

FARO TECHNOLOGIES INC
Form 10-Q
October 26, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2017

OR

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

For the transition period from _____ to _____

Commission File Number: 0-23081

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

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

250 Technology Park, Lake Mary, Florida 32746
(Address of Principal Executive Offices) (Zip Code)
(407) 333-9911
(Registrant's Telephone Number, including Area Code)

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

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

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

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

Smaller reporting
company

Emerging growth company

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

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

There were 16,711,152 shares of the registrant's common stock outstanding as of October 24, 2017.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

| (in thousands, except share data) | September 30, 2017 (unaudited) | December 31, 2016 |
|--|--------------------------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 129,841 | \$ 106,169 |
| Short-term investments | 10,970 | 42,942 |
| Accounts receivable, net | 60,449 | 61,364 |
| Inventories, net | 59,044 | 51,886 |
| Prepaid expenses and other current assets | 20,919 | 16,304 |
| Total current assets | 281,223 | 278,665 |
| Property and equipment: | | |
| Machinery and equipment | 66,049 | 57,063 |
| Furniture and fixtures | 6,863 | 6,099 |
| Leasehold improvements | 19,588 | 18,778 |
| Property and equipment, at cost | 92,500 | 81,940 |
| Less: accumulated depreciation and amortization | (60,189 |) (50,262 |
| Property and equipment, net | 32,311 | 31,678 |
| Goodwill | 52,567 | 46,744 |
| Intangible assets, net | 22,983 | 22,279 |
| Service and sales demonstration inventory, net | 35,250 | 29,136 |
| Deferred income tax assets, net | 14,498 | 14,307 |
| Other long-term assets | 1,049 | 905 |
| Total assets | \$ 439,881 | \$ 423,714 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 11,964 | \$ 11,126 |
| Accrued liabilities | 22,507 | 24,572 |
| Income taxes payable | — | 618 |
| Current portion of unearned service revenues | 29,080 | 27,422 |
| Customer deposits | 3,065 | 2,872 |
| Total current liabilities | 66,616 | 66,610 |
| Unearned service revenues - less current portion | 12,665 | 13,813 |
| Deferred income tax liabilities | 1,683 | 1,409 |
| Other long-term liabilities | 2,191 | 2,225 |
| Total liabilities | 83,155 | 84,057 |
| Commitments and contingencies - See Note 16 | | |
| Shareholders' equity: | | |
| Common stock - par value \$.001, 50,000,000 shares authorized; 18,197,628 and 18,170,267 issued, respectively; 16,711,152 and 16,680,791 outstanding, respectively | 18 | 18 |
| Additional paid-in capital | 218,242 | 212,602 |
| Retained earnings | 179,682 | 183,436 |
| Accumulated other comprehensive loss | (9,387 |) (24,561 |
| Common stock in treasury, at cost; 1,486,476 and 1,489,476 shares, respectively | (31,829 |) (31,838 |

| | | |
|--|------------|------------|
| Total shareholders' equity | 356,726 | 339,657 |
| Total liabilities and shareholders' equity | \$ 439,881 | \$ 423,714 |

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

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

| (in thousands, except share and per share data) | Three Months Ended | | Nine Months Ended | |
|--|--------------------|------------|-------------------|------------|
| | September | September | September | September |
| | 30, 2017 | 30, 2016 | 30, 2017 | 30, 2016 |
| Sales | | | | |
| Product | \$68,563 | \$ 61,280 | \$193,476 | \$ 182,232 |
| Service | 21,687 | 18,320 | 61,018 | 51,654 |
| Total sales | 90,250 | 79,600 | 254,494 | 233,886 |
| Cost of Sales | | | | |
| Product | 26,673 | 25,880 | 78,186 | 74,938 |
| Service | 11,543 | 11,042 | 33,765 | 29,665 |
| Total cost of sales (exclusive of depreciation and amortization, shown separately below) | 38,216 | 36,922 | 111,951 | 104,603 |
| Gross Profit | 52,034 | 42,678 | 142,543 | 129,283 |
| Operating Expenses: | | | | |
| Selling and marketing | 25,990 | 19,781 | 74,884 | 56,399 |
| General and administrative | 10,307 | 10,747 | 32,883 | 31,139 |
| Depreciation and amortization | 4,368 | 3,381 | 12,075 | 9,733 |
| Research and development | 9,019 | 7,928 | 26,530 | 22,344 |
| Total operating expenses | 49,684 | 41,837 | 146,372 | 119,615 |
| Income (loss) from operations | 2,350 | 841 | (3,829) |) 9,668 |
| Other (income) expense | | | | |
| Interest income, net | (78) |) (21) |) (249) |) (119) |
| Other (income) expense, net | (147) |) (167) |) 320 | 824 |
| Income (loss) before income tax expense (benefit) | 2,575 | 1,029 | (3,900) |) 8,963 |
| Income tax expense (benefit) | 947 | (61) |) (442) |) 1,401 |
| Net income (loss) | \$1,628 | \$ 1,090 | \$(3,458) |) \$7,562 |
| Net income (loss) per share - Basic | \$0.10 | \$ 0.07 | \$(0.21) |) \$0.45 |
| Net income (loss) per share - Diluted | \$0.10 | \$ 0.07 | \$(0.21) |) \$0.45 |
| Weighted average shares - Basic | 16,708,446 | 16,674,176 | 16,697,729 | 16,647,662 |
| Weighted average shares - Diluted | 16,796,518 | 16,701,617 | 16,697,729 | 16,669,550 |

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

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

| (in thousands) | Three Months Ended | | Nine Months Ended | |
|---|--------------------|--------------------|--------------------|--------------------|
| | September 30, 2017 | September 30, 2016 | September 30, 2017 | September 30, 2016 |
| Net income (loss) | \$1,628 | \$ 1,090 | \$(3,458) | \$ 7,562 |
| Currency translation adjustments, net of income tax | 3,875 | 1,339 | 15,174 | 6,165 |
| Comprehensive income | \$5,503 | \$ 2,429 | \$11,716 | \$ 13,727 |

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

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

| (in thousands) | Nine Months Ended | |
|--|--------------------|--------------------|
| | September 30, 2017 | September 30, 2016 |
| Cash flows from: | | |
| Operating activities: | | |
| Net (loss) income | \$(3,458) | \$7,562 |
| Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities: | | |
| Depreciation and amortization | 12,075 | 9,733 |
| Stock-based compensation | 4,823 | 4,068 |
| Provision for bad debts | 321 | 727 |
| Loss on disposal of assets | 263 | 814 |
| Provision for excess and obsolete inventory | 1,271 | 2,937 |
| Deferred income tax expense (benefit) | 224 | (734) |
| Income tax benefit from exercise of stock options | — | (354) |
| Change in operating assets and liabilities: | | |
| Decrease (increase) in: | | |
| Accounts receivable | 3,701 | 12,850 |
| Inventories | (11,450) | (8,689) |
| Prepaid expenses and other current assets | (3,834) | (995) |
| (Decrease) increase in: | | |
| Accounts payable and accrued liabilities | (2,774) | 1,128 |
| Income taxes payable | (598) | — |
| Customer deposits | (6) | (1,155) |
| Unearned service revenues | (1,326) | 559 |
| Net cash (used in) provided by operating activities | (768) | 28,451 |
| Investing activities: | | |
| Proceeds from sale of investments | 32,000 | 11,000 |
| Purchases of property and equipment | (6,081) | (5,272) |
| Payments for intangible assets | (1,345) | (1,440) |
| Acquisition of business | (5,496) | (20,911) |
| Net cash provided by (used in) investing activities | 19,078 | (16,623) |
| Financing activities: | | |
| Payments on capital leases | (6) | (6) |
| Payment of contingent consideration for acquisitions | (521) | (434) |
| Income tax benefit from exercise of stock options | — | 354 |
| Proceeds from issuance of stock | 387 | 519 |
| Net cash (used in) provided by financing activities | (140) | 433 |
| Effect of exchange rate changes on cash and cash equivalents | 5,502 | 1,732 |
| Increase in cash and cash equivalents | 23,672 | 13,993 |
| Cash and cash equivalents, beginning of period | 106,169 | 107,356 |
| Cash and cash equivalents, end of period | \$129,841 | \$121,349 |
| The accompanying notes are an integral part of these condensed consolidated financial statements. | | |

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

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

NOTE 1 – DESCRIPTION OF BUSINESS

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

We report our segment information in accordance with the provisions of Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 280, Segment Reporting (“FASB ASC Topic 280”). During fiscal 2016, we evaluated our reportable segments based on our new internal management structure organized around operating activities and the changes implemented in connection with our initiatives to reorganize our business around certain vertical markets. We evaluate business performance based upon several metrics, using revenue growth and segment profit as the primary financial measures. As a result of this assessment, we now report our activities in the following three reportable segments:

The Factory Metrology reporting segment provides solutions for manual and automated measurement and inspection in an industrial or manufacturing environment. Applications include alignment, part inspection, dimensional analysis, first article inspection, incoming and in-process inspection, machine calibration, non-contact inspection, robot calibration, tool building and set-up, and assembly guidance.

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

The Other reporting segment includes our Product Design, Public Safety Forensics and 3D Machine Vision (formerly known as 3D Solutions) operating segments. Our Product Design operating segment provides advanced 3D solutions

to assist in the engineering or design of a movable object, enabling a full digital workflow for applications that include reverse engineering and virtual simulation. Our Public Safety Forensics operating segment provides solutions to public safety officials and professionals to capture environmental or situational scenes in 2D and 3D for crime, crash and fire scene investigations and environmental safety evaluations. Our 3D Machine Vision operating segment provides solutions to customers who require customized 3D measurement and realization solutions not otherwise addressed by our off-the-shelf product offerings.

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All operating segments that do not meet the criteria to be reportable segments are aggregated in the Other reporting segment and have been combined based on the aggregation criteria and quantitative thresholds in accordance with the provisions of FASB ASC Topic 280. There has been no change in our total consolidated financial condition or results of operations previously reported as a result of the change in our reportable segments. The amounts related to our segment information for the three and nine months ended September 30, 2016 have been restated throughout this Quarterly Report on Form 10-Q to reflect the change in reporting segments. Each of our reporting segments employs consistent accounting policies. See Note 15 – Segment Reporting for further information.

NOTE 2 – PRINCIPLES OF CONSOLIDATION

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

NOTE 3 – BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements and notes thereto have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) for interim financial information and with the instructions of Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These condensed consolidated financial statements include all normal recurring accruals and adjustments considered necessary by management for a fair presentation in conformity with U.S. GAAP. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates. The condensed consolidated results of operations for the three and nine months ended September 30, 2017 are not necessarily indicative of results that may be expected for the year ending December 31, 2017 or any future interim period.

The information included in this Quarterly Report on Form 10-Q, including the interim condensed consolidated financial statements and the accompanying notes, should be read in conjunction with the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016. The accompanying December 31, 2016 condensed consolidated balance sheet has been derived from those audited consolidated financial statements.

NOTE 4 – RECLASSIFICATIONS

Certain prior period amounts have been reclassified in the accompanying condensed consolidated financial statements to conform to the current period presentation. Certain prior period stock compensation expenses were reclassified between cost of product sales, cost of service sales, selling and marketing, general and administrative, and research and development expenses in the accompanying condensed consolidated statements of operations for the three and nine months ended September 30, 2016 to reflect the appropriate departmental costs. In addition, deferred income tax assets, net were reclassified from current to non-current in our condensed consolidated balance sheet as of December 31, 2016 as a result of adopting Accounting Standards Update (“ASU”) No. 2015-17, Income Taxes (Topic 740: Balance Sheet Classification of Deferred Taxes (“ASU 2015-17”). See Note 5 – Impact of Recently Issued Accounting Pronouncements for further details.

NOTE 5 – IMPACT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In January 2017, the FASB issued ASU No. 2017-04, Intangible - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment (“ASU 2017-04”), which is intended to simplify the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Under the current guidance, performance of Step 2 requires us to calculate the implied fair value of goodwill by following procedures that would be required in determining the fair value of assets acquired and liabilities assumed in a business combination. Under the new guidance, we will perform our goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An

impairment charge will be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value up to the amount of the goodwill allocated to the reporting unit. The new guidance also eliminates the requirements for any reporting unit with a zero or negative carrying amount to perform Step 2 of the goodwill impairment test if it fails the qualitative assessment. As a result, all reporting units will be subject to the same impairment assessment. We will still have the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary.

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ASU 2017-04 becomes effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019, with early adoption permitted for annual or any interim goodwill impairment tests after January 1, 2017. The amendments in this ASU will be applied on a prospective basis. Disclosure of the nature and reason for the change in accounting principle is required upon transition. This disclosure is required in the first annual period and in the interim period within the first annual period when we initially adopt the amendments in this ASU. We do not expect that the adoption of this guidance will have a material impact on our consolidated financial statements.

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

ASU 2017-01 becomes effective for annual periods beginning after December 15, 2017, including interim periods within those periods, and will be applied prospectively commencing on the effective date. No disclosures are required at transition. Early application is permitted under certain circumstances. We do not expect that the adoption of this guidance will have a material impact on our consolidated financial statements.

In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other than Inventory (“ASU 2016-16”), which removes the prohibition in ASC Topic 740, Income Taxes, against the immediate recognition of the current and deferred income tax effects of intra-entity transfers of assets other than inventory. This ASU requires the tax effects of intra-entity transactions, other than sales of inventory, to be recognized when the transfer occurs, instead of deferred until the transferred asset is sold to a third party or otherwise recovered through use of the asset. The new guidance must be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption and is effective for annual periods beginning after December 15, 2017, and interim periods therein, with early adoption permitted. Currently, we do not expect that the adoption of this guidance will have a material impact on our consolidated financial statements. We will continue to monitor our business for changes that could be impacted due to the adoption of this guidance.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (“ASU 2016-15”), which clarifies how companies present and classify certain cash receipts and cash payments in the statement of cash flows. ASU 2016-15 is effective for annual periods beginning after December 15, 2017, and interim periods therein. Early adoption is permitted. We do not expect that the adoption of this guidance will have a material impact on our consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) (“ASU 2016-02”), which is intended to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. ASU 2016-02 must be applied on a modified retrospective basis and is effective for fiscal years beginning after December 15, 2018, and interim periods within those years, with early adoption permitted. We are currently evaluating the impact of adopting this standard on our consolidated financial statements and related disclosures.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers: (Topic 606) (“ASU 2014-09”), amending its accounting guidance related to revenue recognition. Under this ASU and subsequently issued amendments, revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Additional disclosures are required to provide the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. The ASU and subsequently issued amendments to it are effective for us on January 1, 2018 and permit the use of either the full retrospective or modified retrospective method.

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We are currently evaluating the effect that this guidance will have on our consolidated financial statements by analyzing both transactional and analytical data for each of our revenue streams. The following is a status of our evaluation of impacts by significant revenue stream:

- Measurement equipment and related software: Under current accounting guidance, sales of measurement, imaging and realization equipment and related software sales are generally recognized upon shipment, as we consider the earnings process complete as of the shipping date. The related software sold with our measurement, imaging and realization equipment functions together with such equipment to deliver the tangible product's essential functionality. Upon adopting the new guidance, we do not expect material changes to our accounting for revenue related to our measurement, imaging and realization equipment and related software.

- Extended warranties: Under current accounting guidance, extended warranty sales are recognized on a straight-line basis over the term of the warranty. Upon adopting the new guidance, we do not expect material changes to our accounting for revenue related to extended warranties.

- Software: Under current accounting guidance, software only sales are recognized when no further significant production, modification or customization of the software is required and when 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. These software arrangements generally include short-term maintenance that is considered post-contract support. Maintenance renewals, when sold, are recognized on a straight-line basis over the term of the maintenance agreement. Upon adopting the new guidance, we do not expect material changes to our accounting for revenue related to software only sales and maintenance renewals.

Currently, we recognize sales commission expense as incurred. Under the new guidance, we expect to capitalize the commission expense for those sales arrangements that extend beyond one year and amortize such costs ratably over the term of the contract. As a result, we expect to have an increase in deferred costs on our consolidated balance sheet upon the adoption of the new guidance; however, we are still evaluating the expected impact of this change on our consolidated balance sheet. We do not expect that this will result in a material change to our results of operations or cash flows.

We plan to adopt this guidance utilizing the modified retrospective method and plan to apply the modified retrospective method only to contracts that are not completed as of the date of initial adoption, an option that is available under ASC Topic 606.

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"), simplifying several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 became effective for annual periods beginning after December 15, 2016, and interim periods therein (our fiscal year 2017). We adopted ASU 2016-09 effective January 1, 2017. Under the new guidance, excess tax benefits that were not previously recognized because the related tax deduction had not reduced current taxes payable are to be recorded on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the period in which the new guidance is adopted. Historically, we recognized all excess tax benefits when an option was exercised or a share vested since we did not have a U.S. net operating loss carryforward. Therefore, no adjustment to retained earnings for prior excess tax benefits was required upon adoption.

Under the new guidance, all tax-related cash flows resulting from share-based payments are reported as operating activities in the statement of cash flows. This approach incorporates the net of the inflow and outflow from all tax-related cash flows resulting from share-based payments in the deferred income tax expense (benefit) line item and presents it along with other income tax cash flows as operating activities in the statement of cash flows. Effective January 1, 2017, we adopted this portion of the guidance on a prospective basis and therefore did not restate the prior period's condensed consolidated statement of cash flows.

We also elected to account for forfeitures related to the service condition-based awards as they occur effective January 1, 2017, which is a change from previous guidance that required an estimate of forfeitures. However, we continue to assess performance condition-based awards quarterly as required. In adopting the new policy using a modified

retrospective approach, we assessed the cumulative effect adjustment and recorded to retained earnings the difference between the amount of compensation cost previously recorded and the amount that would have been recorded without assuming forfeitures. The cumulative effect adjustment recorded to retained earnings, net of income tax benefit, was not material.

In November 2015, the FASB issued ASU 2015-17, which requires that deferred tax liabilities and assets be classified as noncurrent in a classified balance sheet. ASU 2015-17 became effective for us on January 1, 2017. We adopted this guidance on

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a retrospective basis, which resulted in the reclassification of current deferred tax assets totaling approximately \$7.6 million as of December 31, 2016 from current to non-current in these condensed consolidated financial statements. In July 2015, the FASB issued ASU 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory (“ASU 2015-11”), which changes the measurement principle for inventory from the lower of cost or market to the lower of cost or net realizable value. ASU 2015-11 defines net realizable value as estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The new guidance must be applied on a prospective basis and became effective for fiscal years beginning after December 15, 2016 (i.e., our fiscal year 2017), and interim periods within those years, with early adoption permitted. We adopted ASU 2015-11 effective January 1, 2017. The adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

NOTE 6 – STOCK-BASED COMPENSATION

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

We have three compensation plans that provide for the granting of stock options and other share-based awards to key employees and non-employee members of the Board of Directors (the “Board”). The 2004 Equity Incentive Plan (“2004 Plan”), the 2009 Equity Incentive Plan (“2009 Plan”), and the 2014 Equity Incentive Plan (“2014 Plan”) provide for granting options, restricted stock, restricted stock units or stock appreciation rights to employees and non-employee directors. In May 2014, our shareholders approved the 2014 Plan, authorizing us to grant awards for up to 1,974,543 shares of common stock, as well as any shares underlying awards outstanding under the 2004 Plan and 2009 Plan as of the effective date of the 2014 Plan that thereafter terminate or expire unexercised or are canceled, forfeited or lapse for any reason. Under the terms of the 2014 Plan, we are not permitted to make any further grants under the 2004 Plan or the 2009 Plan.

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

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

Our annual grants in March 2017 and March 2016 consisted of stock options and restricted stock units that are subject to only time-based vesting. The number of stock options and/or restricted stock units granted was based on the employee’s individual objectives, performance against operational metrics assigned to the employee and overall contribution over the last year. The stock options vest in three equal annual installments beginning one year after the grant date. The restricted stock unit awards vest in full on the three-year anniversary of the grant date. The fair value of these stock-based awards is determined by using (a) the Black-Scholes option valuation model in the case of stock options or (b) the current market price of our common stock on the grant date in the case of restricted stock units. In 2015, we granted performance-based stock options and restricted stock units to certain executives. These awards vest in three annual installments beginning one year after the grant date if the applicable performance measures or strategic objectives are achieved. The related stock-based compensation expense is recognized over the requisite service period, taking into account the probability that we will satisfy the performance measures or strategic

objectives. In addition to certain strategic objectives, the performance-based stock options and restricted stock units granted in 2015 are earned and vest based upon (1) our achievement of specified revenue and earnings per share targets, and (2) our total shareholder return (“TSR”) relative to the TSR attained by companies within our defined peer group.

Due to the application of TSR to certain performance-based grants, the fair value of these awards is determined using the Monte Carlo Simulation valuation model. We expense these market condition awards over the three-year vesting period regardless of the value the award recipients ultimately receive. In February 2017, our Compensation Committee determined that 9,616 performance-based stock options and 300 restricted stock units were earned for the 2016 performance period and 19,362 stock options and 604 restricted stock units were unearned, as the required metrics were not achieved.

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The Black-Scholes option valuation model incorporates assumptions as to stock price volatility, the expected life of options or awards, a risk-free interest rate and dividend yield. The weighted-average grant-date fair value of the stock options that were granted during the nine months ended September 30, 2017 and September 30, 2016 and valued using the Black-Scholes option valuation model was \$14.51 and \$12.42 per option, respectively. For stock options granted during the nine months ended September 30, 2017 and September 30, 2016 valued using the Black-Scholes option valuation model, we used the following assumptions:

| | Nine Months Ended | |
|--------------------------------------|-----------------------|-----------------------|
| | September 30, 2017 | September 30, 2016 |
| Risk-free interest rate | 1.88% - 2.02% | 1.06% - 1.21% |
| Expected dividend yield | — | % — % |
| Expected term of option | 5 years | 4 years |
| Expected volatility | 45.2 | % 46.7% - 47.0% |
| Weighted-average expected volatility | 45.2 | % 46.7 % |

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

A summary of stock option activity and weighted-average exercise prices during the nine months ended September 30, 2017 follows:

| | Options | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value as of September 30, 2017 |
|---|-----------|---------------------------------|---|--|
| Outstanding at January 1, 2017 | 1,090,160 | \$ 48.02 | | |
| Granted | 267,039 | 34.79 | | |
| Forfeited or expired | (72,015) | 44.39 | | |
| Exercised | (14,520) | 26.68 | | |
| Unearned performance-based options | (19,362) | 59.97 | | |
| Outstanding at September 30, 2017 | 1,251,302 | \$ 45.47 | 4.2 | \$ 2,235 |
| Options exercisable at September 30, 2017 | 963,891 | \$ 42.82 | 3.0 | \$ 612 |

The total intrinsic value of stock options exercised during each of the three months ended September 30, 2017 and September 30, 2016 was less than \$0.1 million. For the nine months ended September 30, 2017 and September 30, 2016, the total intrinsic value of stock options exercised in the respective periods was \$0.1 million and \$1.7 million. The fair value of stock options vested during each of the three months ended September 30, 2017 and September 30, 2016 was less than \$0.1 million. The fair value of stock options vested during the nine months ended September 30, 2017 and September 30, 2016 was \$3.0 million and \$3.5 million, respectively.

The following table summarizes the restricted stock and restricted stock unit activity and weighted average grant-date fair values for the nine months ended September 30, 2017:

| | Shares | Weighted-Average Grant Date Fair Value |
|--|-----------|--|
| Non-vested at January 1, 2017 | 150,682 | \$ 33.39 |
| Granted | 152,207 | 35.42 |
| Forfeited | (20,844) | 33.84 |
| Vested | (21,101) | 33.65 |
| Unearned performance-based awards (604) | | 52.83 |
| Non-vested at September 30, 2017 | 260,340 | \$ 34.60 |

We recorded total stock-based compensation expense of \$1.6 million and \$1.4 million for the three months ended September 30, 2017 and September 30, 2016, respectively, and \$4.8 million and \$4.1 million for the nine months

ended September 30, 2017 and September 30, 2016, respectively.

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As of September 30, 2017, there was \$11.0 million of total unrecognized stock-based compensation expense related to non-vested stock-based compensation arrangements. The expense is expected to be recognized over a weighted average period of 2.0 years.

NOTE 7 – CASH AND CASH EQUIVALENTS

We consider cash on hand and all short-term, highly liquid investments that have original maturities of three months or less at the time of purchase to be cash and cash equivalents.

NOTE 8 – SHORT TERM INVESTMENTS

Short-term investments at September 30, 2017 consisted of U.S Treasury Bills totaling \$11.0 million that mature through January 11, 2018. Short-term investments at December 31, 2016 consisted of U.S. Treasury Bills totaling \$42.9 million that matured through June 15, 2017. The interest rate on the U.S. Treasury Bills is less than one percent. The investments are classified as held-to-maturity and recorded at cost plus accrued interest, which approximates fair value. The fair value of the U.S. Treasury Bills at September 30, 2017 and December 31, 2016 were classed as Level 1, as they are traded with sufficient frequency and volume to enable us to obtain pricing information on an ongoing basis. For further discussion of fair value, refer to Note 14 – Fair Value of Financial Instruments.

NOTE 9 – ACCOUNTS RECEIVABLE

Accounts receivable consist of the following:

| | As of September 30, 2017 | As of December 31, 2016 |
|---------------------------------|--------------------------------|-------------------------------|
| Accounts receivable | \$ 62,489 | \$ 63,193 |
| Allowance for doubtful accounts | (2,040) | (1,829) |
| Total | \$ 60,449 | \$ 61,364 |

NOTE 10 – INVENTORIES

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

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

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

Inventories consist of the following:

| | As of September 30, 2017 | As of December 31, 2016 |
|--|--------------------------------|-------------------------------|
| Raw materials | \$ 39,285 | \$ 36,760 |
| Finished goods | 19,759 | 15,126 |
| Inventories, net | \$ 59,044 | \$ 51,886 |
| Service and sales demonstration inventory, net | \$ 35,250 | \$ 29,136 |

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NOTE 11 – EARNINGS PER SHARE

Basic earnings per share is computed by dividing net (loss) or income by the weighted average number of shares outstanding. Diluted earnings per share is computed by also considering the impact of potential common stock on both net income and the weighted average number of shares outstanding. Our potential common stock consists of employee and director stock options, restricted stock units and performance-based awards. Our potential common stock is included in the diluted earnings per share calculation when doing so would not be anti-dilutive. Performance-based awards are included in the computation of diluted earnings per share only to the extent that the underlying performance conditions (and any applicable market condition) (i) are satisfied as of the end of the reporting period or (ii) would be considered satisfied if the end of the reporting period were the end of the related contingency period and the result would be dilutive under the treasury stock method. When we report a net loss, which we did for the nine months ended September 30, 2017, the calculation of diluted net loss per share excludes our potential common stock, as the effect would be anti-dilutive.

For the three and nine months ended September 30, 2017, there were approximately 1,143,523 and 1,145,632 shares, respectively, issuable upon the exercise of options and the contingent vesting of performance-based awards that were excluded from the dilutive calculations, as they were anti-dilutive. For the three and nine months ended September 30, 2016, there were approximately 1,002,856 and 1,042,366, respectively, shares issuable upon the exercise of options and the contingent vesting of performance-based awards that were excluded from the dilutive calculations, as they were anti-dilutive.

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

| | Three Months Ended | | September 30, 2016 | |
|-------------------------------|--------------------|--------------------|--------------------|--------------------|
| | September 30, 2017 | September 30, 2016 | September 30, 2016 | September 30, 2016 |
| | Shares | Per-Share Amount | Shares | Per-Share Amount |
| Basic EPS | 16,708,446 | \$ 0.10 | 16,674,176 | \$ 0.07 |
| Effect of dilutive securities | 88,072 | — | 27,441 | — |
| Diluted EPS | 16,796,518 | \$ 0.10 | 16,701,617 | \$ 0.07 |

| | Nine months ended | | September 30, 2016 | |
|-------------------------------|--------------------|--------------------|--------------------|--------------------|
| | September 30, 2017 | September 30, 2016 | September 30, 2016 | September 30, 2016 |
| | Shares | Per-Share Amount | Shares | Per-Share Amount |
| Basic EPS | 16,697,729 | \$ (0.21) | 16,647,662 | \$ 0.45 |
| Effect of dilutive securities | — | — | 21,888 | — |
| Diluted EPS | 16,697,729 | \$ (0.21) | 16,669,550 | \$ 0.45 |

NOTE 12 – ACCRUED LIABILITIES

Accrued liabilities consist of the following:

| | As of | As of |
|-----------------------------------|---------------|--------------|
| | September 30, | December 31, |
| | 2017 | 2016 |
| Accrued compensation and benefits | \$ 12,347 | \$ 13,649 |
| Accrued warranties | 2,584 | 2,594 |
| Professional and legal fees | 1,442 | 1,775 |
| Taxes other than income | 2,697 | 4,026 |
| Other accrued liabilities | 3,437 | 2,528 |
| | \$ 22,507 | \$ 24,572 |

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Activity related to accrued warranties was as follows:

| | Nine Months Ended September 30, | |
|-------------------------------------|--|-----------------------|
| | 2017 | September 30, 2016 |
| Balance, beginning of period | \$2,594 | \$ 2,309 |
| Provision for warranty expense | 2,606 | 2,292 |
| Fulfillment of warranty obligations | (2,616) | (1,925) |
| Balance, end of period | \$2,584 | \$ 2,676 |

NOTE 13 – INCOME TAXES

For the three months ended September 30, 2017, we recorded income tax expense of \$0.9 million compared with an income tax benefit of \$0.1 million for the three months ended September 30, 2016. Our effective tax rate was 36.8% for the three months ended September 30, 2017 compared with a 5.9% benefit in the prior year period. The change in our income tax expense (benefit) and the increase in our effective tax rate were primarily due to a shift in the geographic mix of pretax income expected for the full year 2017.

For the nine months ended September 30, 2017, we recorded an income tax benefit of \$0.4 million compared with income tax expense of \$1.4 million for the nine months ended September 30, 2016. This change of \$1.8 million was due to a pretax loss during the nine months ended September 30, 2017 compared to pretax income in the same period of 2016. Our effective tax rate decreased by 4.3 percentage points to 11.3% for the nine months ended September 30, 2017 from 15.6% for the same period of 2016. The change was primarily due to the pretax loss during the nine months ended September 30, 2017 compared with pretax income during the same period of 2016 and a shift in the geographic mix of pretax income expected for the full year 2017. Our effective tax rate continued to be lower than the statutory tax rate in the United States, mainly due to our global footprint in foreign jurisdictions with lower tax rates. However, our effective tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of our products and the resulting effect on taxable income in each jurisdiction.

NOTE 14 – FAIR VALUE OF FINANCIAL INSTRUMENTS

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

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

| | As of September 30, 2017 | | |
|------------------------------|-----------------------------|---------|-----------|
| | Level 1 | Level 2 | Level 3 |
| Assets: | | | |
| Short-term investments (1) | \$ 10,970 | \$ — | \$ — |
| Total | \$ 10,970 | \$ — | \$ — |
| Liabilities: | | | |
| Contingent consideration (2) | \$ — | \$ — | \$ —1,742 |
| Total | \$ — | \$ — | \$ —1,742 |

| | As of December 31, 2016 | | |
|----------------------------|----------------------------|---------|---------|
| | Level 1 | Level 2 | Level 3 |
| Assets: | | | |
| Short-term investments (1) | \$ 42,942 | \$ — | \$ — |

| | | | |
|------------------------------|----------|----|----------|
| Total | \$42,942 | \$ | —\$— |
| Liabilities: | | | |
| Contingent consideration (2) | \$— | \$ | —\$2,100 |
| Total | \$— | \$ | —\$2,100 |

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

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Contingent consideration liability represents arrangements to pay the former owners of certain companies we acquired. The remaining undiscounted maximum payment under the arrangements is \$5.6 million. We estimated the fair value of the contingent consideration using a Monte Carlo Simulation, which is based on significant inputs, primarily forecasted future results of the acquired businesses not observable in the market, and thus represents a (2) Level 3 measure. During the three and nine months ended September 30, 2017, we paid \$0.5 million as part of these arrangements. During the three and nine months ended September 30, 2016, we paid \$0.3 million and \$0.4 million, respectively, as part of these arrangements. The remaining change in the fair value of the contingent consideration from December 31, 2016 to September 30, 2017 is related to changes in foreign currency rates.

NOTE 15 – SEGMENT REPORTING

We have three reportable segments; Factory Metrology, Construction BIM-CIM, and Other. These segments are based upon the vertical markets that we currently serve. Business activities that do not meet the criteria to be reportable segments are aggregated in the Other category.

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

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

Our segment structure presented below represents a change from geographic segments due to the reorganization which took place in the year ended December 31, 2016. The amounts for the three and nine months ended September 30, 2016 have been restated to reflect the change in reporting segments. Each of our segments employs consistent accounting policies.

The following tables present information about our reportable segments, including a reconciliation of total segment profit to Income (Loss) from Operations included in the condensed consolidated statements of operations for the three and nine months ended September 30, 2017 and 2016:

| | Factory Metrology | Construction BIM-CIM | Other | Total |
|---------------------------------------|----------------------|-------------------------|----------|-----------|
| Three Months Ended September 30, 2017 | | | | |
| Total sales | \$ 59,339 | \$ 22,751 | \$ 8,160 | \$ 90,250 |
| Segment profit | \$ 20,144 | \$ 5,407 | \$ 493 | \$ 26,044 |
| General and administrative | | | | 10,307 |
| Depreciation and amortization | | | | 4,368 |
| Research and development | | | | 9,019 |
| Income from operations | | | | \$ 2,350 |
| | Factory Metrology | Construction BIM-CIM | Other | Total |
| Three Months Ended September 30, 2016 | | | | |
| Total sales | \$ 58,310 | \$ 15,925 | \$ 5,365 | \$ 79,600 |
| Segment profit | \$ 16,305 | \$ 4,704 | \$ 1,888 | \$ 22,897 |
| General and administrative | | | | 10,747 |
| Depreciation and amortization | | | | 3,381 |
| Research and development | | | | 7,928 |
| Income from operations | | | | \$ 841 |

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| | Factory Metrology | Construction BIM-CIM | Other | Total |
|--------------------------------------|----------------------|-------------------------|-----------|------------|
| Nine Months Ended September 30, 2017 | | | | |
| Total sales | \$ 173,531 | \$ 60,550 | \$ 20,413 | \$ 254,494 |
| Segment profit | \$ 53,497 | \$ 13,799 | \$ 363 | \$ 67,659 |
| General and administrative | | | | 32,883 |
| Depreciation and amortization | | | | 12,075 |
| Research and development | | | | 26,530 |
| Loss from operations | | | | \$(3,829) |

| | Factory Metrology | Construction BIM-CIM | Other | Total |
|--------------------------------------|----------------------|-------------------------|-----------|------------|
| Nine Months Ended September 30, 2016 | | | | |
| Total sales | \$ 168,418 | \$ 47,529 | \$ 17,939 | \$ 233,886 |
| Segment profit | \$ 53,034 | \$ 12,868 | \$ 6,982 | \$ 72,884 |
| General and administrative | | | | 31,139 |
| Depreciation and amortization | | | | 9,733 |
| Research and development | | | | 22,344 |
| Income from operations | | | | \$ 9,668 |

NOTE 16 – COMMITMENTS AND CONTINGENCIES

Leases — We lease buildings and equipment in the normal course of business under non-cancellable operating and capital leases that expire in or before 2026. Total obligations under these leases are approximately \$7.1 million for 2017.

Purchase Commitments — We enter into purchase commitments for products and services in the ordinary course of business. These purchases generally cover production requirements for 60 to 120 days as well as materials necessary to service customer units through the product lifecycle and for warranty commitments. As of September 30, 2017, we had approximately \$44.6 million in purchase commitments that are expected to be delivered within the next 12 months. To ensure adequate component availability in preparation for new product introductions, as of September 30, 2017, we also had \$0.6 million in long-term commitments for purchases to be delivered after 12 months.

Legal Proceedings — We are not involved in any legal proceedings other than routine litigation arising in the normal course of business, none of which we believe will have a material adverse effect on our business, financial condition or results of operations.

NOTE 17 – BUSINESS COMBINATIONS

In April 2017, we completed the acquisition of substantially all of the assets of Instrument Associates, LLC d/b/a Nutfield Technology (“Nutfield”), a component technology business located in Hudson, New Hampshire, which specializes in the design and manufacture of advanced galvanometer-based optical scanners, scan heads and laser kits, for a total purchase price of approximately \$5.5 million. This acquisition supports our long-term strategy to expand our presence in key markets and

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improve our existing product lines with innovative technology. The results of the acquired business' operations as of and after the date of acquisition have been included in our condensed consolidated financial statements for the three and nine months ended September 30, 2017.

In December 2016, we acquired MWF-technology, GmbH ("MWF") for a purchase price, net of cash acquired, of approximately \$6.6 million, paid with cash on hand. MWF, an innovator in mobile augmented reality solutions located near Frankfurt, Germany, provides technology that enables large, complex 3D CAD data to be transferred to a tablet device for use in mobile visualization and comparison to real world conditions. This enables real time, actionable manufacturing insight for in-process inspection, assembly, guidance and positioning.

In August 2016, we acquired Laser Projection Technologies, Inc. ("LPT") for a purchase price, net of cash acquired, of approximately \$17.2 million, paid with cash on hand. LPT, located in Londonderry, New Hampshire, specializes in laser projection and measurement systems used throughout manufacturing environments around the globe to maximize productivity and efficiency. The acquisition enhances our portfolio of 3D measurement solutions and supports our long-term strategy to expand our presence in key markets.

In July 2016, we acquired BuildIT Software & Solutions Ltd. ("BuildIT") for a purchase price, net of cash acquired, of approximately \$3.9 million, paid with cash on hand. BuildIT, a software solutions business located in Montreal, Canada, specializes in process-configurable 3D metrology software solutions with hardware agnostic interfaces. The addition of BuildIT enhances our metrology portfolio, providing customers greater software options to use in a variety of applications to reduce inspection and assembly times and increase productivity.

The acquisitions of Nutfield, MWF, LPT, and BuildIT constitute business combinations as defined by FASB ASC Topic 805, Business Combinations. Accordingly, the assets acquired and liabilities assumed were recorded at their fair values on the date of acquisition.

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

| | BuildIT | LPT | MWF | Nutfield |
|--|---------|----------|---------|----------|
| Accounts receivable | \$237 | \$54 | \$150 | \$160 |
| Inventory | — | 322 | — | 539 |
| Other assets | 36 | 160 | 666 | 96 |
| Deferred income tax assets | — | 1,112 | — | — |
| Intangible assets | 1,015 | 5,474 | 1,816 | 2,329 |
| Goodwill (1) | 3,393 | 11,922 | 5,364 | 2,488 |
| Accounts payable and accrued liabilities | (95) | (747) | (700) | (12) |
| Other liabilities | (471) | (1,086) | (345) | (104) |
| Deferred income tax liabilities | (205) | — | (364) | — |
| Total purchase price, net of cash acquired | \$3,910 | \$17,211 | \$6,587 | \$5,496 |

(1) The goodwill arising from the acquisitions is not expected to be tax deductible.

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

| | BuildIT | | LPT | | MWF | | Nutfield | |
|--|----------|-------------------------------|----------|-------------------------------|----------|-------------------------------|----------|-------------------------------|
| | Amount | Weighted Average Life (Years) | Amount | Weighted Average Life (Years) | Amount | Weighted Average Life (Years) | Amount | Weighted Average Life (Years) |
| Trade name | \$ 346 | 7 | \$ 64 | 1 | \$ 36 | 1 | \$ 29 | 1 |
| Non-competition agreement | 31 | 5 | — | 0 | 3 | 2 | 144 | 5 |
| Technology | 361 | 7 | 4,260 | 7 | 951 | 5 | 1,970 | 10 |
| Customer relationship | 277 | 7 | 1,150 | 7 | 826 | 5 | 95 | 10 |
| Favorable in-place lease | — | 0 | — | 0 | — | 0 | 91 | 12 |
| Fair value of intangible assets acquired | \$ 1,015 | 7 | \$ 5,474 | 7 | \$ 1,816 | 5 | \$ 2,329 | 10 |

The goodwill for the Nutfield acquisition has been allocated to the Factory Metrology reporting segment. The goodwill for the BuildIT, LPT and MWF acquisitions was allocated in connection with our organizational structure realignment during 2016 using the relative fair value approach.

Acquisition and integration costs are not included as components of consideration transferred, but are recorded as expense in the period in which such costs are incurred. To date, we have incurred approximately \$0.9 million in acquisition and integration costs for the BuildIT, LPT, MWF and Nutfield acquisitions.

Pro forma financial results for BuildIT, LPT, MWF and Nutfield have not been presented because the effects of these transactions, individually and in the aggregate, were not material to our consolidated results of operations.

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

The following information should be read in conjunction with the Condensed Consolidated Financial Statements, including the notes thereto, included elsewhere in this Form 10-Q and Management’s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2016.

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

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

- an economic downturn in the manufacturing industry or the domestic and international economies in the regions of the world where we operate;
- our inability to further penetrate our customer base and target markets;
- development by others of new or improved products, processes or technologies that make our products less competitive or obsolete;
- our inability to maintain our technological advantage by developing new products and enhancing our existing products;
- risks associated with expanding international operations, such as fluctuations in currency exchange rates, difficulties in staffing and managing foreign operations, increased political and economic instability, compliance with potentially evolving import and export regulations, and the burdens and potential exposure of complying with a wide variety of U.S. and foreign laws and labor practices;
- our inability to successfully identify and acquire target companies and achieve expected benefits from, and effectively integrate, acquisitions that are consummated;
- the cyclical nature of the industries of our customers and material adverse changes in our customers’ access to liquidity and capital;
- change in the potential for the computer-aided measurement (“CAM2”) market and the potential adoption rate for our products, which are difficult to quantify and predict;
- our inability to protect our patents and other proprietary rights in the United States and foreign countries;
- our inability to adequately establish and maintain effective internal controls over financial reporting;
- fluctuations in our annual and quarterly operating results and the inability to achieve our financial operating targets as a result of a number of factors including, without limitation (i) litigation and regulatory action brought against us, (ii) quality issues with our products, (iii) excess or obsolete inventory, shrinkage or other inventory losses due to product obsolescence, change in demand for our products, scrap or material price changes, (iv) raw material price fluctuations and other inflationary pressures, (v) expansion of our manufacturing capability, (vi) the size and timing of customer orders, (vii) the amount of time that it takes to fulfill orders and ship our products, (viii) the length of our sales cycle to new customers and the time and expense incurred in further penetrating our existing customer base, (ix) increases in operating expenses required for product development and new product marketing, (x) costs associated with new product introductions, such as product development, marketing, assembly line start-up costs and low introductory period production volumes, (xi) the timing and market acceptance of new products and product enhancements, (xii) customer order deferrals in anticipation of new products and product enhancements, (xiii) the

inability of our sales and marketing programs to achieve their sales targets, (xiv) start-up costs associated with opening new sales offices outside of the United States, (xv) fluctuations in revenue without proportionate adjustments in fixed costs, (xvi) inefficiencies in the management of our inventories and fixed assets, (xvii) compliance with government regulations including health, safety, and environmental matters, (xviii) investment costs associated with the training and ramp-up time for new sales people, and (xix) manufacturing inefficiencies associated with new product introductions;

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our ability to achieve profitability;

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

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

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

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

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

difficulties in recruiting research and development engineers and application engineers;

the failure to effectively manage the effects of our growth;

the impact of reductions or projected reductions in government spending, particularly in the defense sector;

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 of time or on commercially reasonable terms;

the impact of fluctuations in exchange rates;

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

the impact of changes in technologies on the competitiveness of our products or their components;

the impact of new product introductions;

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

the sufficiency of our plants to meet manufacturing requirements;

the continuation of our share repurchase program;

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

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

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

other risks and uncertainties discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2016, and in Part II, Item 1A. Risk Factors in the Quarterly Reports on Form 10-Q for the quarterly periods ended March 31, 2017 and June 30, 2017.

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

Overview

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

(“Construction BIM-CIM”) and Public

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Safety Forensics verticals. Our FARO Laser ScanArm®, FARO Cobalt Array Imager, FARO Scanner Freestyle^{3DX} laser scanners and their companion SCENE software also enable a fully digital workflow used to capture real world geometry for the purpose of empowering design, enabling innovation, and speeding up the design cycle, supporting our Product Design vertical. FARO Visual Inspect enables large, complex 3D CAD data to be transferred to a tablet device and then used for mobile visualization and comparison to real world conditions, facilitating in-process inspection, assembly, guidance and positioning for applications in our Factory Metrology and Construction BIM-CIM verticals. Our line of galvanometer-based scan heads and laser scan controllers are used in a variety of laser applications and are integrated into larger components and systems.

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

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

We manufacture our FaroArm®, FARO Laser ScanArm®, FARO Gage, and FARO Laser Tracker™ products in our manufacturing facility located in Switzerland for customer orders from Europe, the Middle East and Africa, in our manufacturing facility located in Singapore for customer orders from the Asia-Pacific region, and in our manufacturing facilities located in Florida and Pennsylvania for customer orders from the Americas. We manufacture our FARO Focus^{3D} in our manufacturing facilities located in Germany and Switzerland for customer orders from Europe, the Middle East, Africa and the Asia-Pacific region, and in our manufacturing facility located in Pennsylvania for customer orders from the Americas. We manufacture our FARO Freestyle^{3DX} products in our facility located in Germany. We manufacture our FARO Laser Projection products in our facility located in Pennsylvania. We expect all of our existing plants to have the production capacity necessary to support our volume requirements through the remainder of 2017.

We account for wholly owned foreign subsidiaries in the currency of the respective foreign jurisdiction; therefore, fluctuations in exchange rates may have an impact on the value of the intercompany account balances denominated in different currencies and reflected in our condensed consolidated financial statements. We are aware of the availability of off-balance sheet financial instruments to hedge exposure to foreign currency exchange rates, including cross-currency swaps, forward contracts and foreign currency options. However, we have not used such instruments in the past, and none were utilized in 2016 or the nine months ended September 30, 2017.

Over the past decade, we have achieved profitability on an annual basis, with the exception of a loss in 2009 that resulted primarily from the decline of the global economy that year. Historically, our sales have grown as a result of continuing market demand for and acceptance of our products, increased sales activity in part through additional sales staff worldwide, new product launches or enhancements, and acquisitions. Our historical financial performance is not indicative of our future financial performance.

We began undertaking several important strategic initiatives in 2016 that we believe will drive our long-term growth and profitability, including:

- reorganizing our business to align our sales, marketing, product management and research and development around specific vertical markets and to better define our end market applications;
- modernizing our sales process to improve the efficiency of our sales organization by supplementing our current direct sales approach of conducting on-site demonstrations with multimedia, web-based demonstrations and cloud-based customer relations development;
- accelerating and maintaining a consistent schedule of new product introductions; and
- reorganizing all functions, processes and people to a harmonized global mindset from our historically regional business structure to improve operational efficiencies.

We successfully completed these primary initiatives during the first half of 2017, including the reorganization of our business to align around specific vertical markets.

As a result of the reorganization discussed above, we realigned our business into three segments: Factory Metrology, Construction BIM-CIM and Other, as further discussed in Note 1 – Description of Business in Part I, Item 1 of this Quarterly Report on Form 10-Q. The presentation throughout this Quarterly Report on Form 10-Q for the three and nine months ended September 30, 2016 has been restated to reflect the change in reporting segments.

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

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Results of Operations

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

| (dollars in thousands) | Three months ended September 30, | | | | Nine months ended September 30, | | | |
|---|----------------------------------|------------|----------|------------|---------------------------------|------------|-----------|------------|
| | 2017 | % of Sales | 2016 | % of Sales | 2017 | % of Sales | 2016 | % of Sales |
| Sales | | | | | | | | |
| Product | \$68,563 | 76.0 % | \$61,280 | 77.0 % | \$193,476 | 76.0 % | \$182,232 | 77.9 % |
| Service | 21,687 | 24.0 % | 18,320 | 23.0 % | 61,018 | 24.0 % | 51,654 | 22.1 % |
| Total sales | 90,250 | 100.0 % | 79,600 | 100.0 % | 254,494 | 100.0 % | 233,886 | 100.0 % |
| Cost of Sales | | | | | | | | |
| Product | 26,673 | 29.6 % | 25,880 | 32.5 % | 78,186 | 30.7 % | 74,938 | 32.0 % |
| Service | 11,543 | 12.8 % | 11,042 | 13.9 % | 33,765 | 13.3 % | 29,665 | 12.7 % |
| Total cost of sales | 38,216 | 42.3 % | 36,922 | 46.4 % | 111,951 | 44.0 % | 104,603 | 44.7 % |
| Gross Profit | 52,034 | 57.7 % | 42,678 | 53.6 % | 142,543 | 56.0 % | 129,283 | 55.3 % |
| Operating Expenses: | | | | | | | | |
| Selling and marketing | 25,990 | 28.8 % | 19,781 | 24.9 % | 74,884 | 29.4 % | 56,399 | 24.1 % |
| General and administrative | 10,307 | 11.4 % | 10,747 | 13.5 % | 32,883 | 12.9 % | 31,139 | 13.3 % |
| Depreciation and amortization | 4,368 | 4.8 % | 3,381 | 4.2 % | 12,075 | 4.7 % | 9,733 | 4.2 % |
| Research and development | 9,019 | 10.0 % | 7,928 | 10.0 % | 26,530 | 10.4 % | 22,344 | 9.6 % |
| Total operating expenses | 49,684 | 55.1 % | 41,837 | 52.6 % | 146,372 | 57.5 % | 119,615 | 51.1 % |
| Income (loss) from operations | 2,350 | 2.6 % | 841 | 1.1 % | (3,829) | (1.5)% | 9,668 | 4.1 % |
| Other (income) expense | | | | | | | | |
| Interest income, net | (78) | (0.1)% | (21) | — % | (249) | (0.1)% | (119) | (0.1)% |
| Other (income) expense, net | (147) | (0.2)% | (167) | (0.2)% | 320 | 0.1 % | 824 | 0.4 % |
| Income (loss) before income tax expense (benefit) | 2,575 | 2.9 % | 1,029 | 1.3 % | (3,900) | (1.5)% | 8,963 | 3.8 % |
| Income tax expense (benefit) | 947 | 1.0 % | (61) | (0.1)% | (442) | (0.2)% | 1,401 | 0.6 % |
| Net income (loss) | \$1,628 | 1.8 % | \$1,090 | 1.4 % | \$(3,458) | (1.4)% | \$7,562 | 3.2 % |

Consolidated Results

Three Months Ended September 30, 2017 Compared to the Three Months Ended September 30, 2016

Sales. Total sales increased \$10.7 million, or 13.4%, to \$90.3 million for the three months ended September 30, 2017 from \$79.6 million for the three months ended September 30, 2016. Total product sales increased by \$7.3 million, or 11.9%, to \$68.6 million for the three months ended September 30, 2017 from \$61.3 million for the three months ended September 30, 2016. Our product sales increased primarily due to increased unit sales in our Construction BIM-CIM vertical and in our other segment, which includes our Public Safety Forensics and Product Design verticals, and higher average selling prices in our Factory Metrology vertical. Service revenue increased by \$3.4 million, or 18.4%, to \$21.7 million for the three months ended September 30, 2017 from \$18.3 million for the three months ended September 30, 2016, primarily due to an increase in warranty and customer service revenue driven by the growth of our installed, serviceable base and focused sales initiatives. Foreign exchange rates had a positive impact on sales of \$0.7 million, increasing our overall sales growth rate by approximately 0.9 percentage points, primarily due to the strengthening of the Euro, partially offset by the decline of the Japanese yen, relative to the U.S. dollar.

Gross profit. Gross profit increased \$9.3 million, or 21.9%, to \$52.0 million for the three months ended September 30, 2017 from \$42.7 million for the three months ended September 30, 2016. Gross margin increased to 57.7% for the three months ended September 30, 2017 from 53.6% in the prior year period. Gross margin from product revenue increased by 3.3 percentage points to 61.1% for the three months ended September 30, 2017 from 57.8% in the prior year period. This increase was primarily due to higher average selling prices in our Factory Metrology vertical as a

result of new product introductions. Gross margin from service revenue increased by 7.1 percentage points to 46.8% for the three months ended September 30, 2017 from 39.7% for the prior year period primarily as a result of higher service revenue.

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Selling and Marketing Expenses. Selling and marketing expenses increased by \$6.2 million, or 31.4%, to \$26.0 million for the three months ended September 30, 2017 from \$19.8 million for the three months ended September 30, 2016. This increase was driven primarily by higher compensation expense, reflecting an increase in selling headcount as part of our strategic initiatives to drive sales growth. Selling and marketing expenses as a percentage of sales were 28.8% for the three months ended September 30, 2017, compared with 24.9% of sales for the three months ended September 30, 2016. Our worldwide period-ending selling headcount increased by 133, or 26.5%, to 635 at September 30, 2017, from 502 at September 30, 2016.

General and administrative expenses. General and administrative expenses decreased by \$0.4 million, or 4.1%, to \$10.3 million for the three months ended September 30, 2017 from \$10.7 million for the three months ended September 30, 2016. This decrease was driven primarily by a decrease in compensation and travel expenses. General and administrative expenses decreased to 11.4% of sales for the three months ended September 30, 2017 from 13.5% of sales for the three months ended September 30, 2016.

Depreciation and amortization expenses. Depreciation and amortization expenses increased by \$1.0 million, or 29.2%, to \$4.4 million for the three months ended September 30, 2017 from \$3.4 million for the three months ended September 30, 2016. This increase was driven primarily by higher amortization of intangible assets related to acquisitions and new production tooling for the manufacture of new products.

Research and development expenses. Research and development expenses increased by \$1.1 million, or 13.8%, to \$9.0 million for the three months ended September 30, 2017 from \$7.9 million for the three months ended September 30, 2016. This increase was mainly due to higher compensation expense resulting from increased headcount in connection with our acquisitions. Research and development expenses as a percentage of sales was 10.0% for the three months ended September 30, 2017 and September 30, 2016.

Other (income) expense, net. For the three months ended September 30, 2017, other income, net, which is largely driven by the effect of foreign exchange rates, remained unchanged when compared to the three months ended September 30, 2016.

Income tax expense (benefit). Income tax expense was \$0.9 million for the three months ended September 30, 2017, compared with an income tax benefit of \$0.1 million for the three months ended September 30, 2016. Our effective tax rate was 36.8% for the three months ended September 30, 2017 compared with a 5.9% benefit in the prior year period. The change in our income tax expense (benefit) and the increase in our effective tax rate were primarily due to a shift in the geographic mix of pretax income expected for the full year 2017. Our effective tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of our products and the resulting effect on taxable income in each jurisdiction, as well as by any change in statutory tax rates in a jurisdiction.

Net income. Our net income was \$1.6 million for the three months ended September 30, 2017 compared to \$1.1 million for the prior year period, reflecting the impact of the factors described above.

Nine Months Ended September 30, 2017 Compared to the Nine Months Ended September 30, 2016

Sales. Total sales increased \$20.6 million, or 8.8%, to \$254.5 million for the nine months ended September 30, 2017 from \$233.9 million for the nine months ended September 30, 2016. Total product sales increased by \$11.3 million, or 6.2%, to \$193.5 million for the nine months ended September 30, 2017 from \$182.2 million for the nine months ended September 30, 2016. Our product sales increase reflected higher unit sales, especially in the Construction BIM-CIM vertical. Service revenue increased by \$9.3 million, or 18.1%, to \$61.0 million for the nine months ended September 30, 2017 from \$51.7 million for the nine months ended September 30, 2016, primarily due to an increase in warranty and customer service revenue driven by the growth of our installed, serviceable base and focused sales initiatives. Foreign exchange rates had a negative impact on sales of \$2.0 million, decreasing our overall sales growth rate by approximately 0.9 percentage points, primarily due to the decline of the Japanese yen, Chinese yuan renminbi, and British pound sterling relative to the U.S. dollar.

Gross profit. Gross profit increased \$13.2 million, or 10.3%, to \$142.5 million for the nine months ended September 30, 2017 from \$129.3 million for the nine months ended September 30, 2016. Gross margin increased to 56.0% for the nine months ended September 30, 2017 from 55.3% in the prior year period. Gross margin from product revenue increased by 0.7 percentage points to 59.6% for the nine months ended September 30, 2017 from 58.9% in

the prior year period. This increase was primarily due to slightly higher average selling prices and an improvement in our manufacturing costs, particularly in our Factory Metrology vertical. Gross margin from service revenue increased by 2.1 percentage points to 44.7% for the nine months ended September 30, 2017 from 42.6% for the prior year period as a result of higher service revenue, partially offset by increased costs due to higher service-related headcount. Selling and Marketing Expenses. Selling and marketing expenses increased by \$18.5 million, or 32.8% to \$74.9 million for the nine months ended September 30, 2017 from \$56.4 million for the nine months ended September 30, 2016. This

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increase was driven primarily by higher compensation expense, reflecting an increase in selling headcount as part of our strategic initiatives to drive sales growth. Selling and marketing expenses as a percentage of sales were 29.4% for the nine months ended September 30, 2017, compared with 24.1% of sales for the nine months ended September 30, 2016. Our worldwide period-ending selling headcount increased by 133, or 26.5%, to 635 at September 30, 2017, from 502 at September 30, 2016.

General and administrative expenses. General and administrative expenses increased by \$1.8 million, or 5.6%, to \$32.9 million for the nine months ended September 30, 2017 from \$31.1 million for the nine months ended September 30, 2016. This increase was driven primarily by higher compensation, advisory services, and global system expenses. General and administrative expenses decreased to 12.9% of sales for the nine months ended September 30, 2017 from 13.3% of sales for the nine months ended September 30, 2016, primarily due to the higher sales in the nine months ended September 30, 2017.

Depreciation and amortization expenses. Depreciation and amortization expenses increased by \$2.4 million, or 24.1%, to \$12.1 million for the nine months ended September 30, 2017 from \$9.7 million for the nine months ended September 30, 2016. This increase was driven primarily by higher amortization of intangible assets related to acquisitions and new production tooling for the manufacture of new products.

Research and development expenses. Research and development expenses increased by \$4.2 million, or 18.7%, to \$26.5 million for the nine months ended September 30, 2017 from \$22.3 million for the nine months ended September 30, 2016. This increase was mainly due to higher compensation expense resulting from increased headcount in connection with our acquisitions. Research and development expenses as a percentage of sales increased to 10.4% for the nine months ended September 30, 2017 from 9.6% for the nine months ended September 30, 2016.

Other (income) expense, net. For the nine months ended September 30, 2017, other expense, net decreased by \$0.5 million to \$0.3 million from \$0.8 million for the nine months ended September 30, 2016. This change was primarily driven by the effect of foreign exchange rates on the value of intercompany account balances of our subsidiaries denominated in other currencies.

Income tax expense (benefit). Income tax benefit was \$0.4 million for the nine months ended September 30, 2017, compared with income tax expense of \$1.4 million for the nine months ended September 30, 2016. This change of \$1.8 million was due to a pretax loss during the nine months ended September 30, 2017 compared to pretax income in the same period of 2016. Our effective tax rate was 11.3% for the nine months ended September 30, 2017 compared with 15.6% in the prior year period. The change in our effective rate was primarily due to the pretax loss during the nine months ended September 30, 2017 compared with pretax income during the same period of 2016 and a shift in the geographical mix of pretax income or loss expected for the full year 2017. Our effective tax rate continued to be lower than the statutory tax rate in the United States, mainly due to our global footprint in foreign jurisdictions with lower tax rates. Our effective tax rate could be impacted positively or negatively by geographic changes in the manufacturing or sales of our products and the resulting effect on taxable income in each jurisdiction, as well as by any change in statutory tax rates in a jurisdiction.

Net (loss) income. Our net loss was \$3.5 million for the nine months ended September 30, 2017 compared to net income of \$7.6 million for the prior year period, reflecting the impact of the factors described above.

Segment Results

Three Months Ended September 30, 2017 Compared to the Three Months Ended September 30, 2016

Total sales by segment for the three months ended September 30, 2017 and September 30, 2016 were as follows (in thousands):

| | Three Months Ended | | | |
|----------------------|--------------------------|---------------|-----------------------|---------------|
| | September 30, 2017 | % of Total | September 30, 2016 | % of Total |
| Factory Metrology | \$59,339 | 65.8 % | \$ 58,310 | 73.3 % |
| Construction BIM-CIM | 22,751 | 25.2 % | 15,925 | 20.0 % |
| Other | 8,160 | 9.0 % | 5,365 | 6.7 % |

| | | |
|-------------|----------|-----------|
| Total sales | \$90,250 | \$ 79,600 |
|-------------|----------|-----------|

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We use segment profit to evaluate the performance of our reportable segments, which are Factory Metrology, Construction BIM-CIM and Other. Segment profit is calculated as gross profit, net of selling and marketing expenses, for the reporting segment. The discussion of segment results for the three months ended September 30, 2017 and 2016 presented below is based on segment profit, as described above, and segment profit as a percent of sales, which is calculated as segment profit divided by net sales for such reporting segment, which we believe will aid investors in understanding and analyzing our operating results. Our definition of segment profit may not be comparable to similarly-titled measures reported by other companies. For additional information, including a reconciliation of total segment profit to income (loss) from operations, see Note 15 – Segment Reporting, in Part I, Item 1 of this Quarterly Report on Form 10-Q.

Factory Metrology

(dollars in thousands)

| | Three Months Ended | |
|--|--------------------|--------------------|
| | September 30, 2017 | September 30, 2016 |
| Total sales | \$59,339 | \$ 58,310 |
| Segment profit | \$20,144 | \$ 16,305 |
| Segment profit as a % of Factory Metrology segment sales | 33.9 % | 28.0 % |

Sales. Total sales in our Factory Metrology segment increased \$1.0 million, or 1.8%, to \$59.3 million for the three months ended September 30, 2017 from \$58.3 million in the prior year period. The increase was driven by higher average selling prices and growth in service revenue, partially offset by a reduction in product unit sales.

Segment profit. Segment profit in our Factory Metrology segment increased \$3.8 million, or 23.5%, to \$20.1 million for the three months ended September 30, 2017 from \$16.3 million in the prior year period. This increase was primarily due to higher average selling prices, growth in service revenue and an improvement in manufacturing costs, partially offset by a reduction in product unit sales and higher selling and marketing expenses resulting from an increase in selling headcount as part of our strategic initiatives to drive sales growth.

Construction BIM-CIM

(dollars in thousands)

| | Three Months Ended | |
|---|--------------------|--------------------|
| | September 30, 2017 | September 30, 2016 |
| Total sales | \$22,751 | \$ 15,925 |
| Segment profit | \$5,407 | \$ 4,704 |
| Segment profit as a % of Construction BIM-CIM segment sales | 23.8 % | 29.5 % |

Sales. Total sales in our Construction BIM-CIM segment increased \$6.9 million, or 42.9%, to \$22.8 million for the three months ended September 30, 2017 from \$15.9 million in the prior year period, primarily reflecting an increase in product unit sales and service revenue.

Segment profit. Segment profit in our Construction BIM-CIM segment increased \$0.7 million, or 14.9%, to \$5.4 million for the three months ended September 30, 2017 from \$4.7 million in the prior year period, primarily driven by an increase in product unit sales and service revenue, partially offset by an increase in selling headcount as part of our strategic initiatives to drive sales growth.

Other

(dollars in thousands)

| | Three Months Ended | |
|--|--------------------|--------------------|
| | September 30, 2017 | September 30, 2016 |
| Total sales | \$8,160 | \$ 5,365 |
| Segment profit | \$493 | \$ 1,888 |
| Segment profit as a % of Other segment sales | 6.0 % | 35.2 % |

Sales. Total sales in our Other segment increased \$2.8 million, or 52.1%, to \$8.2 million for the three months ended September 30, 2017 from \$5.4 million in the prior year period, primarily due to higher product unit sales in our Public Safety Forensics and Product Design verticals as we continue to strategically invest in new markets.

Segment profit. Segment profit in our Other segment was \$0.5 million for the three months ended September 30, 2017 compared to \$1.9 million in the prior year period. This decrease of \$1.4 million was primarily due to higher selling and

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marketing expense resulting from an increase in selling headcount as part of our strategic initiatives to staff emerging verticals with a dedicated sales force to drive sales growth.

Nine Months Ended September 30, 2017 Compared to the Nine Months Ended September 30, 2016

Total sales by segment for the nine months ended September 30, 2017 and September 30, 2016 were as follows (in thousands):

| | Nine Months Ended | | | |
|----------------------|--------------------|------------|--------------------|------------|
| | September 30, 2017 | % of Total | September 30, 2016 | % of Total |
| Factory Metrology | \$173,531 | 68.2% | \$168,418 | 72.0% |
| Construction BIM-CIM | 60,550 | 23.8% | 47,529 | 20.3% |
| Other | 20,413 | 8.0% | 17,939 | 7.7% |
| Total sales | \$254,494 | | \$233,886 | |

Factory Metrology
(dollars in thousands)

| | Nine Months Ended | |
|--|--------------------|--------------------|
| | September 30, 2017 | September 30, 2016 |
| Total sales | \$173,531 | \$168,418 |
| Segment profit | \$53,497 | \$53,034 |
| Segment profit as a % of Factory Metrology segment sales | 30.8% | 31.5% |

Sales. Total sales in our Factory Metrology segment increased \$5.1 million, or 3.0%, to \$173.5 million for the nine months ended September 30, 2017 from \$168.4 million in the same prior year period, mostly driven by higher product unit sales and growth in service revenue.

Segment profit. Segment profit in our Factory Metrology segment increased \$0.5 million, or 0.9%, to \$53.5 million for the nine months ended September 30, 2017 from \$53.0 million in the same prior year period. This increase was primarily due to the higher product unit sales and growth in service revenue, partially offset by higher selling and marketing expenses resulting from an increase in selling headcount as part of our strategic initiatives to drive sales growth.

Construction BIM-CIM
(dollars in thousands)

| | Nine Months Ended | |
|---|--------------------|--------------------|
| | September 30, 2017 | September 30, 2016 |
| Total sales | \$60,550 | \$47,529 |
| Segment profit | \$13,799 | \$12,868 |
| Segment profit as a % of Construction BIM-CIM segment sales | 22.8% | 27.1% |

Sales. Total sales in our Construction BIM-CIM segment increased \$13.1 million, or 27.4%, to \$60.6 million for the nine months ended September 30, 2017 from \$47.5 million in the prior year period, primarily reflecting an increase in product unit sales and higher service revenue.

Segment profit. Segment profit in our Construction BIM-CIM segment increased \$0.9 million to \$13.8 million for the nine months ended September 30, 2017 from \$12.9 million in the prior year period, primarily driven by the increase in sales, partially offset by higher selling and marketing expenses resulting from an increase in selling headcount as part of our strategic initiatives to drive sales growth.

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Other

(dollars in thousands)

| | Nine Months Ended | |
|--|-------------------|---------------|
| | September 30, | September 30, |
| | 2017 | 2016 |
| Total sales | \$20,413 | \$ 17,939 |
| Segment profit | \$363 | \$ 6,982 |
| Segment profit as a % of Other segment sales | 1.8 | % 38.9 |

Sales. Total sales in our Other segment increased \$2.5 million, or 13.8%, to \$20.4 million for the nine months ended September 30, 2017 from \$17.9 million in the prior year period, primarily due to higher product unit sales in our Public Safety Forensics and 3D Machine Vision verticals.

Segment profit. Segment profit in our Other segment decreased \$6.6 million to \$0.4 million for the nine months ended September 30, 2017 from \$7.0 million in the prior year period. This decrease of \$6.6 million was primarily due to higher selling and marketing expense resulting from an increase in selling headcount as part of our strategic initiatives to staff emerging verticals with a dedicated sales force to accelerate the pace of sales growth.

Liquidity and Capital Resources

Cash and cash equivalents increased by \$23.6 million to \$129.8 million at September 30, 2017 from \$106.2 million at December 31, 2016. The increase was primarily driven by the maturity of U.S. Treasury Bills that were not re-invested, partially offset by cash paid for acquisitions of \$5.5 million, property and equipment purchases of \$6.1 million and \$0.8 million of cash used in operating activities during the nine months ended September 30, 2017.

Cash flows from operating activities provide our primary sources of liquidity. Cash used in operations was \$0.8 million during the nine months ended September 30, 2017, compared to cash provided by operations of \$28.5 million during the nine months ended September 30, 2016. The change was mainly due to our net loss in the nine months ended September 30, 2017, an increase in inventory to support new product introductions and a lower reduction in accounts receivable primarily due to higher sales during the three months ended September 30, 2017 compared to the same period in the prior year.

Cash provided by investing activities during the nine months ended September 30, 2017 was \$19.1 million compared to \$16.6 million of cash used in investing activities during the nine months ended September 30, 2016. The change was primarily due to the maturity of U.S. Treasury Bills in 2017 that were not re-invested, partially offset by \$5.5 million in cash paid for the acquisition of Instruments Associates, LLC d/b/a Nutfield Technology in April 2017 compared to \$20.9 million in cash paid for acquisitions during the nine months ended September 30, 2016.

Cash flows used in financing activities was \$0.1 million during the nine months ended September 30, 2017, compared to cash provided by financing activities of \$0.4 million for the nine months ended September 30, 2016. The change was primarily due to no income tax benefit from the exercise of stock options recognized during the nine months ended September 30, 2017 as a result of our prospective adoption of ASU 2016-09 and a decrease in the proceeds from issuances of stock during the nine months ended September 30, 2017 compared to the prior year period.

Of our cash and cash equivalents, \$99.8 million was held by foreign subsidiaries. Our intent is to indefinitely reinvest these funds in our foreign operations, as the cash is needed to fund on-going operations. In the event circumstances change, leading to the conclusion that these funds will not be indefinitely reinvested, we would need to accrue at the time of such determination for the income taxes that would be triggered upon their repatriation.

On November 24, 2008, our Board of Directors approved a \$30.0 million share repurchase program. Acquisitions for the share repurchase program may be made from time to time at prevailing prices, as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The share repurchase program may be discontinued at any time. There is no expiration date or other restriction governing the period over which we can repurchase shares under the program. In October 2015, our Board of Directors authorized an increase to the existing share repurchase program from \$30.0 million to \$50.0 million. We made no stock repurchases during the nine month period ended September 30, 2017 under this program. As of September 30, 2017, we had remaining authorization to repurchase \$18.3 million under the repurchase program.

We believe that our working capital and anticipated cash flow from operations will be sufficient to fund our long-term liquidity requirements for the foreseeable future.

We have no off balance sheet arrangements.

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Contractual Obligations and Commercial Commitments

We enter into purchase commitments for products and services in the ordinary course of business. These purchases generally cover production requirements for 60 to 120 days as well as materials necessary to service customer units through the product lifecycle and for warranty commitments. As of September 30, 2017, we had \$44.6 million in purchase commitments that are expected to be delivered within the next 12 months. To ensure adequate component availability in preparation for new product introductions, as of September 30, 2017, we also had \$0.6 million in long-term commitments for purchases to be delivered after 12 months. Other than as described in the preceding sentences, there have been no material changes to the contractual obligations and commercial commitments table included in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2016.

Critical Accounting Policies

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

In response to the Securities and Exchange Commission's ("SEC") 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 our 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, the reserve for warranties, goodwill impairment, business combinations, and stock-based compensation. 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 have an adverse impact on our operations and financial position.

Revenue Recognition

Revenue is recognized when the price is fixed, collectability is reasonably assured, the title and risks and rewards of ownership have passed to the customer, and the earnings process is complete. Revenue related to our measurement, imaging, and realization equipment and related software is generally recognized upon shipment, as we consider the earnings process complete as of the shipping date. Fees billed to customers associated with the distribution of products are classified as revenue. We warrant our products against defects in design, materials and workmanship for one year. A provision for estimated future costs relating to warranty expense is recorded when products are shipped. We separately sell extended warranties. Extended warranty revenues are recognized on a straight-line basis over the term of the warranty. Costs relating to extended warranties are recognized as incurred. Revenue from sales of software only is recognized when no further significant production, modification or customization of the software is required and when 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. These software arrangements generally include short-term maintenance that is considered post-contract support ("PCS"). We generally establish vendor-specific objective evidence of fair value for this PCS component based on our maintenance renewal rate. Maintenance renewals, when sold, are recognized on a straight-line basis over the term of the maintenance agreement. Revenues resulting from sales of comprehensive support, training and technology consulting services are recognized as such services are performed and are deferred when billed in advance of the performance of services. Revenues are presented net of sales-related taxes.

Reserve for Excess and Obsolete Inventory

Because 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 potentially 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 potentially excess if the quantity on hand exceeds 12 months of expected remaining usage. The resulting obsolete and excess parts are then reviewed to determine if a substitute usage or a future need exists. Items without an identified current or future usage are reserved in an amount equal to 100% of the first-in first-out (“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

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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 over a two-year period, and tax planning strategies that we might employ to utilize such assets, including net operating loss carryforwards. Based on the positive and negative evidence of recoverability, 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 over at least a two-year period.

Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of operating a global business, there are many transactions for which the ultimate tax outcome is uncertain. We establish provisions for income taxes when, despite the belief that tax positions are fully supportable, there remain certain positions that do not meet the minimum probability threshold as described by FASB Accounting Standards Codification (“ASC”) Topic 740, Income Taxes, which is a tax position that is more likely than not to be sustained upon examination by the applicable taxing authority. In the ordinary course of business, we are examined by various federal, state, and foreign tax authorities. We regularly assess the potential outcome of these examinations and any future examinations for the current or prior years in determining the adequacy of our provision for income taxes. We assess the likelihood and amount of potential adjustments and adjust the income tax provision, the current tax liability and deferred taxes in the period in which the facts that gave rise to a revision become known.

Reserve for Warranties

We establish at the time of sale a liability for the one-year warranty included with the initial purchase price of equipment, based upon an estimate of the repair expenses likely to be incurred for the warranty period. The warranty period is measured in installation-months for each major product group. The warranty reserve is included in accrued liabilities in the accompanying condensed 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. We evaluate our 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. We have a history of new product introductions and enhancements to existing products, which may result in unforeseen issues that increase our warranty costs. While such expenses have historically been within expectations, we cannot guarantee this will continue in the future.

Goodwill Impairment

Goodwill represents the excess cost of a business acquisition over the fair value of the net assets acquired. We do not amortize goodwill; however, we perform an annual review in the fourth quarter of each year, or more frequently if indicators of potential impairment exist, to determine if the carrying value of the recorded goodwill or indefinite lived intangible assets is impaired. If an asset is impaired, the difference between the value of the asset reflected in the financial statements and its current fair value is recognized as an expense in the period in which the impairment occurs.

Each period, and for any of our reporting units, we can elect to initially perform a qualitative assessment to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. If we believe, as a result of our qualitative assessment, that it is more likely than not that the fair value of a reporting unit containing goodwill is less than the carrying amount, then the first and second steps of the quantitative goodwill impairment test are unnecessary. If we elect to bypass the qualitative assessment option, or if the qualitative assessment was performed and resulted in us being unable to conclude that it is not more likely than not that the fair value of a reporting unit containing goodwill is greater than the carrying amount, we will perform the two-step quantitative goodwill impairment test. We perform the first step of the two-step quantitative goodwill impairment test by calculating the fair value of the reporting unit using a discounted cash flow method, and then comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of the reporting unit exceeds the fair value, we perform the second step of the quantitative goodwill impairment test to measure the amount of the impairment loss, if any. Management has

concluded there were no goodwill impairment indicators for the nine months ended September 30, 2017. There was no goodwill impairment for the year ended December 31, 2016.

Business Combinations

We allocate the fair value of purchase consideration to the assets acquired and liabilities assumed based on their fair values at the acquisition date. The excess of the fair value of purchase consideration over the fair value of the assets acquired and liabilities assumed is recorded as goodwill. When determining the fair values of assets acquired and liabilities assumed, management makes significant estimates and assumptions, especially with respect to intangible assets. Critical estimates in valuing intangible assets include, but are not limited to, expected future cash flows, which include consideration of future growth rates and margins, customer attrition rates, future changes in technology and brand awareness, loyalty and position, and discount rates. Fair value estimates are based on the assumptions management believes a market participant would use in

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pricing the asset or liability. Amounts recorded in a business combination may change during the measurement period, which is a period not to exceed one year from the date of acquisition, as additional information about conditions existing at the acquisition date becomes available.

Stock-Based Compensation

We measure and record compensation expense using the applicable accounting guidance for share-based payments related to stock options, restricted stock, restricted stock units and performance-based awards granted to our directors and employees. The fair value of stock options, including performance awards, without a market condition is determined by using the Black-Scholes option valuation model. The fair value of restricted stock units and stock options with a market condition is estimated, at the date of grant, using the Monte Carlo Simulation valuation model. The Black-Scholes and Monte Carlo Simulation valuation models incorporate assumptions as to stock price volatility, the expected life of options or awards, a risk-free interest rate and dividend yield. In valuing our stock options, significant judgment is required in determining the expected volatility of our common stock and the expected life that individuals will hold their stock options prior to exercising. Expected volatility for stock options is based on the historical and implied volatility of our own common stock while the volatility for our restricted stock units with a market condition is based on the historical volatility of our own common stock and the stock of companies within our defined peer group. The expected life of stock options is derived from the historical actual term of option grants and an estimate of future exercises during the remaining contractual period of the option. While volatility and estimated life are assumptions that do not bear the risk of change subsequent to the grant date of stock options, these assumptions may be difficult to measure, as they represent future expectations based on historical experience. Further, our expected volatility and expected life may change in the future, which could substantially change the grant-date fair value of future awards of stock options and, ultimately, the expense we record. The fair value of restricted stock and restricted stock units, including performance awards, without a market condition is estimated using the current market price of our common stock on the date of grant.

We expense stock-based compensation for stock options, restricted stock, restricted stock units and performance awards over the requisite service period. For awards with only a service condition, we expense stock-based compensation, adjusted for actual forfeitures, using the straight-line method over the requisite service period for the entire award. For awards with both performance and service conditions, we expense the stock-based compensation, adjusted for actual forfeitures, on a straight-line basis over the requisite service period for each separately vesting portion of the award, taking into account the probability that we will satisfy the performance condition. Furthermore, we expense awards with a market condition over the three-year vesting period regardless of the value that the award recipients ultimately receive. Excess tax benefits or deficits upon exercise of stock options or vesting of restricted stock or restricted stock units are recorded to income tax benefit or expense, respectively. All tax-related cash flows resulting from stock-based compensation cost are classified as operating activities in the condensed consolidated statements of cash flows.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

Foreign Exchange Exposure

We conduct a significant portion of our business outside the United States. As of and for the nine months ended September 30, 2017, 61% of our revenue was invoiced, and a significant portion of our operating expenses were paid, in foreign currencies, and 59% of our assets were denominated in foreign currencies. Fluctuations in exchange rates between the U.S. dollar and such foreign currencies may have a material effect on our results of operations and financial condition and could specifically result in foreign exchange gains and losses. The impact of future exchange rate fluctuations on the results of our operations cannot be accurately predicted due to our constantly changing exposure to various currencies, and the fact that all foreign currencies do not react in the same manner in relation to the U.S. dollar. Our most significant exposures are to the Euro, British pound sterling, Swiss franc, Japanese yen, Chinese yuan renminbi, Mexican peso and Brazilian real. To the extent that the percentage of our non-U.S. dollar revenues derived from international sales increases in the future, our exposure to risks associated with fluctuations in foreign exchange rates may increase. We are aware of the availability of off-balance sheet financial instruments to hedge exposure to foreign currency exchange rates, including cross-currency swaps, forward contracts and foreign currency options. However, we have not used such instruments in the past, and none were utilized in 2016 or the nine months ended September 30, 2017.

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of September 30, 2017. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2017 to provide reasonable assurance that information required to be disclosed in this Quarterly Report on Form 10-Q was recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms and was accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

During the quarter ended September 30, 2017, there was no change in our internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are not involved in any legal proceedings other than routine litigation arising in the normal course of business, none of which we believe will have a material adverse effect on our business, financial condition or results of operations.

Item 1A. Risk Factors

In addition to the other information set forth in this Quarterly Report on Form 10-Q, you should carefully consider the factors discussed under “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the SEC, our Quarterly Reports on Form 10-Q for the quarterly periods ended March 31, 2017 and June 30, 2017, as filed with the SEC, and in this Item 1A before deciding to invest in, or retain, shares of our common stock. These risks could materially and adversely affect our business, financial condition, and results of operations. The risks described in our Annual Report on Form 10-K for the year ended December 31, 2016 and our Quarterly Reports on Form 10-Q for the quarterly periods ended March 31, 2017 and June 30, 2017 are not the only risks we face. Our operations could also be affected by additional factors that are not presently known by us or by factors that we currently consider immaterial to our business. As of September 30, 2017, there have been no material changes in our risk factors from those set forth in our Annual Report on Form 10-K for the year ended December 31, 2016 and our Quarterly Reports on Form 10-Q for the quarterly periods ended March 31, 2017 and June 30, 2017.

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

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

On November 24, 2008, our Board of Directors approved a \$30.0 million share repurchase program. Acquisitions for the share repurchase program may be made from time to time at prevailing prices, as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The share repurchase program may be discontinued at any time. There is no expiration date or other restriction governing the period over which we can repurchase shares under the program. In October 2015, our Board of Directors authorized an increase to the existing share repurchase program from \$30.0 million to \$50.0 million. We made no stock repurchases during the nine month period ended September 30, 2017 under this program. As of September 30, 2017, we had authorization to repurchase \$18.3 million remaining under the repurchase program.

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Item 6. Exhibits

INDEX TO EXHIBITS

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

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SIGNATURE

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

FARO Technologies, Inc.
(Registrant)

Date: October 26, 2017 By: /s/ Robert Seidel
Name: Robert Seidel
Title: Chief Financial Officer
(Duly Authorized Officer and Principal Financial Officer)