and June 30, 2017 were as follows (in thousands):

	Six Months Ended			
	June 30, 2018	% of Total	June 30, 2017	% of Total
3D Factory	\$126,328	66.1%	\$114,584	69.8%
Construction BIM	46,249	24.2%	37,800	23.0%
Emerging Verticals	\$18,501	9.7%	\$11,860	7.2%
Total sales	\$191,078		\$164,244	

3D Factory

(dollars in thousands)

	Six Months Ended			
	June 30, 2018		June 30, 2017	
Total sales	\$126,328		\$114,584	
Segment profit	\$39,414		\$33,319	
Segment profit as a % of 3D Factory segment sales	31.2%		29.1%	

Sales. Total sales in our 3D Factory segment increased by \$11.7 million, or 10.2%, to \$126.3 million for the six months ended June 30, 2018 from \$114.6 million in the prior year period. The increase was driven by higher average selling prices and growth in service revenue.

Segment profit. Segment profit in our 3D Factory segment increased by \$6.1 million, or 18.3%, to \$39.4 million for the six months ended June 30, 2018 from \$33.3 million in the prior year period. This increase was primarily due to higher average selling prices and growth in service revenue, partially offset by higher selling and marketing expenses resulting from an increase in selling headcount as part of our strategic initiatives to drive sales growth.

Construction BIM

(dollars in thousands)

	Six Months Ended			
	June 30, 2018		June 30, 2017	
Total sales	\$46,249		\$37,800	
Segment profit	\$12,316		\$8,392	
Segment profit as a % of Construction BIM segment sales	26.6%		22.2%	

Sales. Total sales in our Construction BIM segment increased by \$8.4 million, or 22.4%, to \$46.2 million for the six months ended June 30, 2018 from \$37.8 million in the prior year period, primarily reflecting an increase in product unit sales and service revenue.

Segment profit. Segment profit in our Construction BIM segment increased by \$3.9 million, or 46.8%, to \$12.3 million for the six months ended June 30, 2018 from \$8.4 million in the prior year period, primarily driven by an increase in product unit sales, partially offset by an increase in selling headcount as part of our strategic initiatives to drive sales growth.

Emerging Verticals

(dollars in thousands)

	Six Months Ended			
	June 30, 2018		June 30, 2017	
Total sales	\$18,501		\$11,860	
Segment profit (loss)	\$1,392		\$(96)	
Segment profit (loss) as a % of Emerging Verticals segment sales	7.5%		(0.8)%	

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Sales. Total sales in our Emerging Verticals segment increased by \$6.6 million, or 56.0%, to \$18.5 million for the six months ended June 30, 2018 from \$11.9 million in the prior year period, primarily due to higher product unit sales in our Public Safety Forensics and Product Design verticals as we continue to strategically invest in new markets. **Segment profit (loss).** Segment profit in our Emerging Verticals segment was \$1.4 million for the six months ended June 30, 2018 compared to segment loss of \$0.1 million in the prior year period. This increase of \$1.5 million was primarily due to higher product sales resulting from the increase in selling headcount as part of our strategic initiatives to staff these verticals with a dedicated sales force to drive sales growth.

Liquidity and Capital Resources

Cash and cash equivalents decreased by \$7.4 million to \$133.6 million at June 30, 2018 from \$141.0 million at December 31, 2017. The decrease was primarily driven by cash paid for acquisitions of \$4.0 million and for our \$1.8 million equity investment in Present4D, property and equipment purchases of \$5.2 million and intangible purchases of \$1.2 million, partially offset by \$7.1 million in proceeds received from the exercise of options during the six months ended June 30, 2018.

Cash provided by operations was less than \$0.1 million during the six months ended June 30, 2018, compared to cash used in operations of \$4.4 million during the six months ended June 30, 2017. The change was mainly due to net income during the six months ended June 30, 2018 compared to a net loss during the same period in the prior year and changes in working capital accounts.

Cash used in investing activities during the six months ended June 30, 2018 was \$12.1 million compared to \$11.2 million of cash provided by investing activities during the six months ended June 30, 2017. The change was primarily due to proceeds of \$21.0 million from the sale of investments during the six months ended June 30, 2017 compared to no investment sale activity during the six months ended June 30, 2018.

Cash flows provided by financing activities was \$7.1 million during the six months ended June 30, 2018, compared to cash provided by financing activities of \$0.3 million for the six months ended June 30, 2017. The change was primarily due to \$7.1 million in cash received from the exercise of employee stock options during the six months ended June 30, 2018 compared to \$0.3 million during the six months ended June 30, 2017.

Of our cash and cash equivalents, \$88.4 million was held by foreign subsidiaries as of June 30, 2018. On December 22, 2017, the United States enacted the Tax Cuts Act, resulting in significant modifications to existing tax law, which includes a provision for repatriation through a one-time transition tax. We continue to gather and analyze information, including whether or not we will repatriate cash to the United States from our foreign subsidiaries.

On November 24, 2008, our Board of Directors approved a \$30.0 million share repurchase program. Acquisitions for the share repurchase program may be made from time to time at prevailing prices, as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The share repurchase program may be discontinued at any time. There is no expiration date or other restriction governing the period over which we can repurchase shares under the program. In October 2015, our Board of Directors authorized an increase to the existing share repurchase program from \$30.0 million to \$50.0 million. We made no stock repurchases during the six month period ended June 30, 2018 under this program. As of June 30, 2018, we had authorization to repurchase \$18.3 million remaining under the repurchase program.

We believe that our working capital and anticipated cash flow from operations will be sufficient to fund our long-term liquidity operating requirements during 2018.

We have no off balance sheet arrangements.

Contractual Obligations and Commercial Commitments

We enter into purchase commitments for products and services in the ordinary course of business. These purchases generally cover production requirements for 60 to 120 days as well as materials necessary to service customer units through the product lifecycle and for warranty commitments. As of June 30, 2018, we had \$69.0 million in purchase commitments that are expected to be delivered within the next 12 months. To ensure adequate component availability in preparation for new product introductions, as of June 30, 2018, we also had \$7.3 million in long-term commitments for purchases to be delivered after 12 months. Other than as described in the preceding sentences, there have been no material changes to the contractual obligations and commercial commitments table included in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2017.

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Critical Accounting Policies

The preparation of our condensed consolidated financial statements requires our management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses, as well as disclosure of contingent assets and liabilities. We base our estimates on historical experience, along with various other factors believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Some of these judgments can be subjective and complex and, consequently, actual results may differ from these estimates under different assumptions or conditions. A discussion of our critical accounting policies is included in Part II, Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in our Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the Securities and Exchange Commission on February 21, 2018. As of June 30, 2018, our critical accounting policies have not changed from those described in our Annual Report on Form 10-K for the year ended December 31, 2017.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Foreign Exchange Exposure

We conduct a significant portion of our business outside the United States. As of and for the six months ended June 30, 2018, 59% of our revenue was invoiced, and a significant portion of our operating expenses were paid, in foreign currencies, and 56% of our assets were denominated in foreign currencies. Fluctuations in exchange rates between the U.S. dollar and such foreign currencies may have a material effect on our results of operations and financial condition and could specifically result in foreign exchange gains and losses. The impact of future exchange rate fluctuations on the results of our operations cannot be accurately predicted due to our constantly changing exposure to various currencies, and the fact that all foreign currencies do not react in the same manner in relation to the U.S. dollar. Our most significant exposures are to the Euro, British pound sterling, Swiss franc, Japanese yen, Chinese yuan renminbi, Mexican peso, Indian rupee, and Brazilian real. To the extent that the percentage of our non-U.S. dollar revenues derived from international sales increases in the future, our exposure to risks associated with fluctuations in foreign exchange rates may increase. We are aware of the availability of off-balance sheet financial instruments to hedge exposure to foreign currency exchange rates, including cross-currency swaps, forward contracts and foreign currency options. However, we have not used such instruments in the past, and none were utilized in 2017 or the six months ended June 30, 2018.

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of June 30, 2018. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of June 30, 2018 to provide reasonable assurance that information required to be disclosed in this Quarterly Report on Form 10-Q was recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms and was accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

During the quarter ended June 30, 2018, there was no change in our internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are not involved in any legal proceedings, including routine litigation arising in the normal course of business, that we believe will have a material adverse effect on our business, financial condition or results of operations.

Item 1A. Risk Factors

In addition to the other information set forth in this Quarterly Report on Form 10-Q, you should carefully consider the factors discussed under “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the SEC, our Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2018, as filed with the SEC, and in this Item 1A before deciding to invest in, or retain, shares of our common stock. These risks could materially and adversely affect our business, financial condition, and results of operations. The risks described in our Annual Report on Form 10-K for the year ended December 31, 2017 and our Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2018 are not the only risks we face. Our operations could also be affected by additional factors that are not presently known by us or by factors that we currently consider immaterial to our business. As of June 30, 2018, there have been no material changes in our risk factors from those set forth in our Annual Report on Form 10-K for the year ended December 31, 2017 and our Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2018.

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

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

On November 24, 2008, our Board of Directors approved a \$30.0 million share repurchase program. Acquisitions for the share repurchase program may be made from time to time at prevailing prices, as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The share repurchase program may be discontinued at any time. There is no expiration date or other restriction governing the period over which we can repurchase shares under the program. In October 2015, our Board of Directors authorized an increase to the existing share repurchase program from \$30.0 million to \$50.0 million. We made no stock repurchases during the six month period ended June 30, 2018 under this program. As of June 30, 2018, we had authorization to repurchase \$18.3 million remaining under the repurchase program.

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Item 6. Exhibits

INDEX TO EXHIBITS

- 3.1 Amended and Restated Articles of Incorporation, as amended (Filed as Exhibit 3.1 to our Registration Statement on Form S-1/A filed September 10, 1997, No. 333-32983, and incorporated herein by reference)
- 3.2 Amended and Restated Bylaws (Filed as Exhibit 3.1 to our Current Report on Form 8-K, filed February 3, 2010 and incorporated herein by reference, SEC File No. 000-23081)
- 4.1 Specimen Stock Certificate (Filed as Exhibit 4.1 to our Registration Statement on Form S-1/A filed September 10, 1997, No. 333-32983, and incorporated herein by reference)
- 10.1 FARO Technologies, Inc. 2014 Incentive Plan, as amended May 11, 2018 (Filed as Exhibit 10.1 to our Current Report on Form 8-K filed May 15, 2018 and incorporated herein by reference)
- 10.2 Transition and Separation Agreement between FARO Technologies, Inc. and Joseph Arezone effective June 5, 2018 (Filed as Exhibit 10.1 to our Current Report on Form 8-K filed June 8, 2018 and incorporated herein by reference).
- 31-A Certification of the President and Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31-B Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32-A Certification of the President and Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32-B Certification of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Labels Linkbase Document
- 101.PRE XBRL Taxonomy Presentation Linkbase Document

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SIGNATURE

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 25, 2018 By: /s/ Robert Seidel

Name: Robert Seidel

Title: Chief Financial Officer

(Duly Authorized Officer and Principal Financial Officer)