FARO TECHNOLOGIES INC
Form 10-Q
October 31, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended **September 30, 2006**

OR

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

For the transition period from _________ to __________

Commission File Number: 0-23081

FARO TECHNOLOGIES, INC.
(Exact name of Registrant as specified in its charter)

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

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

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

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 14,368,940 shares of the registrant's common stock as of October 22, 2006.

FARO TECHNOLOGIES, INC.

Quarterly Report on Form 10-Q
Quarter Ended September 30, 2006

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

(in thousands, except share data)	September 30, 2006	December 31, 2005
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 8,948	$ 9,278
Short-term investments	15,790	16,490
Accounts receivable, net	36,866	28,654
Inventories	26,132	28,650
Deferred income taxes, net	2,765	2,155
Prepaid expenses and other current assets	4,478	2,200
Total current assets	94,979	87,427
Property and Equipment:		
Machinery and equipment	8,684	6,940
Furniture and fixtures	3,696	3,334
Leasehold improvements	2,436	1,710
Property and equipment at cost	14,816	11,984
Less: accumulated depreciation and amortization	(8,056)	(5,920)
Property and equipment, net	6,760	6,064
Goodwill	16,831	14,574
Intangible assets, net	19,172	17,316
Less: accumulated amortization	(12,896)	(10,921)
Intangible assets, net	6,276	6,395
Service Inventory	5,709	4,333
Deferred income taxes, net	3,503	3,855
Total Assets	$ 134,058	$ 122,648
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 9,264	$ 12,301
Accrued liabilities	8,407	5,569
Income taxes payable	2,140	1,406
Current portion of unearned service revenues	3,969	3,168
Customer deposits	562	201
Current portion of long-term debt and obligations under capital leases	110	163
Total current liabilities	24,452	22,808
Unearned service revenues - less current portion	2,713	803
Deferred tax liability, net	1,200	-
Long-term debt and obligations under capital leases - less current portion	163	177
Total Liabilities	28,528	23,788
Commitments and contingencies - See Note O		
Shareholders' Equity:		
Common stock - par value $.001, 50,000,000 shares authorized; 14,516,618 and 14,481,178 issued;	14	14

14,368,940 and 14,290,917 outstanding, respectively				
Additional paid-in-capital		84,439		83,940
Retained earnings		21,795		17,256
Accumulated other comprehensive (loss)		(567)		(2,199)
Common stock in treasury, at cost - 40,000 shares		(151)		(151)
Total Shareholders' Equity		105,530		98,860
Total Liabilities and Shareholders' Equity	$	134,058	$	122,648

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

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

	Three Months Ended		Nine Months Ended	
(in thousands)	Sep 30, 2006	Oct 1, 2005	Sep 30, 2006	Oct 1, 2005
SALES	$ 38,365	$ 32,598	$ 108,463	$ 91,109
COST OF SALES (exclusive of depreciation and amortization, shown separately below)	16,121	14,913	44,822	37,691
GROSS PROFIT	22,244	17,685	63,641	53,418
OPERATING EXPENSES:				
Selling	10,597	8,631	32,458	25,654
General and administrative	5,519	3,169	18,296	11,005
Depreciation and amortization	1,023	967	3,096	2,447
Research and development	1,741	1,864	5,390	4,824
Total operating expenses	18,880	14,631	59,240	43,930
INCOME FROM OPERATIONS	3,364	3,054	4,401	9,488
OTHER INCOME (EXPENSE)				
Interest income	189	116	516	419
Other income (expense), net	153	(191)	440	(330)
Interest expense	(3)	(4)	(9)	(83)
INCOME BEFORE INCOME TAX	3,703	2,975	5,348	9,494
INCOME TAX EXPENSE	514	360	810	1,498
NET INCOME	$ 3,189	$ 2,615	$ 4,538	$ 7,996
NET INCOME PER SHARE - BASIC	$ 0.22	$ 0.18	$ 0.32	$ 0.56
NET INCOME PER SHARE - DILUTED	$ 0.22	$ 0.18	$ 0.31	$ 0.56

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

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

(in thousands)	Nine Months Ended	
	Sep 30, 2006	**Oct 1, 2005**
CASH FLOWS FROM: OPERATING ACTIVITIES:		
Net income	$ 4,538	$ 7,996
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	3,096	2,447
Amortization of stock options and restricted stock units	151	407
Income tax benefit from exercise of stock options	-	(1,041)
Deferred income tax benefit	(402)	(175)
Change in operating assets and liabilities:		
Decrease (increase) in:		
Accounts receivable, net	(7,146)	(7,409)
Inventories	1,601	(10,169)
Prepaid expenses and other current assets	(2,117)	(302)
Increase (decrease) in:		
Accounts payable and accrued liabilities	(537)	(772)
Income taxes payable	666	924
Customer deposits	345	(187)
Unearned service revenues	2,527	833
Net cash provided by (used in) operating activities	2,722	(7,448)
INVESTING ACTIVITIES:		
Acquisition of iQvolution	-	(6,385)
Purchases of property and equipment	(2,680)	(2,936)
Payments for intangible assets	(714)	(174)
Purchases of short-term investments	-	(3,300)
Proceeds from short-term investments	700	14,795
Net cash (used in) provided by investing activities	(2,694)	2,000
FINANCING ACTIVITIES:		
Payments of capital leases	(146)	(26)
Proceeds from issuance of stock, net	-	344
Net cash (used in) provided by financing activities	(146)	318
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	(212)	(268)
DECREASE IN CASH AND CASH EQUIVALENTS	(330)	(5,398)

CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD		9,278		16,357
CASH AND CASH EQUIVALENTS, END OF PERIOD	$	8,948	$	10,959

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

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FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For the Nine Months Ended September 30, 2006 and October 1, 2005
(Unaudited)
(in thousands, except share and per share data, or as otherwise noted)

NOTE A - DESCRIPTION OF BUSINESS

FARO Technologies, Inc. and subsidiaries (collectively the “Company” or “FARO”) design, develop, manufacture, market and support software-based three-dimensional measurement devices for manufacturing, industrial, building construction and forensic applications. The Company’s principal products include the Faro Arm, Faro Scan Arm, Digital Template and Faro Gage, all articulated electromechanical measuring devices, and the Faro Laser Tracker and the Faro Laser Scanner LS, both laser-based measuring devices. Markets for the Company’s products include automobile, aerospace, heavy equipment, countertop manufacturers and law enforcement agencies. The Company sells the vast majority of its products though a direct sales force located in many of the world’s largest industrialized countries.

NOTE B - PRINCIPLES OF CONSOLIDATION

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

NOTE C - BASIS OF PRESENTATION

The consolidated financial statements of the Company include all adjustments considered necessary by management for their fair presentation in conformity with accounting principles generally accepted in the United States of America. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The consolidated results of operations for the three and nine months ended September 30, 2006, are not necessarily indicative of results that may be expected for the year ending December 31, 2006 or any future period.

The information included in this Form 10-Q, including the interim consolidated financial statements and notes that accompany these financial statements, should be read in conjunction with the audited consolidated financial statements and related notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

NOTE D - RECLASSIFICATIONS

Certain amounts have been reclassified to conform to the current period presentation.

NOTE E - IMPACT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In November 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 151, *"Inventory Costs, an Amendment of ARB No. 43, Chapter 4."* SFAS No. 151 retains the general principle of ARB No. 43, Chapter 4, *"Inventory Pricing,"* that inventories are presumed to be stated at cost; however, it amends ARB No. 43 to clarify that abnormal amounts of idle facilities, freight, handling costs and spoilage should be recognized as current period expenses. Also, SFAS No. 151 requires fixed overhead costs be allocated to inventories based on normal production capacity. The guidance in SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company has adopted the provisions of SFAS No. 151 effective January 1, 2006. The impact of this statement was not material to the Company's financial position or results of operations.

In June 2006, the FASB issued Interpretation No. 48, *"Accounting for Uncertainty in Income Taxes"*("FIN 48"). This interpretation of SFAS No. 109, "*Accounting for Income Taxes*," provides guidance for recognizing and measuring tax positions taken or expected to be taken in a tax return that directly or indirectly affect amounts reported in financial statements. This interpretation also provides accounting guidance for the related income tax effects of tax positions that do not meet the recognition threshold specified in this interpretation. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is reviewing FIN 48 and has not yet determined the impact, if any, on its financial position or results of operations.

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, *"Fair Value Measurements."* SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value instruments. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 17, 2007, and interim periods within those fiscal years. The Company is reviewing SFAS 157 and has not yet determined the impact, if any, on its financial position or results of operations.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements." SAB 108 was issued to provide consistency between how registrants quantify financial statement misstatements.

Historically, there have been two widely-used methods for quantifying the effects of financial statement misstatements. These methods are referred to as the "roll-over" and "iron curtain" method. The roll-over method quantifies the amount by which the current year income statement is misstated. Exclusive reliance on an income statement approach can result in the accumulation of errors on the balance sheet that may not have been material to any individual income statement, but which may misstate one or more balance sheet accounts. The iron curtain method quantifies the error as the cumulative amount by which the current year balance sheet is misstated. Exclusive reliance on a balance sheet approach can result in disregarding the effects of errors in the current year income statement that results from the correction of an error existing in previously issued financial statements. We currently use the roll-over method for quantifying identified financial statement misstatements.

SAB 108 established an approach that requires quantification of financial statement misstatements based on the effects of the misstatement on each of the company's financial statements and the related financial statement disclosures. This approach is commonly referred to as the "dual approach" because it requires quantification of errors under both the roll-over and iron curtain methods.

SAB 108 allows registrants to initially apply the dual approach either by (1) retroactively adjusting prior financial statements as if the dual approach had always been used or by (2) recording the cumulative effect of initially applying the dual approach as adjustments to the carrying values of assets and liabilities as of January 1, 2006 with an offsetting adjustment recorded to the opening balance of retained earnings. Use of this "cumulative effect" transition method requires detailed disclosure of the nature and amount of each individual error being corrected through the cumulative

adjustment and how and when it arose.

The Company will evaluate SAB 108 and at the current time, does not believe there will be a material impact from its adoption.

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NOTE F - STOCK-BASED COMPENSATION

In December 2004, the FASB issued SFAS No. 123R, *"Share-Based Payment."* SFAS No. 123R requires employee stock options and rights to purchase shares under stock participation plans to be accounted for under the fair value method, and eliminates the ability to account for these instruments under the intrinsic value method prescribed by APB Opinion No. 25, as allowed under the original provisions of SFAS No. 123. Under the intrinsic value based method, compensation cost is measured by the excess, if any, of the quoted market price of the stock at the grant date over the amount an employee must pay to acquire the stock. Under the fair value based method, compensation cost is measured at the grant date based on the fair value of the award and is recognized over the service period, which is usually the vesting period.

SFAS 123R provides two alternative transition methods in the period of adoption: the modified prospective application method and the modified retrospective application method. The Company has adopted the provisions of SFAS No. 123R effective January 1, 2006 using the modified prospective application transition method. The modified prospective application requires the compensation cost for the portion of awards for which the requisite service has not yet been rendered that are outstanding as of the adoption date be recognized over the remaining service period. The compensation cost for that portion of awards will be based on the grant date fair value of those awards as calculated for pro forma disclosures under SFAS No. 123, as originally issued. All new awards and awards that are modified, repurchased, or cancelled after the adoption date will be accounted for under the provisions of SFAS No. 123R. The Company uses the Black-Scholes option pricing model to determine the fair value of stock option grants. The impact of this statement was not material to the Company's financial position or results of operations. Compensation costs of $21 related to the Company's stock option plan and $164related to compensation costs of the restricted stock unit grants are included in operations in the nine month period ended September 30, 2006.

Had compensation expense for stock options granted in the three and nine month periods ended October 1, 2005 been recorded based on the fair market value at the grant date, the Company's net income and earnings per share would have been as follows:

	Three Months Ended October 1, 2005		Nine Months Ended October 1, 2005	
Net income, as reported	$	2,615	$	7,996
Deduct: Stock-based employee compensation expense (income) included in reported net income, net of related tax effects	$	(72)	$	(109)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	$	(667)	$	(1,894)
Pro forma net income	$	1,876	$	5,993
Earnings per share:				
Basic - as reported	$	0.18	$	0.56
Basic - pro forma	$	0.13	$	0.42
Diluted - as reported	$	0.18	$	0.56
Diluted - pro forma	$	0.13	$	0.42

We will incur minimal expenses in 2006 as calculated under the Black-Scholes method of SFAS 123, related to our adoption of SFAS 123R for the expensing of stock options as we vested substantially all of our unvested and "out-of-the-money" options in the fourth quarter of 2005. The reduction in pre-tax charges estimated by the Company as a result of the acceleration amounts to approximately $7.7 million over the course of the original vesting periods. Options to purchase approximately 704,310 shares of the Company's stock or 52.5% of the Company's total outstanding options were accelerated. The weighted average exercise price of the options subject to acceleration was $21.30. The aggregate pretax expense for the shares subject to acceleration that would have been reflected in the Company's consolidated financial statements beginning in 2006 is approximately $7.7 million, including $4.3 million in 2006, $2.7 million in 2007, and $0.7 million in 2008. The fair value for any future grants will be included in expense over the vesting periods. These expenses will be apportioned according to the classification of the employees who have received stock options into cost of sales, selling, general and administrative or research and development costs.

NOTE G - SUPPLEMENTAL CASH FLOW INFORMATION

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

	Nine Months Ended	
	Sep 30, 2006	Oct 1, 2005
Cash paid for interest	$ 8	$ 82
Cash paid for income taxes	1,251	982
Cash received from income tax refund	-	1,161
Non-Cash Activity:		
Value of shares issued for acquisition of iQvolution	-	3,504
Value of shares issued for milestones related to the acquisition of iQvolution	349	-
Purchase price adjustment for tax effects of acquisition of iQvolution	1,506	-
Capital lease obligations	81	-

NOTE H - ACCOUNTS RECEIVABLE

Accounts receivable consist of the following:

	As of Sep 30, 2006	As of Dec. 31, 2005
Accounts receivable	$ 37,143	$ 28,868
Allowance for doubtful accounts	(277)	(214)
Total	$ 36,866	$ 28,654

NOTE I - INVENTORIES

Inventories consist of the following:

	As of Sep 30, 2006	As of Dec 31, 2005
Raw materials	$ 9,697	$ 11,820
Finished goods	4,479	4,976
Sales demonstration inventory	12,575	12,227
Reserve for excess and obsolete	(619)	(373)
Inventory	26,132	28,650
Service inventory	5,709	4,333
Total	$ 31,841	$ 32,983

NOTE J - EARNINGS PER SHARE

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

	Three Months Ended				Nine Months Ended			
	September 30, 2006		October 1, 2005		September 30, 2006		October 1, 2005	
	Shares	Per-Share Amount	Shares	Per-Share Amount	Shares	Per-Share Amount	Shares	Per-Share Amount
Basic EPS	14,326,357	$ 0.22	14,247,089	$ 0.18	14,333,775	$ 0.32	14,169,733	$ 0.56
Effect of dilutive securities	176,953	-	182,862	-	180,372	-	194,195	-
Diluted EPS	14,503,310	$ 0.22	14,429,951	$ 0.18	14,514,147	$ 0.31	14,363,928	$ 0.56

NOTE K - ACCRUED LIABILITIES

Accrued liabilities consist of the following:

	As of Sep 30, 2006	As of Dec. 31, 2005
Accrued compensation and benefits	$ 5,085	$ 2,641
Accrued warranties	1,015	861
Professional and legal fees	1,568	1,239
Other accrued liabilities	739	828
	$ 8,407	$ 5,569

Activity related to accrued warranties for the nine month periods ended was as follows:

	Sep 30, 2006	Oct 1, 2005
Beginning Balance	$ 861	$ 565
Provision for warranty expense	606	589
Warranty expired	(452)	(302)

Ending Balance	$	1,015	$	852

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NOTE L - INCOME TAXES

The tax provision for the nine months ended September 30, 2006 decreased from the tax provision for the nine months ended October 1, 2005, principally due to a decrease in earnings. Total deferred tax assets for the Company's foreign subsidiaries relating to net operating loss carryforwards were $5.8 million and $5.4 million at September 30, 2006 and December 31, 2005, respectively. The related valuation allowance was $3.7 million and $3.5 million at September 30, 2006 and December 31, 2005, respectively. The Company's effective tax rate decreased slightly to 15.1% for the nine months ended September 30, 2006 from 15.8% in the prior year period. The Company currently estimates the effective tax rate will approximate 15% for the remainder of 2006. The Company's tax rate continues to be lower than the statutory tax rate in the United States primarily as a result of favorable tax rates in foreign jurisdictions. However, our 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.

The effective income tax rate for 2005 and 2006 includes a reduction in the statutory corporate tax rates for our operations in Switzerland. The favorable tax rate is not subject to termination provided the Company maintains a certain level of manufacturing operations in Switzerland. The aggregate dollar effect of this favorable tax rate was approximately $1.1 million, or $0.08 per share, in the nine month period ended September 30, 2006, and $2.1 million, or $0.15 per share, in the nine month period ended October 1, 2005.

The Company received confirmation of a tax holiday during the third quarter of 2006 for its operations in Singapore for a period of four years commencing January 1, 2006 and an additional six year extension at a favorable tax rate subject to certain terms and conditions including employment, spending, and capital investment. The aggregate dollar effect of this favorable tax rate was approximately $0.43 million, or $.03 per share, during the nine month period ended September 30, 2006.

NOTE M - GEOGRAPHIC DATA

The Company develops, manufactures, markets and supports CAD-based quality assurance products integrated with CAD-based inspection and statistical process control software. This one line of business represents approximately 99% of consolidated sales and is the Company's only segment. The Company operates through sales teams established by geographic area. Each team is equipped to deliver the entire line of Company products to customers within its geographic area.

The following table presents information about the Company by geographic area:

	Three Months Ended		Nine Months Ended	
	Sep 30, 2006	Oct 1, 2005	Sep 30, 2006	Oct 1, 2005
SALES				
Americas Region	$ 15,694	$ 13,479	$ 45,105	$ 39,422
Europe/Africa Region	14,908	10,469	42,536	34,408
Asia Pacific Region	7,763	8,650	20,822	17,279
TOTAL	$ 38,365	$ 32,598	$ 108,463	$ 91,109

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NOTE N - OTHER COMPREHENSIVE INCOME

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

	Three Months Ended		Nine Months Ended	
(in thousands)	Sep 30, 2006	Oct 1, 2005	Sep 30, 2006	Oct 1, 2005
NET INCOME	$ 3,189	$ 2,615	$ 4,538	$ 7,996
OTHER COMPREHENSIVE INCOME (LOSS):				
Currency translation adjustments	(599)	754	1,632	(3,398)
COMPREHENSIVE INCOME	$ 2,590	$ 3,369	$ 6,170	$ 4,598

NOTE O - COMMITMENTS AND CONTINGENCIES

Leases—The Company is a party to leases arising in the normal course of business, including leases with related parties that expire on or before 2011. Total obligations under these leases will be approximately $2.5 million for 2006.

Purchase Commitments—The Company enters into purchase commitments for products and services in the ordinary course of business. These purchases generally cover production requirements for 60 to 90 days. On August 11, 2005, FARO entered into an agreement with DELCAM plc under which the Company agreed to purchase approximately $1.4 million in products over a 12-month term. At September 30, 2006, the Company had completed the purchase of $1.4 million in products under this agreement. Effective November 1, 2005, FARO entered into an agreement with Metrologic Group S.A. under which the Company agreed to purchase approximately $0.4 million in products over a 12-month term. At September 30, 2006, $.17 million had been purchased under this agreement. The Company intends to fulfill its purchase agreement with Metrologic Group S.A. Other than the agreements listed above, the Company does not have any long-term commitments for purchases.

Litigation— On November 25, 2003, Cimcore-Romer (now a division of Hexagon) filed a patent infringement suit against the Company in the Federal District Court for the Southern District of California alleging that certain of the Company's products sold in the United States, including the FARO Arm, infringe U.S. Patent 5,829,148 ('148 patent). The Company believes, and has contended in this litigation, that the Company does not infringe the '148 patent and that the '148 patent is invalid.

On July 12, 2005, the court issued an order granting Cimcore-Romer's motion for summary judgment of infringement of three claims of the '148 patent. On July 22, 2005, the Company announced its decision to limit the capability of its U.S.-based FARO Arm products (the FARO Arm, the FARO Gage and the Digital Template) by removing what the Company calls the "infinite rotation feature" by reducing this capability to 50 rotations or fewer. FARO believes that by limiting the range of the joint rotation to 50 rotations, it has removed from its U.S. products the ability to sweep through an unlimited arc, which is a feature of the '148 patent claims addressed by the court's ruling required to infringe the '148 patent. The revised products have not, however, been considered by the courts. Accordingly, the Company cannot give assurance that the revised products will not be deemed to infringe the '148 patent.

On September 20, 2005, the Court vacated its order of summary judgment of infringement and agreed to reconsider its conclusions from the patent claim construction ("Markman") ruling, which is a pretrial hearing often used in patent infringement cases. The new Markman hearing occurred on October 3, 2005 and the hearing-on-summary judgments of infringement occurred on November 14, 2005. On October 18, 2005, the Court issued a revised claim construction that the Company believes materially alters the Court's previous Markman ruling by substantially

narrowing what FARO believes to be key aspects of the claim construction. The Company believes that this narrower claim construction will ultimately lead to a finding that it does not infringe any claim of the '148 patent. On November 14, 2005, the Court denied both the Plaintiffs' Renewed Motion for Summary Judgment of Infringement and the Defendant's Faro's Renewed Motion for Summary Judgment of Non-Infringement, and determined that there existed a genuine issue of material fact with respect to whether Faro infringed the asserted patent. The case was originally set for trial for January 31, 2006. On January 18, 2006, the Court vacated the trial date and remanded the case to the magistrate for resumption of discovery regarding Plaintiffs' alleged compliance with the patent marking provisions of 35 U.S.C. § 287 and all related issues. A hearing on Faro's Motion for Partial Summary Judgment Regarding Plaintiffs' Failure to Comply With the Patent Marking Provisions of 35 U.S.C. § 287 was held on May 11, 2006. A new trial date has been set for October 30, 2006.

In addition, the Company filed two separate requests for reexamination in the U.S. Patent and Trademark Office ("PTO") of the ‘148 Patent, both of which requests were granted. The PTO ruled in the first reexamination in September 2005. The Company believes that the PTO ruling bolsters the Company’s previous position that it does not infringe the '148 patent. More specifically, in the first reexamination, the PTO construed critical claim terms in a relatively narrow manner, which the Company believes is consistent with its stated positions in the patent litigation. The Company’s second reexamination request was granted by the PTO in November 2005 and is based on new "prior art" (that is, earlier issued patent publications) submitted to the PTO which FARO believes will ultimately invalidate the '148 patent. This prior art was not at issue in the first reexamination proceeding. The PTO has not ruled in the second reexamination request.

In the event of an adverse ruling in the Cimcore-Romer litigation, however, the Company could be required to pay substantial damages, cease the manufacturing, use and sale of any infringing products, discontinue the use of certain processes or obtain a license, if available, from Cimcore-Romer with royalty payment obligations by the Company. An adverse decision in the Cimcore-Romer case could materially and adversely affect the Company’s financial condition and results of operations. At this time, however, the Company cannot estimate the potential impact, if any, that might result from this suit, and therefore, no provision has been made to cover such expense.

Securities Litigation— On December 6, 2005, the first of four essentially identical class action securities fraud lawsuits were filed against the Company and certain officers of the Company. On April 19, 2006, the four lawsuits were consolidated, and Kornitzer Capital Management, Inc. was appointed as the lead plaintiff. On May 16, 2006, Kornitzer filed its Consolidated Amended Class Action Complaint against the Company and the individual defendants. The amended complaint also names Grant Thornton LLP, the Company’s independent registered public accounting firm, as an additional defendant.

In the amended complaint, Kornitzer seeks to represent a class consisting of all persons who purchased or otherwise acquired the Company’s publicly traded securities between April 15, 2004 and March 15, 2006. On behalf of the alleged class, Kornitzer seeks an unspecified amount of damages, premised on allegations that each defendant made misrepresentations and omissions of material fact during the class period in violation of the Securities Exchange Act of 1934. Among other things, Kornitzer alleges that the Company’s reported gross margins and net income were knowingly overstated as a result of manipulation of the Company’s inventory levels, that the Company failed to disclose deficiencies associated with the Company’s implementation and use of its enterprise resource planning system and material requirements planning system, made false and misleading statements regarding the Company’s internal controls, failed to disclose the fact that the Company was accruing commissions and bonuses which would have a material, adverse effect upon the Company’s profitability, and improperly reported sales and net income based, in part, on sales and new orders obtained in violation of the Foreign Corrupt Practices Act.

The Company filed a Motion to Dismiss the amended complaint on July 31, 2006. On August 30, 2006, Kornitzer filed its memorandum in opposition to the Company’s Motion to Dismiss. On September 15, 2006, the parties’ counsel presented oral argument on the Motion to Dismiss to the court. The court has not ruled on the Motion to Dismiss. The Company has timely notified the issuer of its Executive Liability and Entity Securities Liability insurance policy of the Securities Litigation, and has reserved the full amount of its $250,000 retention under the policy. Although the Company believes that the material allegations made in the amended complaint are without merit and intends to vigorously defend the Securities Litigation, no assurances can be given with respect to the outcome of the Securities Litigation.

Voluntary Disclosure of Foreign Corrupt Practices Act Matter to the Securities and Exchange Commission and Department of Justice. - As previously reported on the Company's Form 10-K for the year ended December 31, 2005 and Forms 10-Q for the first quarter ended April 1, 2006 and second quarter ended July 1, 2006, the Company learned that its China subsidiary had made payments to certain customers in China that may have violated the FCPA and other applicable laws. The Company's Audit Committee instituted an internal investigation into this matter in February 2006, and the Company voluntarily notified the SEC and the DOJ of this matter in March 2006. The internal investigation into this matter has been completed. The Company has provided to the SEC and the DOJ information obtained during the course of this investigation and is cooperating with both agencies.

The Company's internal investigation has identified certain improper payments made in China and deficiencies in its controls with respect to its operations in China in possible violation of the FCPA. If the SEC or the DOJ determines that violations of the FCPA have occurred, they could seek civil and criminal sanctions, including monetary penalties, against the Company and/or certain of its employees, as well as additional changes to the Company's business practices and compliance programs. Based on current information, it is not possible to predict at this time when the SEC or DOJ investigations will be resolved, what the outcome will be, what sanctions, if any, will be imposed, or the effect that such matters may ultimately have on the Company or its consolidated financial statements. Results of the investigation revealed that referral fee payments in possible violation of the FCPA were $165,000 and $265,000 in 2004 and 2005, respectively, which were recorded in selling expenses in the Company's statements of income. The related sales to customers to which payment of these referral fees had been made totaled approximately $1.3 million and $3.24 million in 2004 and 2005, respectively. Additional improper referral fee payments of $122,000 were made in January and February 2006 related to sales contracts in 2005. The Company anticipates incurring expenses of at least $4.0 million in 2006 relating to the FCPA matter. The Company has incurred approximately $3.6 million in the first nine months of 2006 related to the FCPA matter.

The Company has terminated certain personnel in the Asia-Pacific Region and has re-assigned the duties of other personnel in both the Asia-Pacific Region and the U.S. as a result of the internal investigation. The Company is instituting, or has instituted, the following remedial measures:

- Contracted with a third party forensics accounting team to conduct an in-depth audit of the operations in China and in other countries in the Asia-Pacific Region and to make recommendations for improvement to the internal control systems.

- Reviewing third party distributor arrangements in an effort to assure that all contracts include adherence to the FCPA.

- Performing due diligence on all third party distributors and implementing a process to assess potential new distributors.

- Established an in-house internal audit function including hiring a Director of Internal Audit.

- Consolidating the human resources, financial accounting and reporting functions for the Asia region into the Singapore operations.

- Implemented an internal certification process to ascertain whether similar issues may exist elsewhere in the Company.

- Implemented a quarterly internal certification process to confirm adherence to company policy and all applicable laws and regulations that will include all regional leadership, country management and other sales management.

- Implementing additional training on FCPA and other matters for employees and a confidential compliance reporting system.

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The Company reported sales in China of $9.0 million in 2005 and $4.2 million in 2004, approximately 7% and 4% of total sales, respectively. Depending on how this matter is resolved, the Company's sales in China could be significantly impacted. The termination of certain personnel and the cessation of improper payments in China may have an adverse effect on future operations in China because such action could negatively influence the decisions of a significant number of customers of the Chinese subsidiary to do business with that subsidiary. The potential magnitude of the loss of sales in China as a result of potential violations of the FCPA cannot be estimated at this time.

During the Company's internal investigation of its business practices in China, it became aware that income taxes related to certain commissions and bonus payments to its employees had not been properly reported. The Company has filed the appropriate payroll tax returns and remitted the deficiency.

Other than the litigation mentioned above, the Company is not involved in any other legal proceedings other than routine litigation arising in the normal course of business. The Company does not believe the results of such other litigation, even if the outcome were unfavorable to the Company, would have a material adverse effect on the Company's business, financial condition or results of operations.

NOTE P - CREDIT FACILITY

On July 11, 2006, the Company entered into an Amended and Restated Loan Agreement (the "Amended Loan Agreement"). The Amended Loan Agreement replaced the Company's prior $5.0 million loan agreement entered into on September 17, 2003. The Amended Loan Agreement provides for an available line of credit of $30.0 million. Loans under the Amended Loan Agreement bear interest at the rate of LIBOR plus 1.75% and require the Company to maintain certain ratios and balances with respect to a debt covenant agreement, including current ratio, consolidated EBITDA, and senior funded debt to EBITDA. As of September 30, 2006, the Company is in compliance with all of the covenants under the Amended Loan Agreement. The term of the Amended Loan Agreement extends to April 30, 2009. The Company has not drawn on this line of credit.

NOTE Q - ACQUISITION

On March 29, 2005, the Company acquired 100% of the outstanding stock of privately held iQvolution AG ("iQvolution"). iQvolution, a German company, designs, manufactures and supplies three-dimensional laser scanning products and services. This purchase was a strategic acquisition to enable the Company to enter broader three-dimensional measurement markets. The purchase price for the transaction was approximately $13.6 million, including an initial cash payment of approximately $3.8 million and 314,736 shares of common stock valued at approximately $7.2 million based on the average closing price for the three days immediately preceding the closing, 152,292 shares of which were payable immediately. The remaining 162,444 shares of common stock, valued at approximately $3.7 million, were placed in escrow and may be paid over the following five years subject to achieving predetermined milestones with respect to purchased assets. Subsequent to the purchase, approximately $1.8 million in cash was paid out for the repayment of loans and approximately $0.4 million was paid in fees associated with the purchase. Additionally, the purchase price was adjusted downward by $0.1 million, and these funds were repaid to the Company in the third quarter of 2005 relating to the settlement of a purchase price adjustment clause within the purchase agreement. At September 30, 2006 and December 31, 2005, there were 84,773 and 150,261 shares being held in escrow, respectively.

The Company completed in the first quarter of 2006 the third party valuation of the assets acquired. The Company made an adjustment to the purchase price to reflect a deferred tax liability of approximately $1.5 million. The following table represents the fair value of the assets acquired and liabilities assumed and includes the final determination of the estimated fair values of deferred tax assets, non-compete, and intangible assets, which were preliminary as of December 31, 2005:

		At March 29, 2005
Current assets	$	907
Property and equipment		595
Deferred tax assets		141
Non-compete		348
Intangible assets		3,492
Goodwill		8,309
Current liabilities		(2,235)
Long term debt		(167)
Deferred tax liability		(1,506)
	$	9,884

The non-compete agreement is being amortized over 8 years. The intangible assets are being amortized over their useful lives of 10 years. The excess of the purchase price over the net assets acquired of $8.3 million was recorded as goodwill and is evaluated for impairment on a periodic basis in accordance with SFAS No. 142. The Company expects to record the value of the shares held in escrow to goodwill upon achievement of the predetermined milestones.

The operating results of iQvolution have been included in the consolidated statements of income since the date of acquisition. The following unaudited pro-forma consolidated results of operations for the three months ended April 2, 2005 are presented for informational purposes only and do not purport to be indicative of the consolidated results of operations which actually would have resulted had the acquisition occurred as of the beginning of 2005, or the consolidated results of operations which may result in the future.

(unaudited)		Three Months Ended April 2, 2005
Revenues	$	27,987
Net income	$	2,753
Income per share:		
Basic	$	0.20
Diluted	$	0.19

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

The following information should be read in conjunction with the Consolidated Financial Statements, including the notes thereto, included elsewhere in this Form 10-Q, and the Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's 2005 Annual Report, Form 10-K, for the year ended December 31, 2005.

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

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

- our inability to further penetrate our customer base;
- development by others of new or improved products, processes or technologies that make our products obsolete or less competitive;
- our inability to maintain our technological advantage by developing new products and enhancing our existing products;
- our inability to successfully identify and acquire target companies or achieve expected benefits from acquisitions that are consummated;
- the cyclical nature of the industries of our customers and the financial condition of our customers;
- the fact that the market potential for the CAM2 market and the potential adoption rate for our products are difficult to quantify and predict;
- the inability to protect our patents and other proprietary rights in the United States and foreign countries and the assertion and ultimate outcome of infringement claims against us, including the pending suit by Hexagon's Cimcore-Romer subsidiary against us;
- 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, (iv) raw material price fluctuations, (v) expansion of our manufacturing capability and other inflationary pressures, (vi) the size and timing of customer orders, (vii) the amount of time that it takes to fulfill orders and ship 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) costs associated with new product introductions, such as product development, marketing, assembly line start-up costs and

low introductory period production volumes, (x) the timing and market acceptance of new products and product enhancements, (xi) customer order deferrals in anticipation of new products and product enhancements, (xii) our success in expanding our sales and marketing programs, (xiii) costs associated with opening new sales offices outside of the United States, (xiv) fluctuations in revenue without proportionate adjustments in fixed costs, (xv) the efficiencies achieved in managing inventories and fixed assets, (xvi) investments in potential acquisitions or strategic sales, product or other initiatives, (xvii) shrinkage or other inventory losses due to product obsolescence, scrap or material price changes, (xviii) adverse changes in the manufacturing industry and general economic conditions, and (xix) other factors including the cost of investigation and ongoing litigation expenses noted herein;

- changes in gross margins due to changing product mix of product sold and the different gross margins on different products;
- the outcome of the purported class action lawsuit;
- our inability to successfully implement the requirements of Restriction of use of Hazardous Substances (RoHS) and Waste Electrical and Electronic Equipment (WEEE) compliance into our products;
- the inability of our products to displace traditional measurement devices and attain broad market acceptance;
- the impact of competitive products and pricing in the CAM2 market and the broader market for measurement and inspection devices;
- the effects of increased competition as a result of recent consolidation in the CAM2 market;
- risks associated with expanding international operations, such as fluctuations in currency exchange rates, difficulties in staffing and managing foreign operations, political and economic instability, and the burdens and potential exposure of complying with a wide variety of U.S. and foreign laws and labor practices;
- our inability to maintain our level of sales or grow sales in China as a result of, among other things, the impact of our investigation of potential violations of the Foreign Corrupt Practices Act and modifications to our business practices in China;
- higher than expected increases in expenses relating to our Asia Pacific expansion or our Swiss manufacturing facility;
- our inability to find less expensive alternatives to stock options to attract and retain employees;
- difficulties in recruiting research and development engineers, and application engineers;
- the failure to effectively manage our growth;
- variations in the effective income tax rate and the difficulty in predicting the tax rate on a quarterly and annual basis;
- the loss of key suppliers and the inability to find sufficient alternative suppliers in a reasonable period or on commercially reasonable terms; and
- the matters set forth under “Cautionary Statements” in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” below.

Overview

We design, develop, manufacture, market and support portable, software driven, 3-D measurement systems that are used in a broad range of manufacturing, industrial, building construction and forensic applications. The Company's Faro Arm, Faro Scan Arm, Faro Gage, and Faro Digital Template articulated measuring devices, the Faro Laser Tracker, and their companion CAM2 software, provide for Computer-Aided Design (CAD)-based inspection and/or factory-level statistical process control. Together, these products integrate the measurement, quality inspection, and reverse engineering functions with CAD software to improve productivity, enhance product quality and decrease rework and scrap in the manufacturing process. The Company uses the acronym “CAM2” for this process, which stands for computer-aided manufacturing measurement. In March 2005 the Company acquired iQvolution AG, a German

designer, developer and manufacturer of a portable laser-based device for measuring the detailed composition of factories, oil refineries and other structures. This device and its related software, which the Company sells under the product name Laser Scanner LS also has forensic applications such as capturing detailed 3-D crime scene information. As of September 2006, the Company's products have been purchased by approximately 5,500 customers worldwide, ranging from small machine shops to such large manufacturing and industrial companies as Audi, Bell Helicopter, Boeing, British Aerospace, Caterpillar, Daimler Chrysler, General Electric, General Motors, Honda, Johnson Controls, Komatsu Dresser, Lockheed Martin, Nissan, Siemens and Volkswagen, among many others.

We continue to pursue international markets. We established sales offices in France and Germany in 1996, Great Britain in 1997, Japan and Spain in 2000, Italy in 2001, and China in 2003. We opened sales offices in South Korea and India in 2004. We established sales offices in Poland, Netherlands, Malaysia, Vietnam, and Singapore in 2005 and added a new regional headquarters in Singapore in the third quarter of 2005 along with a new manufacturing and service facility there in the fourth quarter of 2005. In 2003 we began to manage and report our global sales in three regions: the Americas, Europe/Africa and Asia/Pacific. In the nine months ended September 30, 2006, 41.5% of our sales were in the Americas compared to 43.2% in the nine months of 2005, 39.3% were in the Europe/Africa region compared to 37.8% in the nine months of 2005 and 19.2% were in the Asia/Pacific region, compared to 19.0% in the prior year period (see also Note M- Geographic Data, to the financial statements above).

We derive revenues primarily from the sale of our Faro Arm, Faro Scan Arm, Faro Gage, Faro Laser Tracker and Faro Laser Scanner LS 3-D measurement equipment, and their related multi-faceted software. Revenue related to these products is recognized upon shipment. In addition, we sell one to three-year extended warranties and training and technology consulting services relating to our products. We recognize the revenue from extended warranties on a straight-line basis. We also receive royalties from licensing agreements for our historical medical technology and generally recognize the revenue from these royalties as licensees use the technology.

In 2003, we began to manufacture our Faro Arm products in Switzerland for customer orders from the Europe/Africa and Asia/Pacific regions. We began to manufacture our Faro Gage product, and parts of our Faro Laser Tracker product in our Swiss plant in the third quarter of 2004. We began production of the Faro Laser Tracker product in our Swiss plant in 2005. We began to manufacture our Faro Arm products in our Singapore plant in the fourth quarter of 2005, the Faro Laser Tracker in the first half of 2006 and we expect to begin production of our Faro Gage in the second half of 2006. We expect our Singapore plant will supply our Asia/Pacific market for these products. The manufacture of these products for customer orders from the Americas will be done in our manufacturing facilities located in Florida and Pennsylvania. Our Faro Laser Scanner LS product is currently manufactured in our new facility located in Stuttgart, Germany. We expect all our plants to have the production capacity necessary to support our growth through 2006.

We have had seventeen consecutive profitable quarters through September 30, 2006. Our sales growth and profitability has been a result of a number of factors, including: in January 2002, the acquisition of SMX, which manufactured the predecessor to the Faro Laser Tracker, the introduction in October 2002 of the latest generation of our traditional Faro Arm product, the introduction of the Faro Gage in September 2003, the introduction of our Faro Scan Arm product in 2004, the acquisition of iQvolution AG in 2005, which manufactured the predecessor to the Faro Laser Scanner LS, and an increase in the number of sales people worldwide.

The Company reports both sales and new orders in its quarterly earnings releases. In the third quarter of 2006, new order bookings increased $9.2 million, or 31.2%, to $38.7 million from $29.5 million in the year-ago quarter. New orders increased 19.2% in the Americas to $15.5 million, from $13.0 million in the third quarter of 2005. New orders increased 37.4% to $14.7 million in Europe/Africa from $10.7 million in the third quarter of 2005. In Asia/Pacific new orders increased 46.6% to $8.5 million from $5.8 million in the third quarter of 2005.

Accounting for wholly owned foreign subsidiaries is maintained in the currency of the respective foreign jurisdiction and, therefore, fluctuations in exchange rates may have an impact on inter-company accounts reflected in our consolidated financial statements. We are aware of the availability of off-balance sheet financial instruments to hedge exposure to foreign currency exchange rates, including cross-currency swaps, forward contracts and foreign currency options (see Foreign Exchange Exposure below). However, we do not regularly use such instruments, and none were utilized in 2006 or 2005.

The Company's effective tax rate decreased to 15.1% for the nine months ended September 30, 2006 from 15.8% in the prior year period. The Company currently estimates the effective tax rate will approximate 15% for the remainder of 2006. The Company's tax rate continues to be lower than the statutory tax rate in the United States primarily as a result of favorable tax rates in foreign jurisdictions. However, our tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of our products. We have received a favorable income tax rate commitment from the Swiss government as an incentive to establish a manufacturing plant in Switzerland. In 2006 we received approval from the Singapore Economic Development Board for a favorable multi-year income tax holiday for our Singapore headquarters and manufacturing operations subject to certain terms and conditions including employment, spending, and capital investment .

We will incur minimal expenses in 2006 as calculated under the Black-Scholes method of SFAS 123, related to our adoption of SFAS 123(R) for the expensing of stock options as we vested substantially all of our unvested options in the fourth quarter of 2005. The reduction in pre-tax charges estimated by the Company as a result of the acceleration amounts to approximately $7.7 million over the course of the original vesting periods. Options to purchase approximately 704,310 shares of the Company's stock or 52.5% of the Company's total outstanding options were accelerated. The weighted average exercise price of the options subject to acceleration was $21.30. The aggregate pretax expense for the shares subject to acceleration that would have been reflected in the Company's consolidated financial statements beginning in 2006 is approximately $7.7 million, including $4.3 million in 2006, $2.7 million in 2007, and $0.7 million in 2008. The fair value for any future grants will be included in expense over the vesting periods. These expenses will be apportioned according to the classification of the employees who have received stock options into cost of sales, selling, general and administrative or research and development costs.

As previously reported on the Company's Form 10-K for the year ended December 31, 2005 and Forms 10-Q for the first quarter ended April 1, 2006 and the second quarter ended July 1, 2006, the Company learned that its China subsidiary had made payments to certain customers in China that may have violated the FCPA and other applicable laws. The Company's Audit Committee instituted an internal investigation into this matter in February 2006, and the Company voluntarily notified the SEC and the DOJ of this matter in March 2006. The internal investigation into this matter has been completed. The Company has provided to the SEC and the DOJ information obtained during the course of this investigation and is cooperating with both agencies.

The Company's internal investigation has identified certain improper payments made in China and deficiencies in its controls with respect to its operations in China in possible violation of the FCPA. If the SEC or the DOJ determines that violations of the FCPA have occurred, they could seek civil and criminal sanctions, including monetary penalties, against the Company and/or certain of its employees, as well as additional changes to the Company's business practices and compliance programs. Based on current information, it is not possible to predict at this time when the SEC or DOJ investigations will be resolved, what the outcome will be, what sanctions, if any, will be imposed, or the effect that such matters may ultimately have on the Company or its consolidated financial statements. Results of the investigation revealed that referral fee payments in possible violation of the FCPA were $165,000 and $265,000 in 2004 and 2005, respectively, which were recorded in selling expenses in the Company's statements of income. The related sales to customers to which payment of these referral fees had been made totaled approximately $1.3 million and $3.24 million in 2004 and 2005, respectively. Additional improper referral fee payments of $122,000 were made in January and February 2006 related to sales contracts in 2005. The Company anticipates incurring expenses of at least $4.0 million in 2006 relating to the FCPA matter. The Company has incurred approximately $3.6 million in the first nine months of 2006 related to the FCPA matter.

The Company has terminated certain personnel in the Asia-Pacific Region and has re-assigned the duties of other personnel in both the Asia-Pacific Region and the U.S. as a result of the internal investigation. The Company is instituting, or has instituted, the following remedial measures:

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Contracted with a third party forensics accounting team to conduct an in-depth audit of the operations in China and in other countries in the Asia-Pacific region and to make recommendations for improvement to the internal control systems.

- Reviewing third party distributor arrangements in an effort to assure that all contracts include adherence to the FCPA.

- Performing due diligence on all third party distributors and implementing a process to assess potential new distributors.

- Established an in-house internal audit function including hiring a Director of Internal Audit.

- Consolidating the human resources, financial accounting and reporting functions for the Asia region into the Singapore operations.

- Implemented an internal certification process to ascertain whether similar issues may exist elsewhere in the Company.

- Implemented a quarterly internal certification process to confirm adherence to company policy and all applicable laws and regulations that will include all regional leadership, country management and other sales management.

- Implementing additional training on FCPA and other matters for employees and a confidential compliance reporting system.

The Company had sales in China of $9.0 million in 2005 and $4.2 million in 2004, approximately 7% and 4% of total sales, respectively. Depending on how this matter is resolved, the Company’s sales in China could be significantly impacted. The termination of certain personnel and the cessation of improper payments in China may have an adverse effect on future operations in China because such action could negatively influence the decisions of a significant number of customers of the Chinese subsidiary to do business with that subsidiary. The potential magnitude of the loss of sales in China as a result of potential violations of the Foreign Corrupt Practices Act cannot be estimated at this time.

During the Company’s internal investigation of its business practices in China, it became aware that income taxes related to certain commissions and bonus payments to its employees had not been properly reported. The Company has filed the appropriate payroll tax returns and remitted the deficiency.

The Company is currently involved in a patent infringement lawsuit and a class action securities fraud lawsuit. (See PART II. OTHER INFORMATION: Item 1. Legal Proceedings). Neither the ultimate outcome of any of these actions, nor their potential impact on the Company’s business, financial condition, or reported results of operations in any future period can be predicted.

Results of Operations

Three Months Ended September 30, 2006 Compared to the Three Months Ended October 1, 2005

Sales increased by $5.8 million, or 17.8%, to $38.4 million in the three months ended September 30, 2006 from $32.6 million in the three months ended October 1, 2005. This increase resulted primarily from an increase in unit sales. Our sales growth is driven by increased product sales resulting from continuing market demand for and acceptance of our products. Sales in the Americas region increased $2.2 million, or 16.3%, to $15.7 million for the three months ended September 30, 2006 from $13.5 million in the three months ended October 1, 2005. Sales in the Europe/Africa region increased $4.4 million, or 41.9%, to $14.9 million for the three months ended September 30, 2006 from $10.5 million in the three months ended October 1, 2005. Sales in the Asia/Pacific region decreased $0.8 million, or 9.3%, to $7.8 million for the three months ended September 30, 2006 from $8.6 million in the three months ended October 1, 2005.

Gross profit increased by $4.5 million, or 25.4%, to $22.2 million for the three months ended September 30, 2006 from $17.7 million for the three months ended October 1, 2005. Gross margin increased to 58.0% for the three months ended September 30, 2006 from 54.3% for the three months ended October 1, 2005. Gross margin in the third quarter

of 2005 would have been 59.2%, excluding the effects of an adjustment to cost of goods sold in the three months ended October 1, 2005, of approximately $1.6 million related to inventory costing and consumption variances arising from the Company's implementation of a new enterprise resource planning ("ERP") system (see Item 4. Controls and Procedures below). The Company believes the non-GAAP calculation of the gross margin in the third quarter of 2005 provides a more useful comparison to the gross margin in the three months ended September 30, 2006. The gross margin in the three month period ended September 30, 2006 decreased to 58.0% primarily due to a change in the sales mix resulting in an increase in unit sales of product lines with a higher than average cost of sales. We expect the trend of changes in the sales mix to result in gross margins in the range of 57% to 59% through 2006.

Selling expenses increased by $2.0 million, or 23.3%, to $10.6 million for the three months ended September 30, 2006 from $8.6 million for three months ended October 1, 2005. This increase was primarily due to higher compensation and commission expense of $1.1 million related to the increase in sales and higher marketing costs of $0.8 million. Worldwide sales and marketing headcount decreased by 15, or 5.6%, to 251 from 266 between September 30, 2006 and October 1, 2005. Regionally, our sales and marketing headcount decreased by 2, or 2.6%, in the Americas, to 76 from 78; increased by 1, or 1.0%, in Europe/Africa to 112 from 111; and decreased by 14, or 18.28%, in Asia/Pacific to 63 from 77 between September 30, 2006 and October 1, 2005. We intend to continue to selectively increase our sales and marketing headcount as the market demands. As a percentage of sales, selling expenses increased to 27.6% of sales in the three months ended September 30, 2006 from 26.4% in the three months ended October 1, 2005. Regionally, selling expenses were 25.0% of sales in the Americas for the quarter, compared to 25.1% of sales in the year-ago quarter, 32.2% of sales for Europe/Africa compared to 30.4% of sales, and 24.0% of sales compared to 23.5% of sales for Asia/Pacific.

General and administrative expenses increased by $2.4 million, or 75.0%, to $5.6 million for the three months ended September 30, 2006 from $3.2 million for the three months ended October 1, 2005, primarily due to increased professional and legal fees of $1.0 million, of which $0.4 million was related to the Company's investigation of possible violations of the Foreign Corrupt Practices Act by its Chinese subsidiary, an increase in compensation costs of $0.4 million and an increase of $0.3 million related to the incremental expense of the Singapore facility which opened in September 2005. General and administrative expenses as a percentage of sales increased to 14.6% for the three months ended September 30, 2006 from 9.8% for the three months ended October 1, 2005.

Depreciation and amortization expenses remained $1.0 million for the three months ended September 30, 2006 and for the three months ended October 1, 2005.

Research and development expenses decreased by $0.2 million, or 10.5%, to $1.7 million for the three months ended September 30, 2006 from $1.9 million for the three months ended October 1, 2005. This decrease resulted primarily from a decrease in subcontractors' expense of $0.1 million. Research and development expenses as a percentage of sales decreased to 4.4% for the three months ended September 30, 2006 from 5.8% for the three months ended October 1, 2005.

Interest income, net increased by $0.08 million to $0.19 million for the three months ended September 30, 2006 from $0.11 million for the three months ended October 1, 2005, due to an increase in interest rates and an increase in short-term investments.

Other (expense) income, net increased by $0.34 million to income of $0.15 million for the three months ended September 30, 2006, from an expense of $0.19 million for the three months ended October 1, 2005, primarily as a result of foreign exchange transaction gains.

Income tax expense increased by $0.1 million to $0.5 million for the three months ended September 30, 2006 from $0.4 million for the three months ended October 1, 2005. This increase was primarily due to an increase in pretax income. Total deferred taxes for the Company's foreign subsidiaries relating to net operating loss carryforwards were $5.8 million at September 30, 2006 and $5.4 million at December 31, 2005. The related valuation allowance was $3.7 million and $3.5 million at September 30, 2006 and December 31, 2005, respectively. The Company's effective tax rate decreased to 13.9% in the quarter ended September 30, 2006 from 18.0% used in the first six months of 2006 primarily as a result of the effect of the receipt of approval in the third quarter of 2006 of the tax holiday for our operations in Singapore effective January 1, 2006 for a period of four years and an additional six year extension at a favorable tax rate subject to certain terms and conditions including employment, spending, and capital investment. The Company's effective tax rate increased to 13.9% for the three months ended September 30, 2006 from 12.1% in the prior year period as a result of the utilization of net operating loss carryforwards in the nine month period ended October 1, 2005, for which a valuation allowance had previously been applied. The Company currently estimates the

effective tax rate will approximate 15% for the remainder of 2006. The Company's tax rate continues to be lower than the statutory tax rate in the United States primarily as a result of favorable tax rates in foreign jurisdictions. However, our tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of our products and the resulting effect on taxable income in each jurisdiction.

Net income increased by $0.6 million to $3.2 million for the three months ended September 30, 2006, from $2.6 million for the three months ended October 1, 2005 as a result of the factors described above.

Nine Months Ended September 30, 2006 Compared to the Nine Months Ended October 1, 2005

Sales increased by $17.4 million, or 19.1%, to $108.5 million in the nine months ended September 30, 2006 from $91.1 million in the nine months ended October 1, 2005. This increase resulted primarily from an increase in unit sales. Our sales growth is driven by increased product sales resulting from continuing market demand for and acceptance of our products. Sales in the Americas region increased $5.7 million, or 14.5%, to $45.1 million for the nine months ended September 30, 2006 from $39.4 million in the nine months ended October 1, 2005. Sales in the Europe/Africa region increased $8.2 million, or 23.8%, to $42.6 million for the nine months ended September 30, 2006 from $34.4 million in the nine months ended October 1, 2005. Sales in the Asia/Pacific region increased $3.5 million, or 20.2%, to $20.8 million for the nine months ended September 30, 2006 from $17.3 million in the nine months ended October 1, 2005.

Gross profit increased by $10.2 million, or 19.1%, to $63.6 million for the nine months ended September 30, 2006 from $53.4 million for the nine months ended October 1, 2005. Gross margin remained at 58.6% for the nine months ended September 30, 2006 and for the nine months ended October 1, 2005. Gross margin in the nine months ended October 1, 2005, would have been 60.4% ,excluding the effects of an adjustment to cost of goods of approximately $1.6 million related to inventory costing and consumption variances arising from the Company's implementation of a new enterprise resource planning ("ERP") system (see Item 4. Controls and Procedures below). The Company believes the non-GAAP calculation of the gross margin in the nine month period ended October 1, 2005, provides a more useful comparison to the gross margin in the nine month period ended September 30, 2006. The gross margin in the nine month period ended September 30, 2006 decreased to 58.6% primarily due to a change in the sales mix resulting in an increase in unit sales of product lines with a higher than average cost of sales. We expect the trend of changes in the sales mix to result in gross margins in the range of 57% to 59% through 2006.

Selling expenses increased by $6.8 million, or 26.5%, to $32.5 million for the nine months ended September 30, 2006 from $25.7 million for the nine months ended October 1, 2005. This increase was primarily due to higher compensation and commission expense of $4.2 million related to the increase in sales and marketing personnel, higher marketing costs of $2.2 million and higher product demonstration costs of $0.3 million. Worldwide sales and marketing headcount decreased by 15, or 5.6%, to 251 from 266 between September 30, 2006 and October 1, 2005. Regionally, our sales and marketing headcount decreased by 2, or 2.6%, in the Americas, to 76 from 78; increased by 1, or 1.0%, in Europe/Africa to 112 from 111; and decreased by 14, or 18.28%, in Asia/Pacific to 63 from 77 between September 30, 2006 and October 1, 2005. We intend to continue to selectively increase our sales and marketing headcount as the market demands. As a percentage of sales, selling expenses increased to 29.9% of sales in the nine months ended September 30, 2006 from 28.2% in the nine months ended October 1, 2005. Regionally, selling expenses were 27.3% of sales in the Americas for the nine months, compared to 26.3% of sales in the prior year period, 32.1% of sales for Europe/Africa compared to 29.8% of sales and 31.2% of sales compared to 29.1% of sales for Asia/Pacific.

General and administrative expenses increased by $7.3 million, or 66.4%, to $18.3 million for the nine months ended September 30, 2006 from $11.0 million for the nine months ended October 1, 2005 primarily due to increased professional and legal fees of $4.9 million, of which $3.6 million was related to the Company's investigation of possible violations of the Foreign Corrupt Practices Act by its Chinese subsidiary, and an increase in compensation costs of $1.0 million primarily due to the increase in personnel in the company's Asia facilities. General and administrative expenses as a percentage of sales increased to 16.9% for the nine months ended September 30, 2006 from 12.1% for the nine months ended October 1, 2005.

Depreciation and amortization expenses increased by $0.7 million to $3.1 million for the nine months ended September 30, 2006 from $2.4 million for the nine months ended October 1, 2005 as a result of the acquisition of new equipment and intangible assets.

Research and development expenses increased by $0.6 million, or 12.5%, to $5.4 million for the nine months ended September 30, 2006 from $4.8 million for the nine months ended October 1, 2005. This increase resulted primarily from an increase in salaries and subcontractors expense of $0.3 million related to the addition of the Laser Scanner product line. Research and development expenses as a percentage of sales were 5.0% and 5.3% for the nine months ended September 30, 2006 and October 1, 2005, respectively.

Interest income, net increased by $0.17 million to $0.51 million for the nine months ended September 30, 2006 from $0.34 million for the nine months ended October 1, 2005, due to an increase in interest rates and short-term investments.

Other (expense) income, net increased by $0.77 million to income of $0.44 million for the nine months ended September 30, 2006, from an expense of $0.33 million for the nine months ended October 1, 2005, primarily as a result of foreign exchange transaction gains.

Income tax expense decreased by $0.7 million to $0.8 million for the nine months ended September 30, 2006 from $1.5 million for the nine months ended October 1, 2005. This decrease was primarily due to a decrease in pretax income. Total deferred taxes for the Company's foreign subsidiaries relating to net operating loss carryforwards were $5.8 million at September 30, 2006 and $5.4 million at December 31, 2005. The related valuation allowance was $3.7 million and $3.5 million at September 30, 2006 and December 31, 2005, respectively. The Company's effective tax rate decreased to 15.1% for the nine months ended September 30, 2006 from 15.8% in the prior year period primarily as a result of the effect of the receipt of approval in the third quarter of 2006 of the tax holiday for our operations in Singapore effective January 1, 2006 for a period of four years and an additional six year extension at a favorable tax rate subject to certain terms and conditions including employment, spending, and capital investment. The Company currently estimates the effective tax rate will approximate 15% for the remainder of 2006. The Company's tax rate continues to be lower than the statutory tax rate in the United States primarily as a result of favorable tax rates in foreign jurisdictions. However, our tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of our products and the resulting effect on taxable income in each jurisdiction.

Net income decreased by $3.5 million to $4.5 million for the nine months ended September 30, 2006 from $8.0 million for the nine months ended October 1, 2005 as a result of the factors described above.

Liquidity and Capital Resources

On September 17, 2003, the Company entered into a loan agreement with a bank for a line of credit of $5.0 million. This agreement, which bears interest at the rate of LIBOR plus 1.75%, was renewed in August 2005 and had been due on demand. On July 11, 2006, the Company entered into an Amended and Restated Loan Agreement (the "Amended Loan Agreement"). The Amended Loan Agreement replaces the Company's prior $5.0 million loan agreement entered into on September 17, 2003. The Amended Loan Agreement provides for an available line of credit of $30.0 million. Loans under the Amended Loan Agreement bear interest at the rate of LIBOR plus 1.75%.

On January 10, 2005, the Company filed a Registration Statement on Form S-3 with the Securities and Exchange Commission allowing it to raise proceeds of up to $125 million. The proceeds from any offerings with respect to this registration statement, if any, would be used for either repayment or refinancing of debt, acquisition of additional businesses or technologies or for working capital and general corporate purposes. To date, we have not raised any capital under this Form S-3 Registration Statement. The Company must file in a timely manner all reports under the Securities and Exchange Act of 1934 (with certain exceptions) with the SEC for a period of 12 months in order to be

able to use its S-3 registration statement. Because the Company's Form 10-K for the year ended December 31, 2005 and Form 10-Q for the first quarter ended April 1, 2006 were not timely filed, the Company is not eligible to use its Form S-3 registration statement. As a result, the Company would be required to use a Form S-1 registration statement if it were to raise equity or debt in the public markets.

Cash and cash equivalents at September 30, 2006 were $8.9 million, a decrease of $0.4 million from $9.3 million at December 31, 2005. The decrease was primarily attributable to net cash provided by operating activities of $2.7 million, cash used in investing activities to purchase equipment and intangible assets of $3.4 million, offset by proceeds from sales of investments of $0.7 million; cash used in financing activities to make payments of capital leases of $0.15 million, and a decrease of $0.21 million related to the exchange rate effects on cash. In addition, the Company had short term investments of $15.8 million and $16.5 million at September, 2006 and December 31, 2005, respectively.

Cash provided by operations was $2.7 million in the first nine months of 2006 compared to cash used in operations of $7.5 million in the comparable prior year period, an increase of $10.2 million primarily attributable to a reduction in inventory of $1.6 million in the first nine months of 2006 compared to an increase of $10.2 million in the first nine months of 2005.

Net cash used in investing activities was $2.7 million in the first nine months of 2006 compared to net cash provided by investing activities of $2.0 million in the prior year period. This decrease of $4.7 million was primarily the result of a decrease in net proceeds from short term investments of $10.8 million, of which $6.4 million was used for the purchase of iQvolution in the prior period of 2005.

We believe that our working capital, together with anticipated cash flow from our operations and our credit facility will be sufficient to fund our long-term liquidity requirements.

Critical Accounting Policies

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

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

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

future costs relating to warranty expenses is recorded when products are shipped. Costs relating to extended maintenance plans are recognized as incurred. Revenue from the licensing agreements for the use of the Company's technology for medical applications is recognized on an accrual basis based on historical data.

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

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

The Company operates in a number of different countries around the world and considers the statutory rates within each jurisdiction to determine the overall effective tax rate. In 2003, the Company began to manufacture its products in Switzerland, where it has received a favorable income tax rate commitment from the Swiss government as an incentive to establish a manufacturing plant there. The aggregate dollar effect of this favorable tax rate was approximately $1.1 million, or $0.08 per share, in the nine month period ended September 30, 2006, and $2.1 million, or $0.15 per share, in the nine month period ended October 1, 2005.

In 2005, the Company opened a regional headquarters and began to manufacture its products in Singapore, where it has recently received approval for a four year tax holiday from the Singapore Economic Development Board as an incentive to establish a manufacturing plant and regional headquarters. The aggregate dollar effect of this favorable tax rate was approximately $0.43 million, or $.03 per share, during the nine month period ended September 30, 2006.

The Company is subject to certain terms and conditions including employment, spending, and capital investment in each of these countries in order to receive these favorable tax rates or be subject to the statutory rates. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of global business, there are many transactions for which the ultimate tax outcome is uncertain. We have appropriately reserved for our tax uncertainties based on the criteria established by SFAS 5, *"Accounting for Loss Contingencies"*.

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

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Transactions with Related and Other Parties

The Company leases its headquarters in Lake Mary, Florida from Xenon Research, Inc., all of the issued and outstanding capital stock of which is owned by Simon Raab, the Company's Chairman and Co-Chief Executive Officer, and Diana Raab, his spouse. The prior lease expired on February 28, 2006, and the Company executed a new Lease Agreement on August 8, 2006 with Xenon Research. The term of the Lease commenced as of July 1, 2006 and expires at midnight on July 1, 2011 (the "Initial Term"). The Lease will be automatically renewed for one successive five-year term unless the Company provides Xenon Research with written notice of non-renewal at least 90 days prior to the end of the term. The Company also has a one-time right to terminate the Lease after three years (from July 1, 2006) upon written notice delivered to the Landlord one year prior to the date upon which the Company wishes to terminate the Lease.

During the first year of the Initial Term, the fixed rent will be $302,750 per annum payable monthly. Each year thereafter (on July 1), the fixed rent will be increased by three percent over the fixed rent for the preceding year. The lease is a "net lease," meaning that the Company also is responsible for real estate taxes and insurance expenses covering the leased premises. The real estate taxes and insurance expenses are paid by Xenon Research, and the Company reimburses Xenon Research in equal monthly payments for such real estate taxes and insurance expenses with the reimbursement amount to be computed annually based on the real estate taxes and insurance expenses actually paid by Xenon Research. All payments of fixed rent and additional rent will include all applicable sales and use taxes.

Foreign Exchange Exposure

We conduct a significant portion of our business outside the United States. At present, approximately 58% of our revenues are invoiced, and a significant portion of our operating expenses paid, in foreign currencies. Fluctuations in exchange rates between the U.S. dollar and such foreign currencies may have a material adverse effect on our business, results of operations and financial condition, and could specifically result in foreign exchange gains and losses. The impact of future exchange rate fluctuations on the results of our operations cannot be accurately predicted. To the extent that the percentage of our non-U.S. dollar revenues derived from international sales increases (or decreases) in the future, our exposure to risks associated with fluctuations in foreign exchange rates may increase (or decrease).

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

Item 4. Controls and Procedures

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of its management, including its Co-Chief Executive Officers and its Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures as such term is defined under Securities Exchange Act of 1934, as amended (the "Exchange Act") Rule 13a-15(e). Based on that evaluation, the Company's Co-Chief Executive Officers and Chief Financial Officer concluded that as of the end of the period covered by this report the Company's disclosure controls and procedures were, as a result of the investigation described below, ineffective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) accumulated and communicated to the Company's management, including its Co-Chief Executive Officers and Chief Financial Officer, to allow timely decisions regarding required disclosure.

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As previously reported on the Company's Form 10-K for the year ended December 31, 2005 and Forms 10-Q for the first quarter ended April 1, 2006 and the second quarter ended July 1, 2006, the Company learned that its China subsidiary had made payments to certain customers in China that may have violated the FCPA and other applicable laws. The Company's Audit Committee instituted an internal investigation into this matter, and the Company voluntarily notified the SEC and the DOJ of this matter and provided them with information obtained during the course of the investigation and is cooperating with both agencies. The Company's internal investigation has identified certain payments made in China and deficiencies in its controls with respect to its operations in China in possible violation of the FCPA.

Management has evaluated the effectiveness of internal control over financial reporting as of December 31, 2005, in relation to criteria described in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations Commission of the Treadway Commission (COSO). Based upon this evaluation and the facts that arose prior to filing the Form 10-K for the year ended December 31, 2005, management has concluded that certain deficiencies exist in the design and operation of internal controls related to financial reporting, which represent a material weakness in internal control over financial reporting.

As a result of these findings, management has undertaken the following actions to address the control deficiencies:

- Contracted with a third party forensics accounting team to conduct an in-depth audit of the operations in China and in other countries in the Asia-Pacific Region and to make recommendations for improvement to the internal control systems.

- Reviewing third party distributor arrangements in an effort to assure that all contracts include adherence to the FCPA.

- Performing due diligence on all third party distributors and implementing a process to assess potential new distributors.

- Established an in-house internal audit function including hiring a Director of Internal Audit.

- Consolidating the human resources, financial accounting and reporting functions for the Asia region into the Singapore operations.

- Implemented an internal certification process to ascertain whether similar issues may exist elsewhere in the Company.

- Implemented a quarterly internal certification process to confirm adherence to company policy and all applicable laws and regulations that will include all regional leadership, country management and other sales management.

- Implementing additional training on FCPA and other matters for employees and a confidential compliance reporting system.

The matters described above constitute changes to the Company's internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

As previously reported on the Company's Form 10-K for the year ended December 31, 2005 and Form 10-Q for the nine month period ended October 1, 2005, commencing January of 2005, the Company implemented a new enterprise resource planning ("ERP") system. In order to ensure that the system had been properly implemented, management tested the physical inventory in October of 2005. This testing identified a difference between the book balance reflected in the financial records and the physical inventory of approximately $1.6 million related to inventory costing

and consumption variances. The Company believes that this represented a significant deficiency with regard to the Company's internal controls. As a result of the discovery of this significant deficiency, the Company reviewed the inventory and production process maps and controls and implemented changes to its internal control over financial reporting. These changes include, but are not limited to, the security for item card setup and change, cycle count sample sizes and controls over the physical inventory reconciliation process. The implementation of the remediation steps has been completed.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Litigation— On November 25, 2003, Cimcore-Romer (now a division of Hexagon) filed a patent infringement suit against us in the Federal District Court for the Southern District of California alleging that certain of our products sold in the United States, including the FARO Arm, infringe U.S. Patent 5,829,148 ('148 patent). The Company believes, and has contended in this litigation, that the Company does not infringe the '148 patent and that the '148 patent is invalid.

On July 12, 2005, the court issued an order granting Cimcore-Romer's motion for summary judgment of infringement of three claims of the ‘148 patent. On July 22, 2005, the Company announced its decision to limit the capability of its U.S.-based FARO Arm products (the FARO Arm, the FARO Gage and the Digital Template) by removing what we call the "infinite rotation feature" by reducing this capability to 50 rotations or fewer. FARO believes that by limiting the range of the joint rotation to 50 rotations, it has removed from its U.S. products the ability to sweep through an unlimited arc, which is a feature of the ‘148 patent claims addressed by the court’s ruling required to infringe the '148 patent. The revised products have not, however, been considered by the courts. Accordingly, the Company cannot give assurance that the revised products will not be deemed to infringe the ‘148 patent.

On September 20, 2005, the Court vacated its order of summary judgment of infringement and agreed to reconsider its conclusions from the patent claim construction (“Markman”) ruling, which is a pretrial hearing often used in patent infringement cases. The new Markman hearing occurred on October 3, 2005 and the hearing-on-summary judgments of infringement occurred on November 14, 2005. On October 18, 2005, the Court issued a revised claim construction that the Company believes materially alters the Court’s previous Markman ruling by substantially narrowing what FARO believes to be key aspects of the claim construction. The Company believes that this narrower claim construction will ultimately lead to a finding that it does not infringe any claim of the ‘148 patent. On November 14, 2005, the Court denied both the Plaintiffs’ Renewed Motion for Summary Judgment of Infringement and the Defendant’s Faro’s Renewed Motion for Summary Judgment of Non-Infringement, and determined that there existed a genuine issue of material fact with respect to whether Faro infringed the assert patent. The case was originally set for trial for January 31, 2006. On January 18, 2006, the Court vacated the trial date and remanded the case to the magistrate for resumption of discovery regarding Plaintiffs’ alleged compliance with the patent marking provisions of 35 U.S.C. § 287 and all related issues. A hearing on Faro’s Motion for Partial Summary Judgment Regarding Plaintiffs’ Failure to Comply With the Patent Marking Provisions of 35 U.S.C. § 287 was held on May 11, 2006. A new trial date has been set for October 30, 2006.

In addition, the Company filed two separate requests for reexamination in the U.S. Patent and Trademark Office ("PTO") of the ‘148 Patent, both of which requests were granted. The PTO ruled in the first reexamination in September 2005. The Company believes that the PTO ruling bolsters the Company’s previous position that it does not infringe the '148 patent. More specifically, in the first reexamination, the PTO construed critical claim terms in a relatively narrow manner, which the Company believes is consistent with its stated positions in the patent litigation. The Company’s second reexamination request was granted by the PTO in November 2005 and is based on new "prior art" (that is, earlier issued patent publications) submitted to the PTO which FARO believes will ultimately invalidate the '148 patent. This prior art was not at issue in the first reexamination proceeding. The PTO has not ruled in the second reexamination request.

In the event of an adverse ruling in the Cimcore-Romer litigation, however, we could be required to pay substantial damages, cease the manufacturing, use and sale of any infringing products, discontinue the use of certain processes or obtain a license, if available, from Cimcore-Romer with royalty payment obligations by us. An adverse decision in the Cimcore-Romer case could materially and adversely affect our financial condition and results of operations. At this time, however, the Company cannot estimate the potential impact, if any, that might result from this suit, and

therefore, no provision has been made to cover such expense

Securities Litigation - On December 6, 2005, the first of four essentially identical class action securities fraud lawsuits were filed against the Company and certain officers of the Company (the "Securities Litigation"). On April 19, 2006, the four lawsuits were consolidated, and Kornitzer Capital Management, Inc. was appointed as the lead plaintiff. On May 16, 2006, Kornitzer filed its Consolidated Amended Class Action Complaint against the Company and the individual defendants. The amended complaint also names Grant Thornton LLP, the Company's independent registered public accounting firm, as an additional defendant.

In the amended complaint, Kornitzer seeks to represent a class consisting of all persons who purchased or otherwise acquired the Company's publicly traded securities between April 15, 2004 and March 15, 2006. On behalf of the alleged class, Kornitzer seeks an unspecified amount of damages, premised on allegations that each defendant made misrepresentations and omissions of material fact during the class period in violation of the Securities Exchange Act of 1934. Among other things, Kornitzer alleges that the Company's reported gross margins and net income were knowingly overstated as a result of manipulation of the Company's inventory levels, that the Company failed to disclose deficiencies associated with the Company's implementation and use of its enterprise resource planning system and material requirements planning system, made false and misleading statements regarding the Company's internal controls, failed to disclose the fact that the Company was accruing commissions and bonuses which would have a material, adverse effect upon the Company's profitability, and improperly reported sales and net income based, in part, on sales and new orders obtained in violation of the Foreign Corrupt Practices Act.

The Company filed a Motion to Dismiss the amended complaint on July 31, 2006. On August 30, 2006, Kornitzer filed its memorandum in opposition to the Company's Motion to Dismiss. On September 15, 2006, the parties' counsel presented oral argument on the Motion to Dismiss to the court. The court has not ruled on the Motion to Dismiss The Company has timely notified the issuer of its Executive Liability and Entity Securities Liability insurance policy of the Securities Litigation, and has reserved the full amount of its $250,000 retention under the policy. Although the Company believes that the material allegations made in the amended complaint are without merit and intends to vigorously defend the Securities Litigation, no assurances can be given with respect to the outcome of the Securities Litigation.

Voluntary Disclosure of Foreign Corrupt Practices Act Matter to the Securities and Exchange Commissions and Department of Justice - As previously reported on the Company's Form 10-K for the year ended December 31, 2005 and Forms 10-Q for the first quarter ended April 1, 2006 and the second quarter ended July 1, 2006, the Company learned that its China subsidiary had made payments to certain customers in China that may have violated the FCPA and other applicable laws. The Company's Audit Committee instituted an internal investigation into this matter in February 2006, and the Company voluntarily notified the SEC and the DOJ of this matter in March 2006. The internal investigation into this matter has been completed. The Company has provided to the SEC and the DOJ information obtained during the course of this investigation and is cooperating with both agencies.

The Company's internal investigation has identified certain improper payments made in China and deficiencies in its controls with respect to its operations in China in possible violation of the FCPA. If the SEC or the DOJ determines that violations of the FCPA have occurred, they could seek civil and criminal sanctions, including monetary penalties, against the Company and/or certain of its employees, as well as additional changes to the Company's business practices and compliance programs. Based on current information, it is not possible to predict at this time when the SEC or DOJ investigations will be resolved, what the outcome will be, what sanctions, if any, will be imposed, or the effect that such matters may ultimately have on the Company or its consolidated financial statements. Results of the investigation revealed that referral fee payments in possible violation of the FCPA were $165,000 and $265,000 in 2004 and 2005, respectively, which were recorded in selling expenses in the Company's statement of income. The related sales to customers to which payment of these referral fees had been made totaled approximately $1.3 million and $3.24 million in 2004 and 2005, respectively. Additional improper referral fee payments of $122,000 were made in January and February 2006 related to sales contracts in 2005. The Company anticipates incurring expenses of at least $4.0 million in 2006 relating to the FCPA matter. The Company has incurred approximately $3.6 million in the

first nine months of 2006 related to the FCPA matter.

The Company has terminated certain personnel in the Asia-Pacific Region and has re-assigned the duties of other personnel in both the Asia-Pacific Region and the U.S. as a result of the internal investigation. The Company is instituting, or has instituted, the following remedial measures:

- Contracted with a third party forensics accounting team to conduct an in-depth audit of the operations in China and in other countries in the Asia-Pacific region and to make recommendations for improvement to the internal control systems.

- Reviewing third party distributor arrangements in an effort to assure that all contracts include adherence to the FCPA.

- Performing due diligence on all third party distributors and implementing a process to assess potential new distributors.

- Established an in-house internal audit function including hiring a Director of Internal Audit.

- Consolidating the human resources, financial accounting and reporting functions for the Asia region into the Singapore operations.

- Implemented an internal certification process to ascertain whether similar issues may exist elsewhere in the Company.

- Implemented a quarterly internal certification process to confirm adherence to company policy and all applicable laws and regulations that will include all regional leadership, country management and other sales management.

- Implementing additional training on FCPA and other matters for employees and a confidential compliance reporting system.

The Company reported sales in China of $9.0 million in 2005 and $4.2 million in 2004, approximately 7% and 4% of total sales, respectively. Depending on how this matter is resolved, the Company’s sales in China could be significantly impacted. The termination of certain personnel and the cessation of improper payments in China may have an adverse effect on future operations in China because such action could negatively influence the decisions of a significant number of customers of the Chinese subsidiary to do business with that subsidiary. The potential magnitude of the loss of sales in China as a result of potential violations of the FCPA cannot be estimated at this time.

During the Company’s internal investigation of its business practices in China, it became aware that income taxes related to certain commissions and bonus payments to its employees had not been properly reported. The Company has filed the appropriate payroll tax returns and remitted the deficiency.

Other than the litigation mentioned above, the Company is not involved in any other legal proceedings other than routine litigation arising in the normal course of business. The Company does not believe the results of such other litigation, even if the outcome were unfavorable to the Company, would have a material adverse effect on the Company’s business, financial condition or results of operations.

Item 1A. Risk Factors

In addition to the other information set forth in this Form 10-Q, you should carefully consider the factors discussed under “Risk Factors” in our Form 10-K for the year ended December 31, 2005 as filed with the Securities and Exchange Commission. These risks could materially and adversely affect our business, financial condition, and results of operations. The risks described in our Form 10-K for the year ended December 31, 2005 are not the only risks we face. Our operations could also be affected by additional factors that are not presently known to us or by factors that

we currently consider immaterial to our business.

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

The Company’s Annual Meeting of Shareholders was held on September 7, 2006. At such Meeting, Messrs. Simon Raab, Andre Julien, and Hubert d’Amours were elected to serve on the Company’s Board of Directors for a term of three years and Jay W. Freeland was elected for a term of two years. The terms of office of Messrs. Gregory Fraser, Norman Schipper, John Caldwell, and Stephen Cole continued after the meeting. The number of votes cast for, the number of votes withheld, and the number of broker non-votes with respect to the directors elected at the meeting were as follows:

	Votes For	Withheld	Broker Non-Votes
Simon Raab	12,720,076	905,541	0
Jay W. Freeland	12,728,500	897,117	0
Andre Julien	13,157,107	468,510	0
Hubert d’Amours	13,156,941	468,676	0

Item 5. Other Information

The Company leases its headquarters in Lake Mary, Florida from Xenon Research, Inc., all of the issued and outstanding capital stock of which is owned by Simon Raab, the Company's Chairman and Co-Chief Executive Officer, and Diana Raab, his spouse. The prior lease expired on February 28, 2006, and the Company executed a new Lease Agreement on August 8, 2006 with Xenon Research. The term of the Lease commenced as of July 1, 2006 and expires at midnight on July 1, 2011 (the “Initial Term”). The Lease will be automatically renewed for one successive five-year term unless the Company provides Xenon Research with written notice of non-renewal at least 90 days prior to the end of the term. The Company also has a one-time right to terminate the Lease after three years (from July 1, 2006) upon written notice delivered to the Landlord one year prior to the date upon which the Company wishes to terminate the Lease.

During the first year of the Initial Term, the fixed rent will be $302,750 per annum payable monthly. Each year thereafter (on July 1), the fixed rent will be increased by three percent over the fixed rent for the preceding year. The lease is a “net lease,” meaning that the Company also is responsible for real estate taxes and insurance expenses covering the leased premises. The real estate taxes and insurance expenses are paid by Xenon Research, and the Company reimburses Xenon Research in equal monthly payments for such real estate taxes and insurance expenses with the reimbursement amount to be computed annually based on the real estate taxes and insurance expenses actually paid by Xenon Research. All payments of fixed rent and additional rent will include all applicable sales and use taxes.

Item 6. Exhibits

31-A Certification of the Chairman of the Board and Co-Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31-B Certification of the President and Co-Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31-C Certification of the Principal Financial and Accounting Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32-A Certification of the Chairman of the Board and Co-Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32-B	Certification of the President and Co-Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32-C	Certification of the Principal Financial and Accounting Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

FARO Technologies, Inc.
(Registrant)

Date: October 31, 2006

/ S / Keith S. Bair

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