

# SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

## FORM 10-K/A (Amendment No. 1 to Form 10-K)

(Mark One)

- Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the fiscal year ended December 31, 2002 or  
 Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File Number 0-23081

## FARO TECHNOLOGIES, INC.

(Exact name of Registrant as specified in its charter)

Florida

59-3157093

(State or other jurisdiction  
of incorporation or organization)

(I.R.S. Employer Identification No.)

125 Technology Park, Lake Mary, FL

32746

(Address of Principal Executive Offices)

(Zip Code)

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

Securities to be registered pursuant to Section 12(b) of the Act:

Title of Each Class

None

Name of Each Exchange  
On Which Registered

None

Securities to be registered pursuant to Section 12(g) of the Act:

Common Stock, par value \$.001

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definite proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of March 11, 2003, there were outstanding 11,891,726 shares of Common Stock. The aggregate market value of the voting stock held by non-affiliates of the Registrant based on the last sale price reported on the NASDAQ National Market as of June 28, 2002 was \$13,049,034.

### DOCUMENTS INCORPORATED BY REFERENCE

Documents

Form 10-K Reference

Portions of the Proxy Statement for the 2003 Annual Meeting of Shareholders

Part III, Items 10-13

Amendment No. 1 to the Form 10-K Filed by FARO Technologies, Inc. on March 27, 2003

#### Explanatory Note:

This form 10-K/A is being filed for the sole purpose of (1) filing the certifications of the Chief Executive Officer and the Principal Financial and Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act and (2) amending exhibits 99.3 and 99.4 to the Form 10-K filed by the Registrant on March 27, 2003. The certificates were inadvertently omitted from the Registrant's 10-K previously filed with the Securities and Exchange Commission on March 27, 2003. There have been no other changes from the original Form 10-K filed with the Securities and Exchange Commission on March 27, 2003. This Amendment No. 1 on Form 10-K/A supercedes and replaces in its entirety the Registrant's Annual Report on Form 10-K that was filed on March 27, 2003.

## PART I

### CAUTIONARY STATEMENTS FOR FORWARD-LOOKING INFORMATION

FARO Technologies, Inc. (the Company) has made forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995) in this report that are subject to risks and uncertainties, such as statements about our plans, objectives, projections, expectations, assumptions, strategies, or future events. Other written or oral statements, which constitute forward-looking statements, also may be made from time to time by or on behalf of the Company. Words such as “may,” “expects,” “anticipates,” “intends,” “plans,” “believes,” “seeks,” “estimates,” “will,” “should,” “could,” variations of such words, and similar expressions are intended to identify such forward-looking statements. Statements that are not historical facts or that describe the Company’s future plans, objectives, or goals also are forward-looking statements. These statements are not guarantees of future performance and are subject to a number of known and unknown risks, uncertainties, and other factors, including those discussed below and elsewhere in this report, that could cause actual results to differ materially from future results, performances, or achievements expressed or implied by such forward-looking statements. Consequently, undue reliance should not be placed on these forward-looking statements. The Company undertakes no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

Factors that could cause actual results to differ materially from what is expressed or forecasted in such forward-looking statements include, but are not limited to: (i) the potential loss of material customers; (ii) the failure to properly manage growth and successfully integrate acquired businesses such as SpatialMetriX(SMX) Corporation; (iii) inability of the Company’s products to attain broad market acceptance or increased length of the Company’s sales cycle; (iv) inability of the Company to maintain or reduce operating expenses; (v) the impact of competitive product and pricing; (vi) inability of the Company to ramp-up shipments of its new laser trackers and new generation portable measure arm products as a result of manufacturing delays; (vii) fluctuations in quarterly operating results as a result of the size, timing and recognition of revenue from significant orders, increases in operating expenses required for product development and marketing, the timing and market acceptance of new products and product enhancements; customer order deferrals in anticipation of new products and product enhancements; the Company’s success in expanding its sales and marketing programs, and general economic conditions; (viii) the financial condition of the Company’s clients; (ix) adverse consequences of exchange rate fluctuations; (x) inability to protect our intellectual property and other proprietary rights; (xi) dependence on Simon Raab and Gregory A. Fraser and other key personnel; and (xii) the cyclical nature of the industries of the Company’s customers.

#### ITEM 1. BUSINESS

##### Industry Background

The Company believes that there are three principal forces driving the need for its products and services: 1) the widespread use by manufacturers of Computer-Aided Design (CAD) in product development which shortens product cycles; 2) the adoption by manufacturers of quality standards such as Six Sigma and ISO-9000 (and its offshoot QS-9000), which stress the measurement of every step in a manufacturing process to reduce or eliminate defects, and 3) the inability of traditional measurement devices to address many manufacturing problems, especially those related to large components for products such as automobiles, aircraft, and heavy duty construction equipment.

**CAD changes the manufacturing process.** The creation of physical products involves the processes of design, engineering, production and measurement and quality inspection. These basic processes have been profoundly affected by the computer hardware and software revolution that began in the 1980s. CAD software was developed to automate the design process, providing manufacturers with computerized 3-D design capability. Today, most manufacturers use some form of CAD software to create designs and engineering specifications for new products and to quantify and modify designs and specifications for existing products. Use of CAD can shorten the time between design changes. While manufacturers previously designed their products to be in production for longer periods of time, current manufacturing practices must accommodate more frequent product introductions and modifications, while satisfying more stringent quality and safety standards. Assembly fixtures and measurement tools must be figuratively linked to the CAD design to enable production to keep up with the rate of design change.

**Quality standards dictate measurement to reduce defects.** QS-9000 is the name given to the Quality System Requirements of the automotive industry that were developed by Chrysler, Ford, General Motors and major truck manufacturers and issued in late 1994. Companies that become registered under QS-9000 are considered to have higher standards and better quality products. Six Sigma embodies the principles of total quality management that focus on measuring results and reducing product or service failure rates to 3.4 per million. All aspects of a Six Sigma company's infrastructure must be analyzed, and if necessary, restructured to increase revenues and raise customer satisfaction levels. The all-encompassing nature of these and other quality standards has resulted in manufacturers measuring every aspect of their process, including stages of product assembly that may have never been measured before, in part because of the lack of suitable measurement equipment.

**Traditional products don't measure up.** A significant aspect of the manufacturing process, which traditionally has not benefited from computer-aided technology, is measurement and quality inspection. Historically, manufacturers have measured and inspected products using hand-measurement tools such as scales, calipers, micrometers and plumb lines for simple measuring tasks, test (or check) fixtures for certain large manufactured products and traditional coordinate measurement machines ("CMMs") for objects that require higher precision measurement. However, the broader utility of each of these measurement methods is limited.

Although hand-measurement tools are often appropriate for simple geometric measurements, including hole diameters or length and width of a rectangular component, their use for complex part measurements, such as the fender of a car, is limited. Also, these devices do not allow for the measurements to be directly compared to the CAD model of the part. Test fixtures (customized fixed tools used to make comparative measurements of complex production parts to "master parts") are relatively expensive and must be reworked or discarded each time a dimensional change is made in the part being measured. In addition, these manual measuring devices do not permit the manufacturer to compare the dimensions of an object with its CAD model.

Conventional CMMs are generally large, fixed-base machines that provide very high levels of precision and provide a link to the CAD model of the object being measured. However, fixed-base CMM's require the object being measured be brought to the CMM and the object fit within the CMM's measurement grid. As manufactured subassemblies increase in size and become integrated into even larger assemblies, they become less transportable, thus diminishing the utility of a conventional CMM. Consequently, manufacturers must continue to use hand-measuring tools, or expensive customized

test fixtures, in order to measure large or unconventionally shaped objects. Some parts or assemblies are not easily accessible and cannot be measured at all using traditional devices.

Escalating global competition has created a demand for higher quality products with shorter life cycles. Manufacturers require more rapid design, greater control of the manufacturing process, tools to compare components to their CAD specifications and the ability to precisely measure components that cannot be measured or inspected by conventional devices. Moreover, they increasingly require measurement capabilities to be integrated into the manufacturing process and to be available on the factory floor.

### **FARO's Business**

The Company designs, develops, markets and supports portable, software-driven, 3-D measurement systems that are used in a broad range of manufacturing and industrial applications. The Company's principal products are the Faro-Arm Control Station and Control Station Pro (articulated measuring devices), the Faro Laser Tracker and Laser Control Station; and their companion Soft Check Tool and CAM2 software, respectively, which provide for CAD-based inspection and factory-level statistical process control. Together, these products integrate the measurement and quality inspection function with CAD software to improve productivity, enhance product quality and decrease rework and scrap in the manufacturing process. The Company uses the acronym "CAM2" for this process, which stands for Computer-aided manufacturing measurement. The Company's products bring precision measurement, quality inspection and specification conformance capabilities, integrated with leading CAD software, to the factory floor. The Company is a pioneer in the development and marketing of 3-D measurement technology in manufacturing and industrial applications and currently holds 29 patents. The Company's products have been purchased by approximately 2,900 customers worldwide, ranging from small machine shops to such large manufacturing and industrial companies as Audi, Bell Helicopter, Boeing, British Aerospace, Caterpillar, DaimlerChrysler, General Electric, General Motors, Honda, Johnson Controls, Komatsu Dresser, Lockheed Martin, Nissan, Siemens, Volkswagen among many others.

### **Acquisition of SMX**

On January 16, 2002, the Company acquired SpatialMetriX Corporation ("SMX"), a leading manufacturer and supplier of laser trackers and targets, metrology software in exchange for 500,000 shares of FARO common stock (50,000 shares of which are being held in escrow) and the satisfaction by the Company of certain obligations of SMX. In connection therewith, the Company issued an additional 350,000 shares of FARO common stock and paid \$2.0 million in cash to fully satisfy SMX's obligations to its two lenders. The Company also assumed and/or satisfied other obligations of SMX, including approximately \$2.9 million in financing provided by the Company to SMX prior to January 16, 2002.

The Company estimates that SMX had 35% of the installed laser tracker market. The Company exercised its contractual right to acquire SMX only after the successful design by SMX of a new generation laser tracker, which the Company sells at competitive prices compared to both the previous generation SMX tracker, and competitor's current products. SMX's previous generation laser tracker, which was introduced in 1996, was sold until September 2001. SMX halted production and sale of its earlier generation laser tracker in September 2001. The operations of the new laser product line are contributing favorably to the Company's revenue growth and, beginning in the third quarter of 2002, to the results of operations. The Company has sold approximately \$8.8 million in laser products in 2002 and expects to continue to ramp up sales of the laser tracker in 2003. The operating expenses of the new laser product line, beginning with the third quarter 2002, are consistent with the Company's historic operating expense ratios.

## FARO Products

**The FARO Arm Control Station.** The FARO Arm Control Station is a combination of a portable, six or seven-axis, instrumented articulated measurement arm, a touch screen computer, and software programs known as SoftCheck Tools.

- **Articulated Arm**—Each articulated arm is comprised of three major joints, each of which may consist of one, two or three axes of motion. The articulated arm is available in a variety of sizes, configurations and precision levels that are suitable for a broad range of applications. To take a measurement, the operator simply touches the object to be measured with a probe at the end of the arm and presses a button. Data can be captured at either individual points or a series of points. Digital rotational transducers located at each of the joints of the arm measure the angles at those joints. This rotational measurement data is transmitted to an on-board controller that converts the arm angles to precise locations in 3-D space using “xyz” position coordinates and “ijk” orientation coordinates.
- **Touch Screen Computer**—One of the main goals of the Control Station system is to provide computer-based inspection without requiring the operator to program the inspection software or even have to touch a keyboard. As such the company developed software (see the following section) which runs entirely by the operator touching simple icons on the touch screen, not unlike how a restaurant waiter enters an order. The computers are not manufactured by the Company, but are purchased from various suppliers.
- **SoftCheck Tool Software**—SoftCheck Tool is a custom software program designed to lead an operator through the measurement process with minimal training. The extensive use of photos of the customer’s part assist in achieving this goal. These programs are created by the Company from specifications provided by the customer.

**The FARO Arm Control Station Pro.** In contrast to the basic FARO Arm Control Station, the Control Station Pro customers may write their own inspection programs using the Company’s CAM2 software. This product requires more sophisticated operators, and is often used to measure multiple parts in the same day, while the basic FARO Arm Control Station is often dedicated to the same part. The FARO Arm Control Station Pro is a combination of an articulated arm, standard computer (with keyboard), and one of the Company’s following CAM2 Software programs: CAM2 Design, CAM2 Measure or CAM2 Automotive.

**The FARO Laser Tracker Control Station.** A combination of a portable, large volume laser measurement tool, a touch screen computer, and software programs known as SoftCheck Tools.

- **Laser Tracker**—The FARO Laser Tracker® utilizes an ultra-precise laser beam to measure objects of up to 230 feet. It enables manufacturing, engineering, and quality control professionals to measure and inspect large parts, machine tools and other large objects on-site and/or in-process. With its greater angular resolution, repeatability, and accuracy, the FARO Laser Tracker advances already-proven tracker technology. Among its many enhanced features is SuperADM, which improves upon existing Absolute Distance Measurement technology by providing the new time-saving ability to reacquire the laser beam without the need to return to a known reference point or the need to hold the target stationary.
- **Touch Screen Computer**—See description under Faro Arm Control Station above.
- **SoftCheck Tool Software**—See description under Faro Arm Control Station above.

**CAM2 Software** CAM2 is the Company's family of proprietary CAD-based measurement and statistical process control software. The CAM2 product line includes four software programs:

- **CAM2 CAD Analyzer**<sup>®</sup> allows users to convert very large, complex CAD files from engineering workstations into simpler graphical images which make them available on a personal computer level for numerous applications throughout the factory from assembly and inspection planning, to the creation of user or service manuals.
- **CAM2 Measure**<sup>®</sup> allows users to compare measurements of manufactured components or assemblies with the corresponding CAD data for the components or assemblies. CAM2 Measure<sup>®</sup> is offered with the FAROArm<sup>®</sup> and is also offered as an unbundled product.
- **CAM2 Automotive**<sup>®</sup> also allows users to compare measurements of manufactured components with the corresponding CAD file. Unlike CAM2 Measure<sup>®</sup>, CAM2 Automotive<sup>®</sup> is especially suited to the measurement of very large components with large CAD files, typical of those in the automotive industry. CAM2 Automotive<sup>®</sup> is offered with the FAROArm<sup>®</sup> and is also offered as an unbundled product.
- **CAM2 SPC Process**<sup>®</sup> allows for the collection, organization, and presentation of measurement data factory-wide. Not limited to measurements from the FAROArm<sup>®</sup>, CAM2 SPC Process<sup>®</sup> accepts data from CMMs and other computer-based measurement devices from many different measurement applications along the production line.

**Specialty Products.** The Company licenses and supports certain specialty products based on its articulated arm technologies that are used in medical applications. License and support fees from these products do not represent a significant portion of the Company's revenues. However, the Company is maintaining an active campaign to license its formerly developed medical intellectual property to manufacturers of computer assisted surgical products.

### **Customers**

The Company's products have been purchased by approximately 2,900 customers worldwide, ranging from small machine shops to large manufacturing and industrial companies. The Company's ten largest customers by revenue represented an aggregate of 9.0% of the Company's total revenues in 2002. No customer represented more than 1.5% of the Company's sales in 2002.

### **Sales and Marketing**

The Company directs its sales and marketing efforts from its headquarters in Lake Mary, Florida. At December 31, 2002, the Company employed 108 sales and marketing professionals who provide global representation, operating from both the Company's headquarters in the United States, and regional sales offices located in Germany, United Kingdom, France, Spain, Italy and Japan. See Footnote 15 to the Notes to Consolidated Financial Statements, incorporated herein by reference to Item 8 hereof, for financial information about the Company's foreign and domestic operations and export sales required by this Item.

The Company uses a process of integrated lead qualification and sales demonstration. Once a customer opportunity is identified, the Company employs a team-based sales approach involving inside and outside sales personnel who are supported by application engineers. The Company employs a variety of marketing techniques to promote brand awareness and customer identification.

## Research and Development

The Company believes that its future success depends on its ability to achieve technological leadership, which will require ongoing enhancements of its products and the development of new applications and products that provide 3-D measurement solutions. Accordingly, the Company intends to continue to make substantial investments in the development of new technologies, the commercialization of new products that build on the Company's existing technological base and the enhancement and development of additional applications for its products.

The Company's research and development efforts are directed primarily at enhancing the functional adaptability of its current products and developing new and innovative products that respond to specific requirements of the emerging market for 3-D measurement systems. The Company's research and development efforts have been devoted primarily to mechanical hardware, electronics and software. The Company's engineering development efforts will continue to focus on the FAROArm<sup>®</sup>, the FARO Laser Tracker<sup>®</sup>, and the family of CAM2 products. See *Technology* below.

At December 31, 2002, the Company employed 33 scientists and technicians in its research and development efforts. Research and development expenses were approximately \$4.0 million in 2002 as compared to \$3.4 million in 2001 and \$3.5 million in 2000. Research and development activities, especially with respect to new products and technologies, are subject to significant risks, and there can be no assurance that any of the Company's research and development activities will be completed successfully or on schedule, or, if so completed, will be commercially accepted.

## Technology

The primary measurement function of both the articulated arm and the laser tracker is to provide orientation and position information with respect to the probe at the end of the arm (as with the FARO Arm) or target device with respect to the base unit (as with the FARO Laser Tracker). This information is processed by software and can be compared to the desired dimensions contained in the CAD data of a production part or assembly to determine whether the measured data conforms to such dimensional specifications.

- **FARO Arm:** The articulated arm is designed with six or seven joints. The arm consists of aluminum links and rotating joints that are combined in different lengths and configurations, resulting in human arm-like characteristics. Each joint is instrumented with a rotational transducer, a device used to measure rotation, which is based on optical digital technology. The position and orientation of the probe in three dimensions is determined by applying trigonometric calculations at each joint. The position of the end of a link of the arm can be determined by using the angle measured and the known length of the link. Through a complex summation of these calculations at each joint, the position and orientation of the probe is determined.
- **FARO Laser Tracker:** The laser tracker is a portable, high accuracy, three-dimensional coordinate measurement device, which has a measurement range of up to 230 feet. The tracker uses two rotary angular encoders and a laser-based distance measurement system to track and measure the position of a Retroreflector target. The measurement function is accomplished by a laser beam that is reflected from a retroreflecting target, typically a Spherically Mounted Retroreflector (SMR). The orientation of the tracker's mechanical axis is continuously updated based on feedback from a position-sensing detector. The tracker determines the coordinates of the target by measuring two angles and a radial distance. The angles are measured by encoders mounted on the zenith and azimuth axes. The radial distance is measured by a fringe counting interferometer. The software on the controlling computer, CAM2<sup>®</sup> Measure, transforms this data into any user-defined coordinate system.

The Company's products are the result of a successful integration of state-of-the-art developments in mechanical, optical and electronic hardware and applications software. The unique nature of the Company's technical developments is evidenced by its numerous U.S. and international patents. The Company maintains low cost product design processes by retaining development responsibilities for all hardware, electronics and software.

#### ***Mechanical Hardware.***

- The articulated arm is designed to function in diverse environments and under rigorous physical conditions. The arm monitors its temperature to adjust for environments ranging from -10 degrees to +50 degrees Celsius. The arm is constructed of pre-stressed precision bearings to resist shock loads. Low production costs are attained by the proprietary combination of reasonably priced electromechanical components accompanied by the optimization and on-board storage of calibration data. Many of the Company's innovations relate to the environmental adaptability of its products. Significant features include integrated counter-balancing, configuration convertibility and temperature compensation.
- The laser tracker is designed to function in diverse environments and hard to reach locations. The infrared laser adds a Super ADM (Absolute Distance Measurement) measurement mode in which the user does not need to reset the tracker to a reference position following a break in the laser beam.

***Electronics.*** An on-board computer that is designed to handle complex analyses of data as well as communications with a variety of host computers processes the rotational information for each hardware device. The Company's electronics are based on digital signal processing and surface mount technologies. The Company's products meet all mandatory electronic safety requirements. Advanced circuit board development, surface mount production and automated testing methods are used to ensure low cost and high reliability.

***Software.*** CAM2 is a Windows-based family of programs written for the most recent PC-based technology. CAM2 has been entirely designed and programmed by the Company utilizing field input. CAM2 CADanalyser® is a family member for viewing, analyzing and browsing CAD files. CAM2 Measure® is a complete 3D measurement application written entirely on the ACIS CAD development platform. Family member CAM2 Automotive® is also a complete 3D measurement software designed for very large CAD files and for specific Automotive applications and is written using a FARO's proprietary graphics display engine. Family member CAM2 SPC Process® is designed for plant wide dimensional data acquisition and presentation in classical SPC (Statistical Process Control) formats for plant-wide quality control. CAM2 Open Measure is a version of CAM2 Measure which can be adapted to any CAD platform. This permits CAD users to have a complete 3D measurement application operating on their native CAD platform.

All the CAM2 family members implement UNICODE standards for worldwide translation allowing the Company to create foreign language versions to enter international markets more effectively. The software is developed with the cooperation of diverse user sites and a well-developed system for tracking and implementing market demands. The Company's software products are available in 8 languages worldwide.

#### **Intellectual Property**

The Company holds or has pending 29 patents in the United States. The Company also has 12 registered trademarks in the United States, 26 foreign registered trademarks, 6 trademark applications pending in the United States and 4 foreign trademark applications pending.



The Company relies on a combination of contractual provisions and trade secret laws to protect its proprietary information. There can be no assurance that the steps taken by the Company to protect its trade secrets and proprietary information will be sufficient to prevent misappropriation of its proprietary information or to preclude third-party development of similar intellectual property.

Despite the Company's efforts to protect its proprietary rights, unauthorized parties may attempt to copy aspects of the Company's products or to obtain and use information that the Company regards as proprietary. The Company intends to vigorously defend its proprietary rights against infringement by third parties. However, policing unauthorized use of the Company's products is difficult, particularly overseas, and the Company is unable to determine the extent to which piracy of its software products exists. In addition, the laws of some foreign countries do not protect the Company's proprietary rights to the same extent as the laws of the United States.

The Company does not believe that any of its products infringe on the proprietary rights of third parties. There can be no assurance, however, that third parties will not claim infringement by the Company with respect to current or future products. Any such claims, with or without merit, could be time-consuming, result in costly litigation, cause product shipment delays or require the Company to enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to the Company or at all, which could have a material adverse effect upon the Company's business, operating results and financial condition.

### **Manufacturing and Assembly**

The Company manufactures its articulated arm products primarily at its headquarters in Lake Mary, Florida, with manufacture of its laser tracker products in Kennett Square, Pennsylvania. Some manufacturing also occurs in Europe. Manufacturing consists primarily of assembling components and subassemblies, purchased from suppliers, into finished products. The primary components, which include machined parts and electronic circuit boards, are produced by subcontractors according to the Company's specifications. All products are assembled, calibrated and tested for accuracy and functionality before shipment. In limited circumstances, the Company performs in-house circuit board assembly and part machining.

"Quality" has rapidly emerged as a new emphasis in commerce and industry, and is a significant factor in international trade. The Company's manufacturing, engineering and design headquarters have been registered to the ISO 9001 standard since July 1998. Semi-annual surveillance audits have documented continuous improvement to this multinational standard. The Company continues to examine its scope of registration as the business evolves and has chosen English as the standard business language for its operations. This decision is expected to significantly influence the Company's operations and documentation globally. This has been done in concert with the ISO Standard Registrar, and is expected to increase customer confidence in the Company's products and services worldwide.

The Company continues to achieve new levels of certification, achieving Accreditation to Guide 25 in May, 2000, and Registration to ISO/IEC 17025 in October, 2001. These global standards apply to the "Calibration and Certification of Measuring and Test Equipment", and certify the organization's level of training, procedures, and efficiency.

In July, 2002 the Company's European Operations were registered to ISO 9001:2000. In addition the calibration and certification facilities in Europe were accredited to ISO 17025.

In October, 2002 the Company Headquarters completed the transition to the ISO 9001:2000 standard, and continued registration to ISO 17025 for Calibration and Certification Laboratories.

## **Competition**

The broad market for measurement devices, which include hand-measurement tools, test fixtures and conventional, fixed-base CMMs, and portable measurement systems such as the Company's products, is highly competitive. Manufacturers of hand-measurement tools and traditional CMMs include a significant number of well-established companies that are substantially larger and possess substantially greater financial, technical and marketing resources than the Company. There can be no assurance that these entities or others will not succeed in developing products or technologies that will directly compete with those of the Company. The market for measurement software to retrofit traditional CMMs, and for statistical process control is also highly competitive. The Company will be required to make continued investments in technology and product development to maintain its technological advantage over its competition. There can be no assurance that the Company will have sufficient resources to make such investments or that the Company's product development efforts will be sufficient to allow the Company to compete successfully as the industry evolves. The Company's products compete on the basis of portability, accuracy, application features, ease-of-use, quality, price and technical support.

The Company's significant direct competitors for its Control Station and related software are Romer SRL (France), Romer, Inc., a Cimcore Company (California), and Kosaka Laboratory Ltd. (Japan). In addition the Company is aware of a direct competitor in Germany, two direct competitors in Italy, and a direct competitor in the United Kingdom, each of which the Company believes currently has significantly less sales volume than the Company. However, there can be no assurance that these companies or other companies will not devote additional resources to the development and marketing of products that compete with those of the Company. With respect to the laser tracker market, Leica Geosystems (Switzerland) is the company's only significant direct competitor. Leica Geosystems has the largest market share in the laser tracker market, is well established and is substantially larger and possesses substantially greater financial, technical, and marketing resources than the Company. As the market for portable coordinate measurement systems expands, additional competition may emerge and the Company's existing and future competitors may commit more resources to the markets in which the Company participates.

The worldwide trend toward CAD-based factory floor metrology has resulted in the introduction of CAD-based inspection software and statistical process control for conventional CMMs by most of the large CMM manufacturers. Certain CMM manufacturers are miniaturizing, and in some cases increasing the mobility of, their conventional CMMs. Nonetheless, these CMMs still have small measurement volumes, lack the adaptability typical of portable, articulated arm measurement devices and lose accuracy outside the controlled environment of the metrology lab.

## **Backlog**

At December 31, 2002, the Company had orders representing approximately \$8.8 million in product sales outstanding. The majority of these specific orders were shipped by March 11, 2003, and, as of March 11, 2003, the Company had orders representing approximately \$9.6 million in product sales outstanding. At December 31, 2001, the Company had orders representing approximately \$706,000 in product sales outstanding.

The Company's increased backlog is the result of the introduction of its new laser tracker and articulated arm product lines in 2002. The Company expects this backlog to decrease. The Company believes that substantially all of the outstanding sales orders as of March 11, 2003 will be billed during 2003.

## Employees

At December 31, 2002, the Company had 291 full-time employees, consisting of 108 sales and marketing professionals, 61 production staff, 33 research and development staff, 45 administrative staff, and 44 customer service/application engineering specialists. The Company is not a party to any collective bargaining agreements. The Company believes its employee relations are good. Management believes that its future growth and success will depend in part on its ability to retain and continue to attract highly skilled personnel. The Company anticipates that it will obtain the additional personnel required to satisfy its staffing requirements over the foreseeable future.

## Management of the Registrant

The officers and key management personnel of the Company are as follows:

<u>Name</u>	<u>Age</u>	<u>Principal Position</u>
Simon Raab, Ph.D.	50	Chairman of the Board, Chief Executive Officer, and President
Gregory A. Fraser, Ph.D.	48	Executive Vice President, Secretary, and Treasurer
Joanne M. Karimi	44	Vice President of Human Resources
Allen Sajedi	43	Vice President and Chief Technical Officer
Wendelin K.J. Scharbach	47	Co-Managing Director of FARO Europe
Siegfried K. Buss	37	Co-Managing Director of FARO Europe

**Simon Raab, Ph.D.**, a co-founder of the Company, has served as the Chairman of the Board, Chief Executive Officer and a director of the Company since its inception in 1982 and as President since 1986. Mr. Raab holds a Ph.D. in Mechanical Engineering from McGill University, Montreal, Canada, a Masters of Engineering Physics from Cornell University and a Bachelor of Science in Physics with a minor in Biophysics from the University of Waterloo, Canada.

**Gregory A. Fraser, Ph.D.**, a co-founder of the Company, has served as Executive Vice President, Secretary, and Treasurer since August 1999. Prior to that Mr. Fraser served as Chief Financial Officer and Executive Vice President since May 1997 and as Secretary, Treasurer and a director of the Company since its inception in 1982. Mr. Fraser holds a Ph.D. in Mechanical Engineering from McGill University, Montreal, Canada, a Masters of Theoretical and Applied Mechanics from Northwestern University and a Bachelor of Science and Bachelor of Mechanical Engineering from Northwestern University.

**Joanne M. Karimi.**, has served as Vice President of Human Resources of the Company since July 2001 and as Director of Human Resource Systems since October 1998. Prior to that, Ms. Karimi served as Director of Human resources of the Disney Vacation Club, a unit of The Walt Disney Company. Ms. Karimi holds a MBA and a Bachelor's Degree in Business Management from the University of West Florida.

**Allen Sajedi** has served as Vice President and Chief Technical Officer since 2002 and as Chief Engineer of the Company since 1990. Mr. Sajedi holds a Bachelor's Degree in Mechanical Engineering from McGill University, Montreal, Canada.

**Wendelin K.J. Scharbach**, a co-founder of CATS GmbH, a predecessor of FARO Europe, the Company's principal subsidiary in Europe, has served as Co-managing Director of FARO Europe since May 1998. Prior to that Mr. Scharbach was Managing Director of CATS GmbH.

**Siegfried K. Buss**, a co-founder of CATS GmbH, a predecessor of FARO Europe, the Company's principal subsidiary in Europe, has served as Co-managing Director of FARO Europe since May 1998. Prior to that Mr. Buss was Managing Director of CATS GmbH.

**ITEM 2. PROPERTIES.**

The Company's headquarters are located in a leased building in Lake Mary, Florida containing approximately 35,000 square feet. This facility houses the Company's U.S. sales and marketing, production, research and development, administrative staff, and customer service/application operations. Additionally, the Company has a leased facility consisting of 16,000 square feet located in Kennett Square, Pennsylvania. Such facility houses manufacturing operations of the laser tracker product lines.

The Company's European headquarters are located in a leased building in Stuttgart, Germany containing approximately 19,500 square feet. The Company also has a combined sales and research and development facility that is located in a leased building in Aveiro, Portugal containing approximately 2,800 square feet. The Company believes that its current facilities will be adequate for its foreseeable needs and that it will be able to locate suitable space for additional regional offices or enhanced production needs as those needs develop.

The information required by the remainder of this Item is incorporated herein by reference to Exhibit 99.1 attached hereto.

**ITEM 3. LEGAL PROCEEDINGS.**

On January 16, 2002, the Company acquired SpatialMetriX Corporation ("SMX") in exchange for 500,000 shares of FARO common stock (50,000 shares of which are being held in escrow) and the satisfaction by the Company of certain obligations of SMX. In connection therewith, the Company issued an additional 350,000 shares of FARO common stock and paid \$2.0 million in cash to fully satisfy SMX's obligations to its two lenders. The Company also assumed and/or satisfied other obligations of SMX. The Company believes that SMX breached several of its representations and warranties to FARO in connection with the acquisition, and as a result, the Company has asserted indemnification and set-off claims against the former SMX shareholders, which include but are not limited to the shares being held in escrow. The representative for the former SMX shareholders has disclaimed any liability for these claims. There is no pending litigation for these claims. The Company does not believe that the results of such litigation, even if the outcome were unfavorable to the Company, would have a materially adverse effect on the Company's business, financial condition or results of operations.

The Company is not involved in any pending legal proceedings other than routine litigation arising in the ordinary course of business.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.**

No matters were submitted to a vote of security holders during the last quarter of calendar 2002.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER

MATTERS.

The Company's Common Stock, par value \$.001 per share, began trading on the NASDAQ Stock Market in September 1997 under the symbol FARO. Before that date, there was no established public trading market for the Common Stock. The following table sets forth the high and low sale price of the Company's Common Stock for its two most recent fiscal years:

	2002		2001	
	High	Low	High	Low
First Quarter	3.500	1.530	4.375	2.188
Second Quarter	3.560	1.450	2.875	1.406
Third Quarter	2.169	1.060	2.984	1.594
Fourth Quarter	2.100	1.350	2.484	1.297

The Company has not paid any cash dividends on its Common Stock to date. The payment of dividends, if any in the future is within the discretion of the Board of Directors and will depend on the Company's earnings, its capital requirements and financial condition, and may be restricted by future credit arrangements entered into by the Company. The Company expects to retain future earnings for use in operating and expanding its business and does not anticipate paying any cash dividends in the reasonably foreseeable future. As of March 11, 2003, the last sale price of the Company's Common Stock was \$2.56, and there were approximately 87 holders of record of Common Stock. The Company believes that there are approximately 1,300 beneficial owners of its Common Stock.

In 1998 the Board of Directors authorized the officers of the Company, without further approval of the Board, to purchase in the open market up to a maximum of one million shares of the Company's Common Stock. In 1998, the Company purchased 40,000 shares of its Common Stock in the open market under such stock repurchase plan. During the three years in the period ended December 31, 2002 the Company did not purchase any shares of its Common Stock in the open market.

## ITEM 6. SELECTED FINANCIAL DATA.

The operating results of SMX have been included in the consolidated statements effective January 16, 2002, the date of acquisition (See *Acquisition of SMX* above). The pro forma selected financial data is presented for informational purposes assuming that the Company had acquired SMX as of January 1, 2001. The pro forma selected financial data has been prepared for comparative purposes only and do not purport to be indicative of the results of operations and financial position which actually would have resulted had the acquisition occurred on the date indicated, or which may result in the future.

### Years Ended December 31

	Pro Forma		Pro Forma (1)		Historical									
	2002		2001		2002	2001	2000	1999	1998					
<b>Statement of Operations</b>														
<b>Data:</b>														
Sales	\$	46,374,076	\$	47,408,591	\$	46,246,372	\$	36,121,696	\$	40,912,663	\$	33,614,490	\$	27,787,877
Gross profit		25,162,134		24,625,944		25,136,763		21,817,613		26,164,035		19,453,522		16,496,564
Income (loss) from operations		(3,444,656)		(9,253,333)		(2,939,243)		(3,361,610)		(237,350)		(9,705,477)(2)		(5,684,607)
Income (loss) before income taxes		(2,310,244)		(8,416,101)		(1,804,831)		(2,506,226)		464,198		(8,516,286)		(4,480,562)
Net income (loss)		(2,520,984)		(8,757,839)		(2,015,571)		(2,847,964)		39,517		(7,394,822)		(4,931,094)
Net income (loss) per common share:														
Basic	\$	(0.21)	\$	(0.74)	\$	(0.17)	\$	(0.26)	\$	—	\$	(0.67)	\$	(0.46)
Diluted	\$	(0.21)	\$	(0.74)	\$	(0.17)	\$	(0.26)	\$	—	\$	(0.67)	\$	(0.46)
Weighted average common shares outstanding:														
Basic		11,853,732		11,882,449		11,853,732		11,032,449		11,021,606		11,015,140		10,632,708
Diluted		11,853,732		11,882,449		11,853,732		11,032,449		11,094,144		11,015,140		10,632,708

### At December 31

	Pro Forma		Pro Forma (1)		Historical									
	2002		2001		2002	2001	2000	1999	1998					
<b>Consolidated Balance Sheet</b>														
<b>Data:</b>														
Working capital		18,338,541		18,143,563		18,338,541	\$	22,303,204	\$	23,672,736	\$	24,869,844	\$	30,997,769
Total assets		45,194,780		44,441,451		45,194,780		39,654,124		44,699,274		42,103,912		49,120,147
Total debt		1,556,125		55,506		1,556,125		80,626		66,657		26,236		337,710
Total shareholders' equity		33,383,649		32,488,788		33,383,649		32,336,461		35,955,453		36,599,346		45,375,391

(1) The Pro forma statement of operations and balance sheet data reflects a charge to operations of \$1.7 million to record amortization of intangible assets acquired (including \$1.2 million for amortization of goodwill).

(2) Includes a charge to write down development and core technology in the amount of \$3.1 million.

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following information should be read in conjunction with the Consolidated Financial Statements of the Company, including the notes thereto, included elsewhere in this document.

## Overview

The Company designs, develops, markets and supports portable, software-driven, measurement systems that are used in a broad range of manufacturing and industrial applications. The Company's principal products are the Control Station and the Control Station Pro measuring devices and their companion Soft Check Tool and CAM2 software, respectively, which provide for CAD-based inspection and factory-level statistical process control. Together, these products integrate the measurement and quality inspection function with CAD software to improve productivity, enhance product quality and decrease rework and scrap in the manufacturing process. The Company's products bring precision measurement, quality inspection and specification conformance capabilities, integrated with leading CAD software, to the factory floor. The Company is a pioneer in the development and marketing of 3-D measurement technology in manufacturing and industrial applications and currently holds 29 patents. The Company's products have been purchased by approximately 2,900 customers worldwide, ranging from small machine shops to such large manufacturing and industrial companies as Audi, Bell Helicopter, Boeing, British Aerospace, Caterpillar, DaimlerChrysler, General Electric, General Motors, Honda, Johnson Controls, Komatsu Dresser, Lockheed Martin, Siemens and Volkswagen among many others.

From its inception in 1982 through 1992, the Company focused on providing computerized, 3-D measurement devices to the orthopedic and neurosurgical markets. During this period, the company introduced a knee laxity measurement device, a diagnostic tool for measuring posture, scoliosis and back flexibility, and a surgical guidance device utilizing a six-axis articulated arm.

In 1992, in an effort to capitalize on a demand for 3-D portable measurement tools for the factory floor, the Company made a strategic decision to target its core measurement technology to the manufacturing and industrial markets. In order to focus on manufacturing and industrial applications of its technology, the Company phased out the direct sale of its medical products and entered into licensing agreements with two major neurosurgical companies for its medical technology. Since 1992, the Company has entered into additional licensing agreements for the use of its technology for medical applications.

Prior to 2002 the Company accounted for royalty revenues from these licensing agreements as "Other Income". In 2002, the Company reclassified Royalty Revenues from "Other Income" to "Sales" on the basis that the licensing of technology is consistent with the Company's main business of 3D measurement.

In 1995, the Company made a strategic decision to target international markets. The Company established sales offices in France and Germany in 1996, Great Britain in 1997, Japan and Spain in 2000 and Italy in 2001. International sales represented 57.0%, 59.1%, and 50.0% of sales in 2002, 2001, and 2000, respectively.

The Company derives revenues primarily from the sale of its measurement equipment, and its related multi-faceted Soft Check Tool and CAM2 software. Revenue related to these products is recognized upon shipment. Going forward, the Company expects to generate an increasing percentage of its revenue from the sale of its laser tracker product.

Historically, the Company's sales growth has resulted from increased unit sales due to an expanded sales effort that included the addition of sales personnel and expanded promotional efforts. In 2000, the Company introduced The Control Station with SoftCheck Tools, new accessory items such as the FARO Rail, the FARO Powerhouse and new versions of all the members of the CAM2 software

family. In January 2002, the Company acquired SpatialMetrix Corporation ("SMX"), a leading manufacturer and supplier of laser trackers and metrology software. The new generation laser tracker is a high-accuracy, portable 3-dimensional measurement technology.

In addition to providing a one-year basic warranty without additional charge, the Company offers its customers one and three-year extended maintenance contracts, which include on-line help services, software upgrades and hardware warranties. In addition, the Company sells training and technology consulting services relating to its products. The Company recognizes the revenue from extended maintenance contracts proportionately, in the same manner as costs are incurred for such revenues.

Cost of sales consists primarily of material, production overhead and labor. Selling expenses consist primarily of salaries and commissions to sales and marketing personnel, and promotion, advertising, travel and telecommunications.

General and administrative expenses consist primarily of salaries for administrative personnel, rent, utilities and professional and legal expenses. Research and development expenses represent salaries, equipment and third-party services.

Accounting for wholly owned foreign subsidiaries is maintained in the currency of the respective foreign jurisdiction and, therefore, fluctuations in exchange rates may have an impact on intercompany accounts reflected in the Company's consolidated financial statements. In the normal course of business, the Company from time to time employs off-balance sheet financial instruments to hedge its exposure to foreign currency exchange rates, including cross-currency swaps, forward contracts, and foreign currency options (see Foreign Exchange Exposure below).

During fiscal years 2002 and 2001, the Company's sales growth has been adversely affected by the economic slowdown currently affecting the United States and Europe. This effect, however, was partially offset by sales growth resulting from the acquisition of SMX in January 2002. In 2001 the Company adopted a cost reduction plan, which continued into 2002. This plan included reducing discretionary spending, canceling certain non-strategic product developments, and a reduction of the company's existing U.S. workforce, primarily in administration, research and development, and manufacturing.

### **New Products**

The Company commenced shipments of its new generation laser tracker product line late in the third quarter of 2002. The Company also released a new generation of its FAROArm production under the names *Platinum* and *Titanium*. The arms replace previous generation arms that were released in 1998. The Company expects the new generation arms to allow the Company to maintain its market leadership in this segment of the portable measure market. Manufacture of both the new generation laser trackers and the new generation portable measurement arms involve both new and distinct manufacturing designs as well as innovative production processes when compared to the Company's previous product offering.



## Results of Operations

The following table sets forth for the periods presented, the percentage of sales represented by certain items in the Company's consolidated statements of operations:

	Year Ended December 31,		
	2002	2001	2000
<b>Statement of Operations Data:</b>			
Sales	100.0%	100.0%	100.0%
Cost of Sales	45.6%	39.6%	36.0%
Gross margin	54.4%	60.4%	64.0%
Operating expenses:			
Selling	30.0%	37.2%	34.3%
General and administrative	17.0%	16.1%	14.1%
Depreciation and amortization	5.0%	7.1%	7.2%
Research and development	8.7%	9.3%	8.7%
Employee stock options	—	—	0.3%
Total operating expenses	60.7%	69.7%	64.6%
Loss from operations	(6.3)%	(9.3)%	(0.6)%
Interest income	1.2%	2.5%	2.1%
Other income, net	1.3%	(0.1)%	(0.4)%
Interest expense	(0.1)%	—	—
Income (loss) before income taxes	(3.9)%	(6.9)%	1.1%
Income tax expense (benefit)	0.5%	0.9%	1.0%
Net income (loss)	(4.4)%	(7.9)%	0.1%

### 2002 Compared to 2001

**Sales.** Sales increased by \$10.1 million or 28.0%, from \$36.1 million for the year ended December 31, 2001 to \$46.2 million for year ended December 31, 2002. The increase resulted primarily from sales of the new laser product line in 2002. Geographically sales increased in all regions primarily due to sales of the new laser product line (United States increased \$5.1 million or 34.5%, Europe increased \$2.2 million or 15.4%, Japan increased \$1.9 million or 111.8%, other foreign sales increased \$900,000 or 16.4%). (See note 15 to the Financial Statements where "Other Foreign" includes approximately \$800,000 of European Sales). Royalty income included in sales decreased by \$20,000 from \$1,010,000 for the year ended December 31, 2001 to \$990,000 for the year ended December 31, 2002.

**Gross profit.** Gross profit increased by \$3.3 million or 15.1%, from \$21.8 million for the year ended December 31, 2001 to \$25.1 million for the year ended December 31, 2002. Gross margin decreased from 60.4% for the year ended December 31, 2001 to 54.4% for the year ended December 31, 2002. The decrease in gross margin was primarily a result of a one-time inventory write-down (\$729,000) recorded in the second quarter of 2002 related to the new laser product line (see Acquisition of SMX above), the impact of the new laser product line acquired in January 2002 and, to a lesser extent, the new generation arm products introduced in the third quarter of 2002 (see New Products above). Gross margins on sales are expected to ultimately meet or exceed the Company's historic levels once both production facilities are at full production levels. Plant capacity utilization is expected to increase with additional manufacturing efficiencies expected in 2003.

*Selling expenses.* Selling expenses increased by \$456,000 or 3.4%, from \$13.4 million for the year ended December 31, 2001 to \$13.9 million for the year ended December 31, 2002. This increase was a result of higher sales commissions on higher sales in the U.S. (\$1.0 million) and higher expenses in Japan (\$382,000) offset largely by cost reduction measures implemented in the United States (\$742,000) and Europe (\$184,000). While an increase in total expenses was experienced in 2002 compared to 2001, this amount represents a decrease in the percentage of sales from 37.2% in 2001 to 30.0% in 2002.

*General and administrative expenses.* General and administrative expenses increased by \$2.1 million or 36.2% from \$5.8 million for the year ended December 31, 2001 to \$7.9 million for the year ended December 31, 2002. The increase was due to administrative expenses resulting from the integration of the former SMX in 2002 (\$915,000), professional fees unrelated to SMX (\$352,000), a provision for doubtful accounts receivable (\$245,000) recorded in the second quarter of 2002 related to the recently acquired laser product line, and a shifting of personnel from Research and Development to Administrative positions (\$549,000).

*Depreciation and amortization expenses.* Depreciation and amortization expenses decreased by \$292,000, or 11.2%, from \$2.6 million for the year ended December 31, 2001 to \$2.3 million in 2002. Depreciation and amortization expenses in 2002 reflect the effect (approximately \$740,000) of the adoption, effective January 1, 2002, of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" (SFAS No. 142) partly offset by an increase in depreciation resulting from newly acquired assets in late 2002. See note 6 consolidated financial statement.

*Research and development expenses.* Research and development expenses increased by \$663,000, or 19.5%, from \$3.4 million for the year ended December 31, 2001 to \$4.0 million for the year ended December 31, 2002 principally as a result of research and development expenses of the new laser tracker product line (\$1.6 million) offset in part by lower expenses for the new generation arm development in the US (\$388,000) and shifting of personnel to administrative positions costs in Europe (\$549,000—see General and Administrative expenses above).

*Interest income.* Interest income decreased by \$339,000, or 37.7%, from \$900,000 for the year ended December 31, 2001 to \$561,000 for the year ended December 31, 2002. The decrease was primarily attributable to lower interest bearing cash balances (see Liquidity and Capital Resources below) and lower interest rates prevailing in 2002.

*Other income(loss).* Other income increased by \$644,000, from \$43,000 loss for the year ended December 31, 2001 to \$601,000 in income for the year ended December 31, 2002 primarily due to foreign currency gains during the current year.

*Income tax expense.* Income tax expense decreased by \$131,000 from \$342,000 for the year ended December 31, 2001 to \$211,000 for the year ended December 31, 2002.

*Net loss.* Net loss decreased by \$800,000 from \$2.8 million for the year ended December 31, 2001 to \$2.0 million for the year ended December 31, 2002 primarily due to higher gross profit from increased sales and cost savings measures implemented in the US and Europe, partially offset by integration expenses of the Laser Division and reduced income tax expense.

#### **2001 Compared to 2000**

*Sales.* Sales decreased \$4.8 million, or 11.7%, from \$40.9 million in 2000 to \$36.1 million in 2001. The decrease resulted from lower sales in the U.S. (\$5.7 million, or 27.9%, from \$20.5 million to

\$14.8 million) and Germany (\$1.7 million, or 19.8%, from \$8.6 million to \$6.9 million), partially offset by increased sales in the remainder of the world (an increase of \$2.5 million, or 21.0%, from \$11.9 million to \$14.4 million). The decrease in the U.S. primarily resulted from lower product unit sales resulting mainly from the slowing U.S. economy throughout 2001. The decrease in Germany reflects the adverse translation effect (approximately \$700,000) of the stronger U.S. dollar in 2001. Royalty income included in Sales increased by \$550,000 from \$460,000 for the year ended December 31, 2000 to \$1,010,000 for the year ended December 31, 2001.

*Gross profit.* Gross profit decreased by \$4.4 million, or 16.8%, from \$26.2 million in 2000 to \$21.8 million in 2001. Gross margin decreased to 60.4% in 2001 from 64.0% in 2000. The decrease in gross margin resulted primarily from downward pressure on unit prices in the U.S. and Europe and the translation effect of the stronger U.S. dollar on international sales.

*Selling expenses.* Selling expenses decreased \$598,000, or 4.3%, from \$14.0 million in 2000 to \$13.4 million in 2001. This decrease was primarily a result of lower selling expenses in the United States (\$1.3 million) resulting from cost reduction efforts in the second half of 2001 and lower sales commissions on lower U.S. sales, the translation effect of the stronger U.S. dollar in 2001 (approximately \$250,000), offset in part by higher expenses in Europe (\$670,000) and Japan (\$282,000), principally as a result of higher compensation and marketing expenses.

*General and administrative expenses.* General and administrative expenses increased by \$50,000, or 1.0%, from \$5.8 million in 2000 to \$5.8 million in 2001. The increase was due to new operations in Japan (\$188,000), offset in part by lower expenses in the U.S. (\$53,000) and Europe (\$15,000) and the effect of the stronger U.S. dollar in 2001 (approximately \$70,000).

*Depreciation and amortization expenses.* Depreciation and amortization expenses decreased by \$372,000, or 12.8%, from \$2.9 million in 2000 to \$2.5 million in 2001 primarily as a result of assets becoming fully amortized in 2001.

*Research and development expenses.* Research and development expenses decreased by \$179,000, or 5.0%, from \$3.5 million in 2000 to \$3.4 million in 2001. The decrease was due to decline across many expense categories in Europe (\$286,000) and the translation effect of the stronger U.S. dollar in 2001 (\$50,000) on the European R&D expenses, offset in part by increase across many expense categories in the United States (\$157,000).

*Interest income.* Interest income increased by \$40,000, from \$860,000 in 2000 to \$900,000 in 2001 primarily as a result of higher average principal amounts invested in 2001, including loans to SMX (see Liquidity and Capital Resources below).

*Other income, net.* Net expenses decreased by \$114,000 from \$157,000 in 2000 to \$43,000 in 2001. The decrease resulted principally from lower foreign exchange losses in Europe in 2001.

*Income tax expense.* Income tax expense decreased by \$83,000, from \$425,000 in 2000 to \$342,000 in 2001. The net tax expense resulted from an increase in the valuation allowance for the Company's US deferred income tax assets offset by benefits realized by the utilization of German net operating loss carryforwards which were previously reserved. At December 31, 2001 the Company has deferred income tax assets of approximately \$7.7 million (including \$1.4 million related to the U.S. operations and \$6.3 million related to foreign operations) which are offset by a valuation allowance of

approximately \$7.6 million. These deferred income tax assets are primarily attributable to net operating loss carryforwards and intangible assets for which future income tax benefits may be realized.

*Net income (loss).* The Company's net income (loss) decreased by \$2.9 million, from net income of \$40,000 in 2000 to a loss of \$2.8 million in 2001 to due to the factors mentioned above.

### **Acquisition of SMX**

On January 16, 2002, the Company acquired SpatialMetriX Corporation ("SMX"), a leading manufacturer and supplier of laser trackers and targets, metrology software and contract inspection services, in exchange for 500,000 shares of FARO common stock (50,000 shares of which are being held in escrow) and the satisfaction by the Company of certain obligations of SMX. In connection therewith, the Company issued an additional 350,000 shares of FARO common stock and paid \$2.0 million in cash to fully satisfy SMX's obligations to its two lenders. The Company also assumed and/or satisfied other obligations of SMX, including approximately \$2.9 million in financing provided by the Company to SMX prior to January 16, 2002.

The Company estimates that SMX had 35% of the installed laser tracker market. The Company exercised its contractual right to acquire SMX only after the successful design by SMX of a new generation laser tracker, which the Company sells at competitive prices compared to both the previous generation SMX tracker, and competitor's current products. SMX's previous generation laser tracker, which was introduced in 1996, was sold until September 2001. SMX halted production and sale of its earlier generation laser tracker in September 2001. The operations of the new laser product line are contributing favorably to the Company's revenue growth and, beginning in the third quarter of 2002, results of operations. The Company sold approximately \$8.8 million in laser products and services in 2002 and expects to continue to ramp up sales of the laser tracker in 2003. The operating expenses of the new laser product line are, beginning in the third quarter of 2002, consistent with the Company's historic operating expense ratios.

### **Liquidity and Capital Resources**

Since 1997, the Company has financed its operations primarily from cash provided by operating activities and from the proceeds of its 1997 initial public offering of Common Stock (approximately \$31.7 million). Total marketable securities (cash and cash equivalents, short-term investments and investments) at December 31, 2002 were \$5.9 million, compared to \$14.1 million at December 31, 2001. This significant (\$8.2 million) reduction is primarily due to the acquisition of SMX in January 2002 and the related operating expenses for the year ending December 31, 2002.

We believe that our working capital, together with anticipated cash flow from our operations, will be sufficient to fund our long-term liquidity requirements. Our liquidity is not dependant upon the use of off-balance sheet financing arrangements, such as scrutinization of receivables or obtaining access to assets through special purpose entities.

For the year ended December 31, 2002, net cash used in operating activities was \$5.0 million compared to \$842,000 in 2001. Net cash used in operating activities was from increases in accounts receivable and inventories (\$5.9 million) and a decrease in accounts payable (\$1.8 million) offset by net profit before depreciation (\$252,000) and provisions for expenses (\$1.2 million) and other items (\$1.2 million). Net cash used by investing activities for the year ended December 31, 2002 was \$118,000 compared to net cash provided of \$267,000 in 2001. The change in investing activities was due primarily to the acquisition of SMX. Net cash provided by financing activities for the year ended December 31, 2002 was \$1.4 million compared to \$9,000 in 2001. In 2002 a line of credit was utilized in the amount of \$1.5 million. The Company invests excess balances in short-term investment-grade securities, such as money market investments, obligations of the U.S. government and its agencies, and obligations of state and local governmental agencies.

On January 16, 2002, in connection with its acquisition of SMX, the Company issued 500,000 shares of FARO common stock and satisfied certain obligations of SMX. Additionally, the Company issued an additional 350,000 shares of FARO common stock and paid \$2.0 million in cash to fully satisfy SMX's obligations to its two lenders (see Acquisition of SMX above). The Company also assumed and/or settled other obligations of SMX, including approximately \$2.9 million in financing provided by the Company to SMX prior to January 16, 2002.

The Company recently commenced shipments of its new generation laser tracker product line and released a new generation Platinum and Titanium advanced portable measure arm products (see New Products above). Manufacture of both the new generation laser trackers and the new generation portable measure arms involve new and distinct manufacturing designs, and production processes, when compared to the Company's previous product offering. Plant capacity utilization is expected to increase with additional manufacturing efficiencies expected in the fourth quarter.

The Company's principal commitments at December 31, 2002 consisted of leases on its headquarters and regional offices (see *Contractual Obligations and Commercial Commitments* below). There were no material commitments for capital expenditures at that date. The Company believes that its cash, investments and cash flows from operations will be sufficient to satisfy its working capital and capital expenditure needs at least through 2003.

### Contractual Obligations and Commercial Commitments

The Company was a party to a term loan that expires in 2003, capital leases for automotive and other equipment with an initial term of 36 to 60 months and non-cancelable operating leases, including leases with related parties (see Note 8 of Notes to Consolidated Financial Statements) that expire on or before 2007.

Commitments under these agreements are as follows at December 31, 2002:

Year	Payments due under:			Total
	Term Loan	Capital Leases	Operating Leases	
2003	\$ 11,625	\$ 37,825	\$ 1,415,417	\$ 1,464,867
2004	—	24,783	877,354	902,137
2005	—	14,684	516,316	531,000
2006	—	5,197	197,897	203,094
2007 and thereafter	—	2,364	17,440	19,804
<b>Total</b>	<b>\$ 11,625</b>	<b>\$ 84,853</b>	<b>\$ 3,024,424</b>	<b>\$ 3,120,902</b>

## **Critical Accounting Policies**

In response to the SEC'S financial reporting release, FR-60, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, we have selected our most subjective accounting estimation processes for purposes of explaining the methodology used in calculating the estimate in addition to any inherent uncertainties pertaining to the estimate and the possible effects on the Company's financial condition. The two accounting estimation processes discussed below are the Company's process of recognizing research and development expenditures, and determining the allowances for both obsolete and slow-moving inventory and doubtful accounts receivable. These estimation processes affect current assets and operating results and are therefore critical in assessing the financial and operating status of the Company. These estimates involve certain assumptions that if incorrect could create an adverse impact on the Company's operations and financial position.

Research and development costs incurred in the discovery of new knowledge and the resulting translation of this new knowledge into plans and designs for new products, prior to the attainment of the related products' technological feasibility, are recorded as expenses in the period incurred. Product design costs incurred in the development of products after technological feasibility is attained are capitalized and amortized using the straight-line method over the estimated economic lives of the related products, not to exceed 3 years. The Company considers technological feasibility to be established when the Company has completed all planning, designing, coding and testing activities that are necessary to establish design specifications including function, features and technical performance requirements. Capitalization of product design costs ceases and amortization of such costs begins when the product is available for general release to customers. The Company periodically assesses the value of capitalized product design costs and records a write-down for impairment when, in the circumstances (including the discontinuance or probable discontinuance of the related products from the market), it deems the asset to be obsolete or impaired.

The reserve for obsolete and slow-moving inventory was \$90,000, \$298,000 and \$418,000 at December 31, 2002, 2001 and 2000, respectively. The reserve for obsolete and slow-moving inventory is used to state the Company's inventories at the lower of average cost or net realizable value. Since the amount of inventorial cost that the Company will truly recoup through sales cannot be known with exact certainty, the Company relies on past sales experience and future sales forecasts. Inventory is considered as obsolete if the Company has withdrawn it from the market or if the Company has had no sales of the product for the past 12 months nor sales forecasted for the next 12 months, therefore an allowance in an amount equal to 100% of the average cost of such inventory is recorded. The Company classifies as slow-moving inventory with quantities of on hand greater than the amounts we have sold in the past 12 months or have forecasted to sell in the next 12 months, and reserve such amount as is adequate to reduce the carrying value to net realizable value.

The Company performs ongoing evaluations of its customers and adjusts their credit ratings accordingly. The Company continuously monitors collections and payments from its customers and maintains a provision for un-collectable amounts based on its historical experience and any other issues it has identified. While such credit losses have historically been within its expectations, the Company cannot guarantee this will continue in the future. The allowances recorded for 2002, 2001 and 2000 were approximately, \$582,000, \$311,000 and \$30,000 respectively.

## **Transactions with Related and Other Parties**

The Company leases its headquarters from Xenon Research, Inc. ("Xenon"), all of the issued and outstanding capital stock of which is owned by Simon Raab, the Company's President and Chief

Executive Officer, and Diana Raab, his spouse. The term of the lease expires on February 28, 2006, and the Company has two five-year renewal options. Base rent under the lease was \$397,000 for 2002. Base rent during renewal periods will reflect changes in the U.S. Bureau of Labor statistics consumer Price Index for all Urban Consumers.

In June 2000, the Company and each of the former CATS shareholders entered into an Amended and Restated Loan Agreement pursuant to which the Company granted loans to the former shareholders of CATS gmbh in the aggregate amount of \$1.1 million ("the Loans"). The loans were made to fund the tax obligations incurred by the former CATS shareholders in connection with the Company's acquisition of CATS gmbh in 1998. The Company agreed to the terms of the loans are part of the acquisition agreement for CATS gmbh. The Loans are for a term of three years, at an interest rate of approximately 4.7%, and grant the borrowers an option to extend the term for an additional three years. As collateral for the Loans, the former CATS shareholders pledged to the Company 177,074 shares of the Company's Common Stock. The Loans are a non-recourse obligation of the former CATS shareholders.

The company engaged Cole & Partners, a mergers and acquisition and corporate finance advisory service firm, to serve as the company's financial advisor in connection with the company's acquisition in January, 2002 of SpatialMetriX, Inc. Stephen R. Cole, one of the Company's directors and member of the Audit Committee, is the founding Partner and President of Cole & Partners. The Company paid to Cole & Partners total fees of approximately \$450,000 for its services, of which \$302,000 was paid in 2002.

### **Foreign Exchange Exposure**

The Company conducts a significant portion of its business outside the United States. At present, the majority of the Company's revenues are invoiced, and a significant portion of its operating expenses paid, in foreign currencies. Fluctuations in exchange rates between the U.S. dollar and such foreign currencies may have a material adverse effect on the Company's business, results of operations and financial condition, and could specifically result in foreign exchange gains and losses. The impact of future exchange rate fluctuations on the results of the Company's operations cannot be accurately predicted. To the extent that the percentage of the Company's non-U.S. dollar revenues derived from international sales increases in the future, the Company's exposure to risks associated with fluctuations in foreign exchange rates will increase further. See additional discussion under *Impact of Recently Issued Accounting Standards* below.

### **Inflation**

The Company believes that inflation has not had a material impact on its results of operations in recent years and does not expect inflation to have a material impact on its operations in 2003.

### **Conversion to the Euro**

On January 1, 2002, certain member countries of the European Union adopted the Euro as their national currency. The transition period for the introduction of the Euro ended June 30, 2002. The adoption of the Euro did not have a material effect on the Company's financial condition or results of operations.

### **Impact of Recently Issued Accounting Standards**

In October 2001, the Financial Accounting Standards Board ("FASB") issued Statement No. 144, "*Accounting for the Impairment or Disposal of Long-Lived Assets*," (SFAS No. 144) which addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS No. 144 supersedes Statement of Financial Accounting Standards No. 121, "*Accounting for the Impairment of*

*Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,*” (SFAS No. 121) but retains many of the fundamental provisions of SFAS No. 121. SFAS No. 144 also supersedes APB Opinion No. 30, *“Reporting the Results of Operations, Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.”* SFAS No. 144 retains the requirement in Opinion 30 to report separately discontinued operations and extends this reporting requirement to a component of an entity that either has been disposed of or is classified as held for sale. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. Early application is permitted. The Company does not expect the adoption of SFAS No. 144 to have a material impact on its financial statements or results of operations.

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 142, *“Goodwill and Other Intangible Assets”* (SFAS No. 142). SFAS No. 142 requires that goodwill no longer be amortized to earnings, but instead be reviewed for impairment. The Company adopted this new Statement effective January 1, 2002.

In January 2001, the Company adopted FASB Statement No. 133 (SFAS No. 133), *Accounting for Derivative Instruments and Hedging Activities*, as amended. SFAS 133 requires companies to recognize all their derivative instruments as either assets or liabilities at fair value in the statement of position. In September 2002, the Company entered into a foreign exchange rate swap allowing the Company the right to purchase up to \$1.8 million at a base rate of 1.0444 Euros per \$1.00. Under the agreement, the Company and the bank are to compensate one another based on the exchange rate agreement differential at specified measurement dates. This foreign exchange rate agreement does not qualify for special hedge accounting treatment, as it does not meet the specified criteria under SFAS 133. Therefore the changes in fair value are included in the determination of earnings.

In June 2001, Statement of Financial Accounting Standards No. 142, *“Goodwill and Other Intangible Assets”* (“Statement 142”), was issued stating that indefinite-life identifiable intangible assets and goodwill are not amortized. The Company periodically reviews its identifiable assets and goodwill, considering factors such as projected cash flows and revenue and earnings multiples, to determine whether the value of the assets are impaired and the amortization periods are appropriate. If an asset is impaired, the difference between the value of the asset reflected on the financial statements and its current fair value is recognized as an expense in the period in which the impairment occurs. Goodwill is impaired when the carrying amount of the reporting unit exceeds the implied fair value of the reporting unit. The Company adopted this accounting standard on January 2, 2002.

In June 2001, the FASB issued Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* (SFAS No. 143) which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The standard applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development, and (or) normal use of the asset. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002. The Company believes that the adoption of SFAS No. 143 will not have a material effect in its financial position or results of operations.

In June 2002, the FASB issued Statement of Financial Accounting Standards No. 146 (SFAS 146), *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullified Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination*



*Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. SFAS 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when a liability is incurred rather than when an exit or disposal plan is approved. We are required to adopt the provisions of SFAS 146 for any exit or disposal activities initiated after December 31, 2002. The effect of adoption of SFAS 146 will be a change on a prospective basis of the timing of when restructuring charges are recorded from a commitment date approach to when a liability is recorded. The Company does not expect the adoption of SFAS 146 to have a material impact on its financial statements or results of operations.

In November 2002, the FASB issued FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. This interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The disclosure requirements of this interpretation are effective for interim and annual periods after December 15, 2002. The initial recognition and initial measurement requirements of this interpretation are effective prospectively for guarantees issued or modified after December 31, 2002. The interpretation's expanded disclosures will not have a material impact on the Company's financial position or results of operations.

In November 2002, the EITF reached a consensus on Issue 00-21, "Multiple-Deliverable Revenue Arrangements" ("EITF 00-21"). EITF 00-21 addresses how to account for arrangements that may involve the delivery or performance of multiple products, services, and/or rights to use assets. The consensus mandates how to identify whether goods or services or both that are to be delivered separately in a bundled sales arrangement should be accounted for separately because they are "separate units of accounting." The guidance can affect the timing of revenue recognition for such arrangements, even though it does not change rules governing the timing or pattern of revenue recognition of individual items accounted for separately. The final consensus will be applicable to agreements entered into in fiscal years beginning after June 15, 2003 with early adoption permitted. Additionally, companies will be permitted to apply the consensus guidance to all existing arrangements as the cumulative effect of a change in accounting principle in accordance with APB Opinion No. 20, *Accounting Changes*. The Company is assessing, but at this point does not believe the adoption of EITF 00-21 will have a material impact on our financial position, cash flows or results of operations.

In December 2002, the FASB issued Statement of Financial Accounting Standards No. 148 (SFAS 148), *Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123*, SFAS 148 amends SFAS 123 to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The transition guidance and annual disclosure provisions of SFAS 148 are effective for financial statements issued for fiscal years ending after December 15, 2002, and are included in Note 1 to the consolidated financial statements. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. The Company does not believe the adoption of this statement will have a material impact on its financial position or results of operations.

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**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

The information required by this item is incorporated by reference herein from the section of this Report in Part II, Item 7, under the captions “Foreign Exchange Exposure”, “Inflation” and “Conversion to the Euro Currency” above.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

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## INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT'S REPORT

To the Board of Directors and Shareholders of FARO Technologies, Inc.:

We have audited the accompanying consolidated balance sheets of FARO Technologies, Inc. and subsidiaries as of December 31, 2002 and 2001, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of FARO Technologies, Inc. and subsidiaries at December 31, 2002 and 2001 and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States.

As described in Note 6 to the financial statements, the Company adopted Statement of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets", effective January 1, 2002.

/s/ ERNST & YOUNG LLP

Orlando, Florida  
March 19, 2003

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2002	2001
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 4,023,614	\$ 7,238,564
Short term investments (Note 1)	1,437,537	4,744,559
Accounts receivable, net of allowance (Note 4)	14,236,160	9,385,568
Income taxes refundable	—	545,118
Inventories, net (Note 5)	9,126,857	5,575,793
Prepaid expenses and other current assets	1,142,576	1,851,003
Deferred income taxes	—	76,418
	29,966,744	29,417,023
<b>PROPERTY AND EQUIPMENT—at cost:</b>		
Machinery and equipment	5,338,681	4,038,582
Furniture and fixtures	1,342,207	1,313,809
Leasehold improvements	332,082	139,555
	7,012,970	5,491,946
Less accumulated depreciation	(4,995,111)	(3,945,247)
	2,017,859	1,546,699
INTANGIBLE ASSETS—net (Note 6)	11,542,489	2,632,791
INVESTMENTS (Note 1)	427,478	2,129,679
NOTES RECEIVABLE (Note 2)	1,240,210	3,927,932
	45,194,780	39,654,124
<b>TOTAL ASSETS</b>	<b>\$ 45,194,780</b>	<b>\$ 39,654,124</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Current portion of long-term debt (Note 8)	\$ 49,450	\$ 25,120
Amounts due under credit line	1,459,647	—
Accounts payable	4,781,243	2,937,271
Accrued liabilities (Note 7)	3,202,231	3,064,463
Income taxes payable	106,954	—
Current portion of unearned service revenues	1,930,736	855,120
Customer deposits	97,942	231,845
	11,628,203	7,113,819
OTHER LONG-TERM LIABILITIES (Note 8)	182,928	203,844
	11,811,131	7,317,663
<b>COMMITMENTS AND CONTINGENCIES (Note 11)</b>		
<b>SHAREHOLDERS' EQUITY:</b>		
Class A preferred stock—par value \$.001, 10,000,000 shares authorized, no shares issued and outstanding	—	—
Common stock—par value \$.001, 50,000,000 shares authorized, 11,931,726 and 11,075,252 issued; 11,891,726 and 11,035,252 outstanding, respectively	11,932	11,075
Additional paid-in capital	49,462,548	47,704,087
Unearned compensation	(14,768)	(109,000)
Accumulated deficit	(14,131,669)	(12,116,098)
Other comprehensive loss	(1,793,769)	(3,002,978)
Common stock in treasury, at cost—40,000 shares	(150,625)	(150,625)
	33,383,649	32,336,461
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 45,194,780</b>	<b>\$ 39,654,124</b>

See accompanying notes to condensed consolidated financial statements.

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

	Year Ended December 31,		
	2002	2001	2000
SALES	\$ 46,246,372	\$ 36,121,696	\$ 40,912,663
COST OF SALES	21,109,609	14,304,083	14,748,628
Gross profit	25,136,763	21,817,613	26,164,035
<b>OPERATING EXPENSES</b>			
Selling	13,891,917	13,436,209	14,033,725
General and administrative	7,873,338	5,812,803	5,763,040
Depreciation and amortization	2,267,763	2,559,495	2,931,546
Research and development	4,033,462	3,370,716	3,549,670
Employee stock options (Note 12)	9,526	—	123,404
Total operating expenses	28,076,006	25,179,223	26,401,385
LOSS FROM OPERATIONS	(2,939,243)	(3,361,610)	(237,350)
OTHER INCOME (EXPENSE)			
Interest income (Note 1)	561,112	900,281	860,254
Other income, net	601,336	(43,150)	(157,372)
Interest expense	(28,036)	(1,747)	(1,334)
INCOME (LOSS) BEFORE INCOME TAXES	(1,804,831)	(2,506,226)	464,198
INCOME TAX EXPENSE (Note 10)	210,740	341,738	424,681
NET INCOME (LOSS)	\$ (2,015,571)	\$ (2,847,964)	\$ 39,517
NET INCOME (LOSS) PER SHARE—BASIC	\$ (0.17)	\$ (0.26)	\$ —
NET INCOME (LOSS) PER SHARE—DILUTED	\$ (0.17)	\$ (0.26)	\$ —

See accompanying notes to condensed consolidated financial statements.

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**

	Common Stock		Additional Paid-in Capital	Unearned Compensation	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Common Stock in Treasury	Total
	Shares	Amounts						
<b>BALANCE, JANUARY 1, 2000</b>	11,059,510	\$ 11,060	\$47,544,844	\$ (123,404)	\$ (9,307,651)	\$ (1,374,878)	\$ (150,625)	\$36,599,346
Net Income					39,517			39,517
Currency translation adjustment, net of tax						(832,035)		(832,035)
Comprehensive loss								(792,518)
Issuance of common stock	5,715	6	25,215					25,221
Amortization of unearned compensation				123,404				123,404
<b>BALANCE, DECEMBER 31, 2000</b>	11,065,225	\$ 11,066	\$47,570,059	\$ —	\$ (9,268,134)	\$ (2,206,913)	\$ (150,625)	\$35,955,453
Net loss					(2,847,964)			(2,847,964)
Currency translation adjustment, net of tax						(796,065)		(796,065)
Comprehensive loss								(3,644,029)
Options granted subject to variable accounting			109,000	(109,000)				—
Issuances of common stock	10,027	9	25,028					25,037
<b>BALANCE, DECEMBER 31, 2001</b>	11,075,252	\$ 11,075	\$47,704,087	\$ (109,000)	\$ (12,116,098)	\$ (3,002,978)	\$ (150,625)	\$32,336,461
Net loss					(2,015,571)			(2,015,571)
Currency translation adjustment, net of tax						1,209,209		1,209,209
Comprehensive loss								(806,362)
Options subject to variable accounting			(84,706)	84,706				—
Amortization of Unearned Compensation				9,526				9,526
Issuance of common stock in connection with the acquisition of SMX	850,000	850	1,826,650					1,827,500
Issuance of common stock	6,474	7	16,517					16,524
<b>BALANCE DECEMBER 31, 2002</b>	11,931,726	\$ 11,932	\$49,462,548	\$ (14,768)	\$ (14,131,669)	\$ (1,793,769)	\$ (150,625)	\$33,383,649

See accompanying notes to condensed consolidated financial statements.

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Years Ended December 31,		
	2002	2001	2000
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income (loss)	\$ (2,015,571)	\$ (2,847,964)	\$ 39,517
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,267,763	2,559,495	2,931,546
Foreign currency gains	(184,027)	—	—
Inventory write-down	729,286	—	—
Provision for bad debts	582,463	310,981	30,271
Provision for inventory losses	663,269	856,551	300,955
Deferred income taxes	76,418	802,722	(127,139)
Employee stock options	9,526	—	123,404
Change in operating assets and liabilities:			
Accounts receivable	(2,514,764)	197,437	(946,693)
Income taxes refundable	545,118	(545,118)	234,470
Inventories	(3,382,190)	(178,323)	(549,516)
Prepaid expenses & other current assets	468,205	(796,145)	(586,176)
Accounts payable and accrued liabilities	(1,805,060)	(894,764)	2,095,884
Income taxes payable	106,953	(684,409)	684,409
Unearned revenues	404,530	268,794	436,132
Customer deposits	(947,999)	108,249	55,817
Net cash provided by (used in) operating activities	(4,996,080)	(842,494)	4,722,881
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Acquisition of SMX	(3,028,615)	—	—
Cash from investments	5,009,223	6,250,000	6,690,000
Purchases of investments	—	(2,150,029)	(7,422,252)
Investment in notes receivable	—	(2,799,086)	(1,001,593)
Purchases of property and equipment, net	(1,287,317)	(788,168)	(1,197,532)
Investment in intangible assets	(810,895)	(245,694)	(120,264)
Net cash provided by investing activities	(117,604)	267,023	(3,051,641)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Borrowings on line of credit	1,459,647	—	—
Payments of long-term debt and notes payable	(30,889)	(16,497)	(14,070)
Proceeds from issuance of stock—net	16,524	25,037	25,221
Net cash provided by financing activities	1,445,282	8,540	11,151
Effect of exchange rate changes on cash	453,452	(223,823)	(161,035)
INCREASE (DECREASE) IN CASH	(3,214,950)	(790,754)	1,521,356
CASH, BEGINNING OF PERIOD	7,238,564	8,029,318	6,507,962
CASH, END OF PERIOD	\$ 4,023,614	\$ 7,238,564	\$ 8,029,318

See accompanying notes to condensed consolidated financial statements.



**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**YEARS ENDED DECEMBER 31, 2002, 2001, and 2000**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Description of Business**—FARO Technologies, Inc. and subsidiaries develops, manufactures, markets and supports Computer Aided Design (CAD)-based quality assurance products and CAD-based inspection and statistical process control software.

**Principles of Consolidation**—The consolidated financial statements include the accounts of FARO Technologies, Inc. and all majority-owned subsidiaries (collectively, the “Company”). All significant intercompany transactions and balances have been eliminated. The financial statements of the 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 translation of financial statements are reflected as a separate component of comprehensive (loss) income.

**Revenue Recognition, Product Warranty and Extended Maintenance Contracts**—Revenue related to the Company’s measurement equipment and related software is recognized upon shipment as the Company considers the earnings process substantially complete as of the shipping date. Revenue from sales of software only is recognized when no further significant production, modification or customization of the software is required and where the following criteria are met: persuasive evidence of a sales agreement exists, delivery has occurred, and the sales price is fixed or determinable and deemed collectible. Revenues resulting from sales of comprehensive support, training and technology consulting services are recognized as such services are performed. Extended maintenance plan revenues are recognized in proportion to maintenance costs projected to be incurred. The Company warrants its products against defects in design, materials and workmanship for one year. A provision for estimated future costs relating to warranty expenses is recorded when products are shipped. Costs relating to extended maintenance plans are recognized as incurred. Revenue from the licensing agreements for the use of its technology for medical applications is generally recognized as received. Amounts representing royalties for the current year and not received as of year end, are estimated as due (based on historical data) and recognized in the current year.

**Cash and Cash Equivalents**—The Company considers cash on hand and amounts on deposit with financial institutions which have original maturities of three months or less to be cash and cash equivalents.

All short-term investments in debt securities which have maturities of three months or less are classified as cash and equivalents, which are carried at market value based upon the quoted market prices of those investments at each respective balance sheet date.

**Investments**—Short-term investments ordinarily consist of short-term debt securities acquired with cash not immediately needed in operations. Such amounts have maturities not exceeding one year. Investments ordinarily consist of debt securities acquired with cash not immediately needed in operations. Such amounts have maturities of at least one year (none has maturities exceeding two years).

Investments consisted of the following:

	December 31	
	2002	2001
Government agency securities	\$ —	\$ 2,032,679
Corporate bonds	427,478	—
Certificates of deposit	—	97,000
	\$ 427,478	\$ 2,129,679

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

Management determines the appropriate classification of its short term investments and investments in debt securities at the time of the purchase and reevaluates such determinations at each balance sheet date. All investments in debt securities are classified as held to maturity as the company has the positive intent and ability to hold the securities to maturity. Held to maturity securities are stated at amortized cost. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and interest are included in other income in the consolidated statements of operations. The Company's investments in debt securities are diversified among high credit quality securities in accordance with the Company's investment policy. The gross unrealized gain on all held to maturity debt securities was approximately \$13,000 and \$123,000 at December 31, 2002 and 2001, respectively.

**Inventories**—Inventories are stated at the lower of average cost or net realizable value. In order to achieve a better matching of production costs with the revenues generated in production, certain fixed overhead costs and certain general and administrative costs that are related to production are capitalized into inventory when they are incurred and are charged to cost of sales as product costs at the time of sale. Shipping and handling costs are classified as a component of Cost of Sales in the Consolidated Statements of Operations.

Sales demonstration inventory is comprised of measuring devices utilized by sales representatives to present the Company's products to customers. These products remain in sales demonstration inventory for six to twelve months and are subsequently sold at prices that produce slightly reduced gross margins.

**Property and Equipment**—Property and equipment are recorded at cost. Depreciation is computed using the straight-line and declining-balance methods over the estimated useful lives of the various classes of assets as follows:

Machinery and equipment	2 to 5 years
Furniture and fixtures	3 to 10 years

Leasehold improvements are amortized on the straight-line basis over the lesser of the life of the asset or the term of the lease.

**Intangibles**—Goodwill represents the excess of purchase price over the fair value of businesses acquired and was amortized on a straight-line basis over 5 years through December 31, 2001. Effective January 1, 2002, the Company ceased to amortize goodwill in accordance with the provisions of SFAS No. 142 (see *Recently Adopted Accounting Standards* below).

Other acquired intangibles principally include core technology, existing product technology and customer relationships that arose in connection with the acquisition of CATS. Other acquired intangibles are recorded at fair value at the date of acquisition and are amortized over their estimated useful lives of primarily 3 to 5 years.

Product design costs incurred in the development of products after technological feasibility is attained are capitalized and amortized using the straight-line method over the estimated economic lives of the related products, not to exceed 3 years. The Company considers technological feasibility to be established when the Company has completed all planning, designing, coding and testing activities that are necessary to establish design specifications including function, features and technical performance requirements. Capitalization of product design costs ceases and amortization of such costs begins when the product is available for general release to customers.

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

Patents are recorded at cost. Amortization is computed using the straight-line method over the lives of the patents, which is 17 years. Other intangibles are amortized over periods ranging from 3 to 5 years.

Goodwill represents the excess cost of a business acquisition over the fair value of the net assets acquired. In accordance with Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("Statement 142"), indefinite-life identifiable intangible assets and goodwill are not amortized. The Company periodically reviews its identifiable intangible assets and goodwill, considering factors such as projected cash flows and revenue and earnings multiples, to determine whether the value of the assets are impaired and the amortization periods are appropriate. If an asset is impaired, the difference between the value of the asset reflected on the financial statements and its current fair value is recognized as an expense in the period in which the impairment occurs. Goodwill is impaired when the carrying amount of the reporting unit exceeds the implied fair value of the reporting unit. The Company adopted this accounting standard on January 2, 2002.

The table below sets forth what reported net income and earnings per share would have been in all periods presented, exclusive of amortization expense recognized in those periods related to goodwill and other intangible assets that are no longer being amortized.

	For the Year Ended December 31,		
	2002	2001	2000
Reported net income (loss)	\$ (2,015,571)	\$ (2,847,964)	\$ 39,517
Add back: Goodwill amortization	—	740,946	722,509
<b>Adjusted net income (loss)</b>	<b>\$ (2,015,571)</b>	<b>\$ (2,107,018)</b>	<b>\$ 762,026</b>
<b>Basic earnings per share</b>			
Reported net income (loss)	\$ (0.17)	\$ (0.26)	\$ 0.00
Goodwill amortization	—	0.07	0.07
<b>Adjusted net income (loss)</b>	<b>\$ (0.17)</b>	<b>\$ (0.19)</b>	<b>\$ 0.07</b>
<b>Diluted earnings per share</b>			
Reported net income (loss)	\$ (0.17)	\$ (0.26)	\$ 0.00
Goodwill amortization	—	0.07	0.07
<b>Adjusted net income (loss)</b>	<b>\$ (0.17)</b>	<b>\$ (0.19)</b>	<b>\$ 0.07</b>

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 141, "Business Combinations" ("Statement 141") and Statement 142. Statement 141 eliminates the pooling method of accounting for all business combinations initiated after June 30, 2001 and addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. The Company adopted this accounting standard for all business combinations initiated after June 30, 2001.

**Research and Development**—Research and development costs incurred in the discovery of new knowledge and the resulting translation of this new knowledge into plans and designs for new products, prior to the attainment of the related products' technological feasibility, are recorded as expenses in the period incurred.

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**Income Taxes**—Deferred tax assets and liabilities reflect the future income tax effects of temporary differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective tax bases and are measured using enacted tax rates that apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

**Fair Value of Financial Instruments**—The Company's financial instruments include cash and cash equivalents, short-term investments, accounts receivable, investments, foreign exchange rate agreements, and accounts payable. The carrying amounts of such financial instruments approximate their fair value.

**Earnings Per Share**—Basic earnings per share ("EPS") is computed by dividing earnings available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution of securities that could share in the earnings. A reconciliation of the number of common shares used in calculation of basic and diluted EPS is presented in Note 13.

**Concentration of Credit Risk**—Financial instruments which potentially expose the Company to concentrations of credit risk consist principally of operating demand deposit accounts. The Company's policy is to place its operating demand deposit accounts with high credit quality financial institutions.

No customer represented more than 6.0% of the Company's total sales for the years ended December 31, 2002, 2001 and 2000.

**Stock-Based Compensation**—In accordance with Statement of Financial Accounting Standards ("SFAS" No. 123), "*Accounting for Stock-Based Compensation*," ("SFAS No. 123"), the Company has elected to continue to account for its employee stock compensation plans under Accounting Principle Board (APB) Opinion No. 25 with pro-forma disclosures of net earnings and earnings per share, as if the fair value based method of accounting defined in SFAS No. 123 has been applied. Under the intrinsic value based method, compensation cost is the excess, if any, of the quoted market price of the stock at the grant date or other measurement date over the amount an employee must pay to acquire the stock. Under the fair value based method, compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period.

In April 2000, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 44 (FIN 44), *Accounting for Certain Transactions Involving Stock Compensation, an Interpretation of APB Opinion No. 25*. FIN 44 clarifies and modifies APB Opinion No. 25, *Accounting for Stock Issued to Employees*. During 2001, certain options to purchase common stock were effectively re-priced and will be accounted for as variable plan options. Such accounting could result in future charges to earnings (see Note 12).

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**Long-Lived Assets**—Long-lived assets, including property and equipment and certain intangible assets to be held and used by the Company are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of the assets may not be recoverable. Impairment losses are recognized if expected future discounted or undiscounted cash flows of the related assets are less than their carrying values. Measurement of an impairment loss is based on the fair value of the asset. Long-lived assets and certain identifiable intangibles to be disposed of are reported at the lower of carrying amount or fair value less cost to sell. See Note 2 regarding the impairment of certain developed and core technology.

**Estimates**—The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Impact of Recently Issued Accounting Standards**—In January 2001, the Company adopted FASB Statement No. 133 (SFAS No. 133), *Accounting for Derivative Instruments and Hedging Activities*, as amended. SFAS 133 requires companies to recognize all their derivative instruments as either assets or liabilities at fair value in the statement of position. In September 2002, the Company entered into a foreign exchange rate swap allowing the Company the right to purchase up to \$1.8 million at a base rate of 1.0444 Euros per \$1.00. Under the agreement, the Company and the bank are to compensate one another based on the exchange rate agreement differential at specified measurement dates. This foreign exchange rate agreement does not qualify for special hedge accounting treatment, as it does not meet the specified criteria under SFAS 133. Therefore the changes in fair value are included in the determination of earnings.

This foreign exchange rate agreement set to expire in September 2003 was terminated in December 2002. During the year ended December 31, 2002, the Company recognized a loss of \$105,000 related to the change in fair value and the subsequent termination of the foreign exchange rate agreement. This loss is included in "Other Income."

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 141, *Business Combinations* ("Statement 141") and Statement 142. Statement 141 eliminates the pooling method of accounting for all business combinations initiated after June 30, 2001 and addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. The Company adopted this accounting standard for all business combinations initiated after June 30, 2001.

In June 2001, Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* ("Statement 142"), was issued stating that indefinite-life identifiable intangible assets and goodwill are not amortized. The Company periodically reviews its identifiable assets and goodwill, considering factors such as projected cash flows and revenue and earnings multiples, to determine whether the value of the assets are impaired and the amortization periods are appropriate. If an asset is impaired, the difference between the value of the asset reflected on the financial statements and its current fair value is recognized as an expense in the period in which the impairment occurs. Goodwill is impaired when the carrying amount of the reporting unit exceeds the implied fair value of the reporting unit. The Company adopted this accounting standard on January 1, 2002. The effect of the adoption

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

resulted in a decrease to depreciation and amortization of approximately \$740,000 for the year ended December 31, 2002.

In June 2001, the FASB issued Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* (SFAS No. 143) which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The standard applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development, and (or) normal use of the asset. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002. The Company believes that the adoption of SFAS No. 143 will not have a material effect in its financial position or results of operations.

In October 2001, the Financial Accounting Standards Board ("FASB") issued Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, (SFAS No. 144) which addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS No. 144 supersedes Statement of Financial Accounting Standards No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, (SFAS No. 121) but retains many of the fundamental provisions of SFAS No. 121. SFAS No. 144 also supersedes APB Opinion No. 30, *Reporting the Results of Operations, Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. SFAS No. 144 retains the requirement in Opinion 30 to report separately discontinued operations and extends this reporting requirement to a component of an entity that either has been disposed of or is classified as held for sale. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. Adoption of this standard has not had a material impact on the financial position or results of operation.

In June 2002, the FASB issued Statement of Financial Accounting Standards No. 146 (SFAS 146), *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullified Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including certain costs incurred in a restructuring)*. SFAS 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when a liability is incurred rather than when an exit or disposal plan is approved. We are required to adopt the provisions of SFAS 146 for any exit or disposal activities initiated after December 31, 2002. The effect of adoption of SFAS 146 will be a charge on a prospective basis of the timing of when restructuring charges are recorded from a commitment date approach to when a liability is recorded. The Company does not expect the adoption of SFAS 146 to have a material impact on its financial position or results of operations.

In November 2002, the FASB issued FASB interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, including indirect Guarantees of Indebtedness of Others*. This interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The disclosure requirements of this interpretation are effective for interim and annual periods after December 15 2002. The initial recognition and initial measurement requirements of this interpretation are effective prospectively for guarantees issued or

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

modified after December 31, 2002. The interpretations's expanded disclosures will not have a material impact on the Company's financial position or results of operations.

In November 2002, the EITF reached a consensus on Issue 00-21, *Multiple-Deliverable Revenue Arrangements* ("EITF 00-21"). EITF 00-21 addresses how to account for arrangements that may involve the delivery or performance of multiple products, services, and/or rights to use assets. The consensus mandates how to identify whether goods or services or both that are to be delivered separately in a bundled sales arrangement should be accounted for separately because they are "separate units of accounting" The guidance can affect the timing of revenue recognition for such arrangements, even though it does not change rules governing the timing or pattern of revenue recognition of individual items accounted for separately. The final consensus will be applicable to agreements entered into in fiscal years beginning after June 15, 2003 with early adoption permitted. Additionally, companies will be permitted to apply the consensus guidance to all existing arrangements as the cumulative effect of a change in accounting principle in accordance with APB Opinion No. 20, *Accounting Changes*. The Company is assessing, but at this point does not believe the adoption of EITF 00-21 will have a material impact on our financial position, cash flows or results of operations.

**Reclassification**—Certain 2001 and 2000 amounts have been reclassified to conform to 2002 classifications.

**2. ACQUISITION**

On January 16, 2002, the Company acquired SpatialMetriX Corporation ("SMX") in exchange for 500,000 shares of FARO common stock (50,000 shares of which are being held in escrow) and the satisfaction by the Company of certain obligations of SMX. In connection therewith, the Company issued an additional 350,000 shares of FARO common stock and paid \$2.0 million in cash to fully satisfy SMX's obligations to its two lenders. The Company also assumed and/or satisfied other obligations of SMX. The transaction was recorded utilizing the purchase method of accounting in accordance with Statement of Financial Accounting Standard No. 142, *Goodwill and Other Intangible Assets*." SMX was a manufacturer and supplier of laser trackers and metrology software. SMX's previous generation laser tracker, which was introduced in 1996, was sold until September 2001. SMX halted production and sale of its earlier generation laser tracker in September 2001. The Company exercised its contractual right to acquire SMX only after the successful design by SMX of a new generation laser tracker, which the Company sells at competitive prices compared to both the previous generation SMX tracker, and competitor's current products.

The acquisition was recorded under the purchase method of accounting and the final allocation among tangible and intangible assets and liabilities is as follows:

Tangible assets	\$ 3,723,000
Intangible assets:	
Purchased Technology	1,500,000
Patents and licenses	500,000
Goodwill	7,243,000
Liabilities assumed	(5,778,000)
	\$ 7,188,000

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

The operating results of SMX have been included in the consolidated statements of operations since the date of acquisition. The following unaudited pro forma results of operations for the year ended December 30, 2002 and 2001 are presented for informational purposes assuming that the Company had acquired SMX as of January 1, 2001. These pro forma results of operations have been prepared for comparative purposes only and do not purport to be indicative of the results of operations which actually would have resulted had the acquisition occurred on the date indicated, or the results of operations which may result in the future.

	Year ended December 31	
	2002	2001
Revenues	\$ 46,374,076	\$ 47,408,591
Net loss	\$ 2,520,984	\$ (8,757,839)
Loss per share:		
Basic	\$ (0.21)	\$ (0.74)
Diluted	\$ (0.21)	\$ (0.74)

**3. SUPPLEMENTAL CASH FLOW INFORMATION**

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

	Years ended December 31		
	2002	2001	2000
Cash paid for interest	\$ 22,927	\$ 1,747	\$ 1,334
Cash paid for income taxes	0	673,787	54,000
Non cash investing and financing activities:			
Fixed assets acquired under capital lease obligations	42,376	33,041	55,795
Issuance of common stock in connection with the SMX acquisition	1,827,500	—	—
Conversion of SMX notes receivable in connection with SMX acquisition	2,875,000	—	—

**4. ALLOWANCE FOR DOUBTFUL ACCOUNTS**

The allowance for doubtful accounts is as follows:

	Years ended December 31		
	2002	2001	2000
Balance, beginning of year	\$ 339,715	\$ 353,514	\$ 334,612
Provision	582,643	310,981	30,271
Amounts written off	(70,326)	(324,780)	(11,369)
Balance, end of year	\$ 851,852	\$ 339,715	\$ 353,514



**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**5. INVENTORIES**

Inventories, net consist of the following:

	December 31	
	2002	2001
Raw materials	\$ 3,214,119	\$ 496,298
Work-in-process	1,580,667	1,875,912
Finished goods	793,094	341,348
Sales demonstration	3,538,977	2,862,235
	\$ 9,126,857	\$ 5,575,793

The allowance for obsolete and slow-moving inventory is as follows:

	Years ended December 31		
	2002	2001	2000
Balance, beginning of year	\$ 297,508	\$ 417,930	\$ 1,080,815
Charges to Cost of Sales	663,269	856,551	300,955
Amounts written off	(870,808)	(976,973)	(963,840)
	\$ 89,969	\$ 297,508	\$ 417,930

**6. INTANGIBLE ASSETS**

Intangible assets consist of the following:

	December 31	
	2002	2001
Goodwill	\$ 9,559,888	\$ 2,770,670
Existing product technology	3,777,842	4,589,775
Customer relationships	1,055,451	477,842
Product design costs	3,704,377	341,948
Patents	2,041,979	1,225,815
Other	884,472	131,033
	21,024,009	9,537,083
Accumulated amortization	(9,481,520)	(6,904,292)
	\$ 11,542,489	\$ 2,632,791

Amortization expense was \$1,156,668, \$1,557,819, and \$2,062,293 in 2002, 2001, and 2000, respectively. Effective January 1, 2002, the Company stopped amortizing certain indefinite-lived intangibles. This resulted in a decrease in amortization expense of approximately \$740,000. The estimated amortization expense for each of the five succeeding fiscal years is as follows: 2003—\$746,000; 2004—\$496,000; 2005—\$495,000; 2006—\$488,000; 2007—\$486,000.

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**7. ACCRUED LIABILITIES**

Accrued liabilities consist of the following:

	December 31	
	2002	2001
Accrued compensation and benefits	\$ 1,173,438	\$ 1,060,378
Accrued royalties and warranties	114,328	138,200
Other accrued liabilities	1,914,465	1,865,885
	\$ 3,202,231	\$ 3,064,463

**8. NOTES PAYABLE AND DEBT**

The Company has available lines of credit aggregating \$1,500,000. Drawings under the lines of credit bear interest at a rate equivalent to a 30-day commercial paper plus 2.75%. At December 31, 2002, borrowings under the lines of credit aggregated \$1,459,647. There were no amounts outstanding under the line of credit at December 31, 2001.

Debt consists of the following:

	December 31	
	2002	2001
4-year, 5.9% automobile loan	\$ 11,625	\$ 12,887
Obligations under capital leases	84,853	67,739
	96,478	80,626
Total	96,478	80,626
Less current portion	(49,450)	(25,120)
	\$ 47,028	\$ 55,506

Long-term debt of \$47,028 and \$55,506 is included in other long-term liabilities in the accompanying consolidated balance sheet as of December 31, 2002 and 2001, respectively. Long-term debt at December 31, 2002 is due as follows: 2004—\$24,783; 2005—\$14,684; 2006—\$5,197; and thereafter \$2,364.

In 1999, a subsidiary financed the purchase of a motor vehicle with a term loan that expires in 2003. Additionally, in 2000 the Company's Japanese subsidiary entered into capital leases for automotive and other equipment with an initial term of 36 to 60 months. The present value of the minimum lease payments due under the lease agreements is included in Long-term debt.

**9. RELATED PARTY TRANSACTIONS**

**Related Party Lease**—The Company leases its plant and office building from Xenon Research, Inc. ("Xenon"), a 25.3% shareholder. Pursuant to the terms of the lease agreement, which expires in 2006, the Company has a five-year renewal option. The base rent during renewal periods will reflect changes in the U.S. Bureau of Labor Statistics, Consumer Price Index for all Urban Consumers. Rent expense under this lease was approximately \$398,000 in 2002, \$391,000 in 2001, and \$355,000 in 2000.

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**Related Party Loans**—On June 20, 2000 the Company and each of the former CATS shareholders entered into an Amended and Restated Loan Agreement pursuant to which the Company granted loans to the former CATS shareholders in the aggregate amount of \$1.1 million (“the Loans”). The Loans outstanding are for a term of three years, at an interest rate of approximately 4.7%, and grant the borrowers an option to extend the term for an additional three years.

**Related party consulting services**—The Company engaged Cole & Partners, a mergers and acquisition and corporate finance advisory service firm, to serve as the Company’s financial advisor in connection with the Company’s acquisition in January, 2002 of SpatialMetrix, Inc. Stephen R. Cole, one of the Company’s directors and member of the audit committee, is the founding partner and president of Cole & Partners. The Company paid to Cole & Partners total fees of approximately \$450,000 for its services, of which \$302,000 was paid in 2002.

**10. INCOME TAXES**

(Loss) income before taxes consisted of the following:

	Years ended December 31		
	2002	2001	2000
Domestic	\$ (1,349,335)	\$ (2,229,358)	\$ 1,814,032
Foreign	(455,496)	(276,868)	(1,349,834)
	\$ (1,804,831)	\$ (2,506,226)	\$ 464,198

The components of the income tax expense (benefit) for income taxes are as follows:

	Years ended December 31		
	2002	2001	2000
Current:			
Federal	\$ 119,076	\$ (460,984)	\$ 503,000
State	15,244	—	48,820
	134,320	(460,984)	551,820
Deferred:			
Federal	71,708	731,704	(115,891)
State	4,712	71,018	(11,248)
	76,420	802,722	(127,139)
	\$ 210,740	\$ 341,738	\$ 424,681

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

Income tax expense (benefit) for the years ended December 31, 2002, 2001, and 2000, differ from the amount computed by applying the federal statutory corporate rate to (loss) income before income taxes. The differences are reconciled as follows:

	Years ended December 31		
	2002	2001	2000
Tax (benefit) expense at statutory rate	\$ (510,740)	\$ (775,605)	\$ 157,827
State income taxes, net of federal benefit	(32,078)	(73,568)	55,155
Foreign tax rate difference	638,794	194,430	28,551
Research and development credit	(157,177)	(159,160)	(134,638)
Nondeductible items	27,134	33,356	36,684
Change in deferred tax asset valuation allowance	244,807	1,092,132	430,392
Other	—	30,153	(149,290)
<b>Total income tax expense</b>	<b>\$ 210,740</b>	<b>\$ 341,738</b>	<b>\$ 424,681</b>

The components of the Company's net deferred income tax asset are as follows:

	December 31,	
	2002	2001
<b>Net deferred income tax asset—Current</b>		
Product design costs	\$ (89,897)	\$ (41,880)
Tax credits	503,850	382,315
Other	468,900	240,408
Valuation allowance	(882,853)	(504,425)
<b>Net deferred income tax asset—Current</b>	<b>\$ —</b>	<b>\$ 76,418</b>
<b>Net deferred income tax asset—Non-current</b>		
Depreciation	\$ 426,909	\$ 411,803
Employee stock options	183,348	183,348
Unearned service revenue	313,753	169,362
Intangible assets	2,941,665	3,227,871
Carryforwards	3,080,466	3,087,378
Valuation allowance	(6,946,141)	(7,079,762)
<b>Net deferred income tax asset—Non current</b>	<b>\$ —</b>	<b>\$ —</b>

At December 31, 2002, the Company's domestic entities had deferred income tax assets in the amount of \$1,806,863. For financial reporting purposes a valuation allowance of \$1,806,863 was set up during the year to appropriately reflect the portion of the deferred tax asset that is more likely than not to be realized.

At December 31, 2002, the Company's foreign subsidiaries had deferred income tax assets relating to net operating loss carry-forwards, which do not expire, and intangible assets of \$3,080,466, and \$2,941,665, respectively. For financial reporting purposes, a valuation allowance of \$6,022,131 has been recognized to offset the deferred tax assets relating to the net operating losses and intangible assets.

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**11. COMMITMENTS AND CONTINGENCIES**

**Leases**—The following is a schedule of future minimum lease payments required under non-cancelable operating leases, including leases with related parties (see Note 9), in effect at December 31, 2002:

Year Ending December 31	Amount
2003	\$ 1,415,417
2004	877,354
2005	516,316
2006	197,897
2007 and thereafter	17,440
<b>Total future minimum lease payments</b>	<b>\$ 3,024,424</b>

Rent expense for 2002, 2001, and 2000, was approximately \$1,004,000 \$1,101,000, and \$1,120,000, respectively.

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

**12. STOCK OPTION PLANS**

The Company has three stock option plans that provide for the granting of stock options to key employees and non-employee members of the Board of Directors. The 1993 Stock Option Plan ("1993 Plan") and the 1997 Employee Stock Option Plan ("1997 Plan") provide for granting incentive stock options and nonqualified stock options to officers and key employees of the Company. The 1997 Non-employee Director Plan provides for granting nonqualified stock options and formula options to non-employee directors.

The Company is authorized to grant options for up to 703,100 shares of Common Stock under the 1993 Plan, of which 70,011 options are currently outstanding at exercise prices between \$.36 and \$3.60. These options vest over primarily 3 and 4-year periods. The Company is also authorized to grant options for up to 1,400,000 shares of Common Stock under the 1997 Plan, of which 1,331,502 options are currently outstanding at exercise prices between \$1.50 and \$10.34 (for those meant to qualify for treatment as incentive stock options). These options vest over a three-year period. The Company is also authorized to grant up to 250,000 shares of Common Stock under the 1997 Non-employee Director Plan of which 153,000 options are currently outstanding at exercise prices between \$2.21 and \$4.48. Each non-employee director is granted 3,000 options upon election to the Board of Directors and then annually upon attending the annual meeting of shareholders (formula options). Formula options granted to directors are generally granted upon the same terms and conditions as options granted to officers and employees. These options vest over a three-year period.

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

The Company's 1997 Non-Employee Directors' Fee Plan, under which the Company is authorized to issue up to 250,000 shares of Common Stock, permits non-employee directors to elect to receive directors' fees in the form of Common Stock rather than cash. Common Stock issued in lieu of cash directors' fees is issued at the end of the quarter in which the fees are earned, with the number of shares being based on the fair market value of the Common Stock for the five trading days immediately preceding the last business day of the quarter.

In the fourth quarter of 2001, the Company cancelled approximately 548,000 "out of the money" options, including approximately 440,000 options issued under the 1997 Plan and approximately 108,000 options issued under the 1997 Non-employee Director Plan. As a result, 91,000 options granted in 2001, under the 1997 Plan and to holders of some of the options cancelled, were subjected to variable accounting treatment. Under FIN No. 44, stock options issued within six months of a cancellation must be accounted for as variable under certain circumstances. Variable accounting requires companies to re-measure compensation costs for the variable options until the options are exercised, cancelled, or forfeited without replacement. Compensation is dependent on fluctuations in the quoted stock prices for the Company's common stock. Such compensation costs will be recognized over a three-year vesting schedule until the options are fully vested, exercised, cancelled, or forfeited, after which time the compensation will be recognized immediately at each reporting period.

Compensation costs charged to operations associated with the Company's stock option plans were \$9,526, \$0 and \$123,404 in 2002, 2001 and 2000, respectively. Compensation cost was based on the difference between the value of the stock, at date of grant, and its exercise price multiplied by the number of shares vested in each year.

A summary of stock option activity and weighted average exercise prices follows:

	Years Ended December 31,					
	2002		2001		2000	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding at beginning of year	949,498	\$ 4.19	1,291,315	\$ 8.61	1,140,686	\$ 9.79
Granted	958,945	2.20	334,000	1.77	260,050	2.70
Cancelled			(548,074)	12.45	—	
Forfeited	(352,930)	8.32	(123,197)	7.60	(108,249)	6.63
Exercised	(1,000)	0.36	(4,546)	0.36	(1,172)	3.60
Outstanding at end of year	<u>1,554,513</u>	2.41	<u>949,498</u>	4.19	<u>1,291,315</u>	8.61
Outstanding exercisable at year-end	701,042	\$ 2.77	474,464	\$ 6.32	881,640	\$ 10.23
Weighted-average fair value of options granted during the year	\$ 1.25		\$ 1.00		\$ 1.63	

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

A summary of stock options outstanding and exercisable as of December 31, 2002 follows:

Exercise Price	Options Outstanding	Weighted-Average Remaining Contractual Life (Years)	Options Exercisable
\$0.36 to \$1.50	258,012	8.33	100,879
\$1.51-\$2.20	296,945	9.45	58,739
\$2.21-\$2.40	420,000	7.12	91,250
\$2.41-\$3.00	336,850	7.97	212,136
Over \$3.00	242,706	3.58	238,038
	<b>1,554,513</b>		<b>701,042</b>

Remaining non-exercisable options as of December 31, 2002 become exercisable as follows:

Years Ending December 31	Amount
2003	360,504
2004	299,993
2005	192,974
	<b>853,471</b>

Had compensation cost for the Company's stock-based compensation plans been determined consistent with SFAS No. 123, the Company's net earnings and earnings per share would have been as follows:

	Years Ended December 31,		
	2002	2001	2000
Net (loss) income			
As reported	\$ (2,015,571)	\$ (2,847,964)	\$ 39,517
Pro forma	(2,392,846)	(3,173,944)	(943,306)
Loss per share—Basic			
As reported	\$ (0.17)	\$ (0.26)	\$ —
Pro forma	(0.21)	(0.29)	(0.09)
Loss per share—Diluted			
As reported	\$ (0.17)	\$ (0.26)	\$ —
Pro forma	(0.21)	(0.29)	(0.09)

The Company used the Black-Scholes option-pricing model to determine the fair value of grants made. The following assumptions were applied in determining the pro forma compensation cost:

	Years Ended December 31,		
	2002	2001	2000
Risk-free interest rate	2.51% to 5.13%	3.60% to 6.72%	4.44% to 6.72%
Expected dividend yield	0%	0%	0%
Expected option life	3-10 years	1-10 years	3-10 years
Stock price volatility	62.30%	62.50%	65.30%

The effects of applying SFAS No. 123 for the pro forma disclosures are not representative of the effects expected on reported net (loss) income and income per share in future years since the disclosures do not reflect compensation expense for options granted prior to 1996.

**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

**13. LOSS PER SHARE**

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

	Years Ended December 31,					
	2002		2001		2000	
	Shares	Per-Share Amount	Shares	Per-Share Amount	Shares	Per-Share Amount
Basic LPS	11,853,732	\$(0.17)	11,032,449	\$(0.26)	11,021,606	\$ 0.00
Effect of Dilutive Securities:						
Stock Options					72,538	
Diluted LPS	11,853,732	\$(0.17)	11,032,449	\$(0.26)	11,094,144	\$ 0.00

The effect of 92,532 and 123,454 dilutive securities is not included in the computations for the years 2002 and 2001 respectively, because to do so would be antidilutive.

**14. EMPLOYEE RETIREMENT BENEFITS PLAN**

The Company maintains a 401(k) defined contribution retirement plan for its U.S. employees, which provides benefits for all employees meeting certain age and service requirements. The Company may make a discretionary contribution each Plan year, as determined by its Board of Directors. Discretionary contributions or employer matches can be made to the participant's account but cannot exceed 6% of compensation. Costs charged to operations in connection with the Plan during 2002, 2001 and 2000 aggregated \$102,900, \$83,400 and \$35,000, respectively.

**15. SEGMENT GEOGRAPHIC DATA**

The Company develops, manufactures, markets and supports Computer Aided Design (CAD)-based quality assurance products and CAD-based inspection and statistical process control software. This one line of business represents approximately 98% of consolidated sales. The Company operates through sales teams established by geographic area. Each team is equipped to deliver the entire line of Company products to customers within its geographic area. The Company has aggregated the sales teams into a single operating segment as a result of the similarities in the nature of products sold, the type of customers and the methods used to distribute the Company's products.

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

	December 31,					
	2002		2001		2000	
	Sales	Long-lived Assets	Sales	Long-lived Assets	Sales	Long-lived Assets
United States	\$ 19,877,629	\$ 11,561,939	\$ 14,764,091	\$ 2,058,163	\$ 20,457,634	\$ 2,326,790
Germany	7,640,931	1,597,349	6,936,796	1,944,642	8,557,809	3,385,662
France	3,199,462	14,395	3,128,551	6,842	2,927,787	9,136
Japan	3,599,084	148,495	1,701,635	91,737	—	—
United Kingdom	3,591,080	3,957	2,973,442	—	2,603,297	—
Other Foreign	8,338,186	234,213	6,617,181	78,106	6,366,136	136,031
	<u>\$ 46,246,372</u>	<u>\$ 13,560,348</u>	<u>\$ 36,121,696</u>	<u>\$ 4,179,490</u>	<u>\$ 40,912,663</u>	<u>\$ 5,857,619</u>



**FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)**

The geographical sales information presented above represents sales to customers located in each respective country whereas the long-lived assets information represents assets held in the respective countries.

**16. QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)**

Quarter Ended	March 31, 2002	June 30, 2002	September 30, 2002	December 31, 2002
Sales	\$ 8,721,611	\$ 10,309,596	\$ 12,104,695	\$ 15,110,470
Gross profit	4,892,979	5,101,870	6,551,955	8,589,959
Net income (loss)	(1,652,763)	(2,006,136)	71,995	1,571,333
Net income (loss) per share:				
Basic	\$ (0.14)	\$ (0.17)	\$ 0.01	\$ 0.13
Diluted	\$ (0.14)	\$ (0.17)	\$ 0.01	\$ 0.13

Quarter Ended	March 31, 2001	June 30, 2001	September 30, 2001	December 31, 2001
Sales	\$ 8,504,530	\$ 8,468,631	\$ 8,740,886	\$ 10,407,649
Gross profit	5,065,003	5,004,830	5,624,500	6,123,280
Net income (loss)	(1,127,255)	(1,583,284)	(699,035)	561,610
Net income (loss) per share:				
Basic	\$ (0.10)	\$ (0.14)	\$ (0.06)	\$ 0.05
Diluted	\$ (0.10)	\$ (0.14)	\$ (0.06)	\$ 0.05

Royalty Income has been reclassified from "Other Income" to "Sales". The amount reclassified by quarter is as follows: 2002-Q1 \$132,000, Q2 \$193,000, Q3 \$288,000, Q4 \$379,941; 2001-Q1 \$99,000, Q2 \$203,500, Q3 \$324,000, and Q4 \$381,600.

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.**

None

**PART III**

Certain information required by Part III is omitted from this Report in that the Registrant will file a definitive proxy statement pursuant to Regulation 14A (the "Proxy Statement") not later than 120 days after the end of the fiscal year covered by this Report and certain information included therein is incorporated herein by reference. Only those sections of the Proxy Statement that specifically address the Items set forth herein are incorporated by reference. Such incorporation does not include the Compensation Committee Report or the Performance Graph included in the Proxy Statement.

**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.**

The information to be set forth under the captions "Election of Directors" and "Section 16 (a) Beneficial Ownership Reporting Compliance" in the Proxy Statement is incorporated herein by reference.

The information concerning the Company's executive officers required by this Item is incorporated by reference herein from the section of this Report in Part I, Item 1, entitled "Management of the Registrant."

**ITEM 11. EXECUTIVE COMPENSATION.**

The information to be set forth under the caption "Executive Compensation" in the Proxy Statement is incorporated herein by reference; provided, however that the Company specifically excludes from such incorporation by reference any information set forth under the caption "Compensation Committee Report on Executive Compensation."

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.**

Security ownership of certain beneficial owners and management to be set forth under the caption "Beneficial Owners and Management" and "Equity Compensation Plan Information" in the Proxy Statement is incorporated herein by reference.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.**

The information to be set forth under the caption "Certain Relationships and Related Transactions" in the Proxy Statement is incorporated herein by reference.

**ITEM 14. CONTROLS AND PROCEDURES.**

The Company currently has in place systems relating to internal controls and procedures with respect to its financial information. Management periodically reviews and evaluates these internal control systems with its internal auditors and its independent accountants. The Company has completed such a review and evaluation in connection with the preparation of this Annual Report. The Company has determined that there have been no significant changes in its internal controls or in other factors that could significantly affect these controls subsequent to its most recent evaluation. While the Company believes its internal controls are effective, the Company cannot provide assurance that the current internal controls will not change in the future to reflect potentially new rules of the SEC.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K.

(a) Documents Filed as Part of this Report. The following documents are filed as part of this Report:

(1) **Financial Statements.** Included in Part II, Item 8 is an index to the Consolidated Financial Statements of FARO Technologies, Inc. and Report of Ernst & Young LLP, Independent Certified Public Accountants, filed as part of this Form 10-K. Additionally, incorporated herein by reference to Exhibit 99.2 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001, are the audited financial statements of SpatialMetrix Corporation ("SMX") for each of the two years in the period ended December 31, 2001.

(2) **Financial Statement Schedules.** Schedules not listed in the index to the Consolidated Financial Statements included in Part II, Item 8, have been omitted because they are not applicable or are not required or the information required to be set forth therein is included in the Consolidated Financial Statements or Notes thereto.

(3) **Exhibits.**

<u>Exhibit No.</u>	<u>Description</u>
3.1	Articles of Incorporation, as amended ( <i>Filed as Exhibit 3.1 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference</i> )
3.2	Bylaws, as amended ( <i>Filed as Exhibit 3.2 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference</i> )
4.1	Specimen Stock Certificate ( <i>Filed as Exhibit 4.1 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference</i> )
10.1	1993 Stock Option Plan, as amended ( <i>Filed as Exhibit 10.1 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference</i> )
10.2	1997 Employee Stock Option Plan ( <i>Filed as Exhibit 10.2 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference</i> )
10.3	1997 Non-Employee Director Stock Option Plan ( <i>Filed as Exhibit 10.3 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference</i> )
10.4	Amended and Restated Loan Agreement dated as of June 20, 2000, between the Registrant and Wendelin Scharbach, together with a Promissory Note, Stock Pledge Agreement, and Affidavit and Indemnity Agreement in the forms attached hereto a Exhibits A, B, and C thereto.
10.5	Amended and Restated Loan Agreement dated as of June 20, 2000, between the Registrant and Sigfried Buss, together with a Promissory Note, Stock Pledge Agreement, and Affidavit and Indemnity Agreement in the forms attached hereto a Exhibits A, B, and C thereto.

<u>Exhibit No.</u>	<u>Description</u>
10.6	[WCMA Note, Loan and Security Agreement, dated April 23, 1997, between the Registrant and Merrill Lynch Business Financial Services, Inc. (Filed as Exhibit 10.6 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)]
10.7	Business Lease, dated March 1, 1991, between the Registrant (as successor-by-merger to FARO Medical Technologies (U.S.), Inc.) and Xenon Research, Inc. (Filed as Exhibit 10.7 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)
10.8	Nonexclusive Unique Application Reseller Agreement, dated September 9, 1996, between the Registrant and Autodesk, Inc. (Filed as Exhibit 10.9 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)
10.9	Form of Patent and Confidentiality Agreement between the Registrant and each of its employees (Filed as Exhibit 10.10 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)
10.10	Nonexclusive Unique Application Reseller Agreement, dated as of March 1, 1998, between the Registrant and Autodesk, Inc. (Filed as Exhibit 10.11 to Registrant's Form 10-K for calendar year 1997, No. 0-23081, and incorporated herein by reference)
10.11	First Amendment to Business Lease, dated as of January 20, 1998, between the Registrant (as successor by merger to FARO Medical Technologies (US), Inc.) and Xenon Research, Inc., (Filed as Exhibit 10.12 to Registrant's Form 10-K for calendar year 1997, No. 0-23081 and incorporated herein by reference)
10.12	WCMA Line of Credit No. 740-07K27 dated May 30, 2002 between the Registrant and Merrill Lynch Business Financial Services, Inc. (Filed herewith)
10.13	Agreement and Plan of Merger dated September 14, 2001, as amended, between the Registrant and Spatialmetrix Corporation (Filed as Exhibit 2.1 to Registrant's Current report on Form 8-K dated January 16, 2002 and incorporated herein by reference)
21.1	List of Subsidiaries (Filed as Exhibit 21.1 to Registrant's Form 10-K for calendar year 2001. No. 0-23081 and incorporated herein by reference)
23.1	Consent of Ernst & Young LLP (Filed herewith)
24.1	Power of Attorney relating to subsequent amendments (included on the signature page(s) of this report).

<u>Exhibit No.</u>	<u>Description</u>
99.1	Properties ( <i>Filed as Exhibit 99.1 to Registrant's Form 10-K for calendar year 2001. No. 0-23081 and incorporated herein by reference</i> )
99.2	Audited Financial Statements of SpatialMetrix Corporation for the two years in the period ended December, 31, 2001 ( <i>Filed as Exhibit 99.2 to Registrant's Form 10-K for calendar year 2001, No. 0-23081 and incorporated herein by reference</i> )
99.3	Written Statement of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
99.4	Written Statement of the Principal Financial Officer Pursuant to 18 U.S.C Section 1350

**(b) Reports on Form 8-K**

None



## CERTIFICATION

I, Simon Raab, certify that:

1. I have reviewed this annual report on Form 10-K of FARO Technologies, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of FARO Technologies, Inc. as of, and for, the periods presented in this annual report;
4. FARO Technologies, Inc.'s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for FARO Technologies, Inc. and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to FARO Technologies, Inc., including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - b) evaluated the effectiveness of FARO Technologies, Inc.'s disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
  - c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. FARO Technologies, Inc.'s other certifying officer and I have disclosed, based on our most recent evaluation, to FARO Technologies, Inc.'s auditors and the audit committee of FARO Technologies, Inc.'s board of directors:
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect FARO Technologies, Inc.'s ability to record, process, summarize and report financial data and have identified for FARO Technologies, Inc.'s auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in FARO Technologies, Inc.'s internal controls; and
6. FARO Technologies, Inc.'s other certifying officer and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 31, 2003

/s/ Simon Raab

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Name: Simon Raab  
Title: President and Chief Executive Officer-Director  
(Principal Executive Officer)

## CERTIFICATION

I, Gregory A. Fraser, certify that:

1. I have reviewed this annual report on Form 10-K of FARO Technologies, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of FARO Technologies, Inc. as of, and for, the periods presented in this annual report;
4. FARO Technologies, Inc.'s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for FARO Technologies, Inc. and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to FARO Technologies, Inc., including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - b) evaluated the effectiveness of FARO Technologies, Inc.'s disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
  - c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. FARO Technologies, Inc.'s other certifying officer and I have disclosed, based on our most recent evaluation, to FARO Technologies, Inc.'s auditors and the audit committee of FARO Technologies, Inc.'s board of directors:
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect FARO Technologies, Inc.'s ability to record, process, summarize and report financial data and have identified for FARO Technologies, Inc.'s auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in FARO Technologies, Inc.'s internal controls; and
6. FARO Technologies, Inc.'s other certifying officer and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 31, 2003

/s/ Gregory A. Fraser

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Name: Gregory A. Fraser  
Title: Executive Vice President, Secretary, Treasurer and  
Director (Principal Financial and Accounting Officer)



## AMENDED AND RESTATED LOAN AGREEMENT

THIS AMENDED AND RESTATED LOAN AGREEMENT (the "Agreement") is dated and entered into as of June 20, 2000, by and between FARO Technologies, Inc., a Florida corporation ("Lender"), whose current mailing address is 125 Technology Park, Lake Mary, Florida 32746, and Wendelin Karl Johannes Scharbach, an individual resident of the Federal Republic of Germany ("Borrower"), whose current mailing address is Schwarzwaldstrasse 94, 68163 Mannheim, Germany.

WHEREAS, on May 15, 1998, Lender acquired CATS computer aided technologies, Computeranwendungen in der Fertigungssteuerung GmbH, a limited liability company under the laws of the Federal Republic of Germany ("CATS"). Borrower was a holder of Quotas in CATS.

WHEREAS, pursuant to a Loan Agreement dated August 2, 1999 between Lender and Borrower (the "Original Loan Agreement"), Lender has agreed to loan to Borrower an amount equal to his tax obligation to the German tax authority in connection with the acquisition of CATS. The maximum amount of the loans is estimated to be approximately \$2 million.

WHEREAS, the German tax authority have indicated to Borrower that they would be willing to issue a preliminary tax assessment for fiscal year 1998 based on a value of U.S. \$4.875 per share of Common Stock of Lender (using an exchange rate of U.S. Dollars to Deutsche Marks ("DM") of 1:1.8403 for May 1999).

WHEREAS, Borrower received 458,334 shares of Lender common stock as part of the purchase price for the acquisition of CATS. Using a price of \$4.875 per share of Lender common stock, the value of the shares of Lender common stock received by Borrower would equal DM 4,111,926. The tax payable with respect to such shares based on such value would equal DM 1,154,400.14.

WHEREAS, based on a stock price per share of Lender common stock on May 15, 1998 of U.S. \$11.125, the value of the shares of Lender common stock received by Borrower would equal DM 9,048,634 (using an exchange rate of U.S. Dollars to DM of 1:1.7746 for May 1998). The tax payable with respect to such shares based on such value would equal DM 2,540,854.82.

WHEREAS, because the tax assessment received by Borrower is only preliminary, the German tax authority could at any time revise the tax assessment based on the price per share of Lender common stock on May 15, 1998.

WHEREAS, the parties wish to amend the Original Loan Agreement to provide that Lender will loan to Borrower an initial amount of DM 1,154,400.14 resulting from the preliminary tax assessment as provided for in the Original Loan Agreement, and that Lender will pay an additional amount of DM 1,386,454.68 (DM 2,540,854.82 less DM 1,154,400.14) into an escrow account to cover possible additional taxes payable because of a higher value of the 458,334 shares of Lender common stock issued to Borrower in connection with the acquisition of

CATS. The amount paid into escrow would increase the amount of the Loan under this Agreement if distributed to pay additional taxes.

WHEREAS, once the German tax authority have issued a final tax assessment, the amount in the escrow account will be used to pay such amount of additional tax or, to the extent the amount in the escrow account is not needed to pay additional taxes, will be repaid to Lender. To the extent the amount in the escrow account is used to pay additional taxes, such amount would be evidenced by a new promissory note issued by Borrower to Lender and such note would be secured by shares of common stock of Lender.

WHEREAS, this Agreement amends and restates the Original Loan Agreement.

In consideration of the loan described below and the mutual covenants and agreements contained herein, Borrower and Lender agree as follows:

1. LOANS.

A. Initial Loan.

i. Lender hereby agrees to make a loan to Borrower in the principal amount of DM 1,154,400.14 (the "Initial Loan").

ii. The amount of the Initial Loan is equal to the tax payable by Borrower (based on the preliminary tax assessment issued to Borrower by the German tax authority for fiscal year 1998, which used a value of U.S. \$4.875 per share of Lender common stock, and based on an exchange rate of U.S. Dollars to DM of 1:1.8403 for May 1999) with respect to Borrower's receipt of 458,334 shares of Lender common stock in connection with Lender's acquisition of CATS.

iii. To evidence his obligation to repay the Initial Loan, and to otherwise induce Lender to make the Initial Loan, Borrower shall execute and deliver to Lender a Promissory Note, Stock Pledge Agreement, Affidavit and Indemnity Agreement, Stock Power and UCC-1 Financing Statement in the forms attached hereto as Exhibits A, B, C, D and E, respectively (together, the "Loan Documents") with respect to the Initial Loan at such time that the Initial Loan is made.

iv. Lender will be obligated to make the Initial Loan to Borrower within three (3) business days after Borrower presents written evidence to Lender that the German tax authority has requested payment of the tax obligations described in Section 4 of this Agreement.

B. Additional Loan.

i. Lender hereby agrees to make an additional loan to Borrower in the principal amount of up to DM 1,386,454.68 (the "Additional Loan"), as is necessary to enable Borrower to satisfy his tax obligations to the German tax authority as a result of Borrower's receipt of 458,334 shares of Lender common

stock of the Lender that Borrower received in connection with Lender's acquisition of CATS. Lender will be obligated to make the Additional Loan only if the German tax authority issues a final tax assessment that assesses a greater tax obligation on Borrower than the preliminary tax assessment issued to Borrower by the German tax authority for fiscal year 1998 with respect to Borrower's receipt of 458,334 shares of Lender common stock in connection with Lender's acquisition of CATS.

ii. The maximum amount of the Additional Loan is equal to (i) DM 2,540,854.82, which is the tax payable by Borrower (based on a stock price per share of Lender common stock on May 15, 1998 of U.S. \$11.125 and using an exchange rate of U.S. Dollars to DM of 1:1.7746 for May 1998) with respect to Borrower's receipt of 458,334 shares of Lender common stock in connection with Lender's acquisition of CATS, less (ii) the amount of the Initial Loan.

iii. To evidence his obligation to repay the Additional Loan, and to otherwise induce Lender to make the Additional Loan, Borrower shall execute and deliver to Lender the Loan Documents with respect to the Additional Loan at such time as the Additional Loan is made.

iv. To secure Lender's obligation pursuant to this Agreement to make the Additional Loan to Borrower, Lender shall deposit U.S. \$676,319.36 (DM 1,386,454.68 divided by 2.05, the exchange rate of U.S. Dollars to DM on June 9, 2000) in an escrow account (the "Escrow Account") with Firststar Bank Milwaukee, N.A. (the "Escrow Agent") pursuant to an Escrow Agreement dated on or about the date of this Agreement among Lender, Borrower, and the Escrow Agent, a copy of which is attached as Exhibit F to this Agreement. Any interest on the funds in the Escrow Account shall be paid to the Lender.

v. All funds shall remain in the Escrow Account until the earlier of (i) July 1, 2004 or (ii) the date that Borrower presents written evidence to Lender and the Escrow Agent that the German tax authority has requested payment of the final tax assessment with respect to the tax obligations for the 458,334 shares of Lender common stock that Borrower received in connection with Lender's acquisition of CATS. Lender will be obligated to make the Additional Loan, and funds from the Escrow Account shall be paid to Borrower to fund the Additional Loan, within three (3) business days after Borrower presents written evidence to Lender that the German tax authority has requested payment of the tax obligations described in Section 4 of this Agreement.

vi. The Escrow Agent is obligated to pay to the Borrower funds from the Escrow Account (without permission of the Lender) as are necessary to enable Borrower to satisfy his tax obligations to the German tax authority as described in Section 4 of this Agreement upon presentation by Borrower to the Escrow Agent of (i) copies of the Loan Documents for the Additional Loan executed by Borrower and delivered to Lender, and (ii) written evidence to Lender that the

German tax authority has requested payment of the tax obligations described in Section 4 of this Agreement.

vii. Any funds remaining in the Escrow Account after July 1, 2004 or any funds not needed to pay the final tax assessment with respect to the tax obligations for the 458,334 shares of Lender common stock that Borrower received in connection with Lender's acquisition of CATS shall be returned immediately to Lender.

C. Definition of the Loans. The Initial Loan and the

Additional Loan are each referred to as a "Loan" and collectively are referred to as the "Loans."

2. LENDER'S COMMITMENT. Lender's obligation to extend the Loans to Borrower is a valid, legal, irrevocable and binding corporate obligation which shall not be rescinded or withdrawn in the event of a change of Lender's present management or ownership.

3. TERMS AND CONDITIONS OF LOAN. The Loans shall be governed by the following terms and conditions in addition to all terms and conditions set forth in the Loan Documents.

A. Payment.

i. Notwithstanding any contrary provision set forth herein or in any document related hereto, Borrower shall be obligated to pay all outstanding principal, together with all then accrued and unpaid interest under each Loan, on or before the earlier of (a) the end of the three year period that commences on the date the Borrower executes and delivers the Loan Documents to Lender with respect to each Loan, or (b) that date when the preceding five (5) trading days of the Lender's common stock yields an average closing price of \$11.34 per share (each such date hereinafter referred to as the "Maturity Date"). On such Maturity Date as defined in Section 3A(i)(b), it shall be within Borrower's discretion to repay the Loans either in cash, or, in lieu thereof, with shares of the common stock of Lender at an agreed upon price of \$11.34 per share. For the purpose of repaying the Loans with shares of the Lender's common stock as provided for in this Section 3A(i), Borrower shall be required to utilize that portion of the Collateral (as defined in Section 3E below) which is equal in value to the amount of Loans being repaid.

ii. Notwithstanding the foregoing, in the event a Loan is still outstanding at end of the three year period that commences on the date Borrower executes and delivers the Loan Documents to the Lender with respect to such Loan, Borrower shall have the option of either: (a) requiring Lender to renew or extend the Loan for an additional term of three (3) years or (b) canceling the Loan, effective as of the three year anniversary date, by providing Lender with written notice in accordance with the provisions of Section 10 below, and in exchange for such cancellation Borrower shall irrevocably authorize Lender to dispose of the

Collateral in accordance with the terms and conditions of Section 9 below. The parties hereby agree that the three year anniversary date shall be the date which coincides with the end of the three year period that commences on the date Borrower executes and delivers the Loan Documents to the Lender with respect to a Loan, and if Borrower elects to cancel such Loan effective as of such date, the date shall hereinafter be referred to as the "Anniversary Cancellation Date." If on the Anniversary Cancellation Date, the value of the Collateral is less than the sum of: (i) the outstanding principal balance of the Loan; (ii) any accrued but unpaid interest on the Loan; (iii) any fees authorized and due and owing to Lender pursuant to the Promissory Note with respect to the Loan; and (iv) any costs and expenses authorized and due and owing to Lender pursuant to the Promissory Note with respect to the Loan, Borrower shall not be required to pay to Lender the amount by which the sum of items (i) through (iv) exceeds the value of the Collateral. On the other hand, if on the Anniversary Cancellation Date, the value of the Collateral exceeds the sum of items (i) through (iv), Lender shall be required to release and return to Borrower, free and clear of all liens and encumbrances, the portion of the Collateral which exceeds the sum of items (i) through (iv). For purposes of determining the value of the Collateral on the Anniversary Cancellation Date, the parties shall utilize the closing price of the shares of Lender's common stock (as traded on the NASDAQ National Market) on that particular date, or, if that date is not a trading day on the NASDAQ National Market, the immediately preceding trading day.

iii. All Shares used by Borrower to repay the Loan pursuant to the provisions of Section 3A(i) above, as well as all Shares comprising the Collateral used by Borrower to compensate Lender for the cancellation of the Loan pursuant to the provisions of Section 3A(ii) above, shall be subject to sale by Lender on Borrower's behalf in accordance with the terms and conditions of Section 9 below, and Borrower shall cooperate with Lender in effecting any such sale.

B. Interest.

i. Except as otherwise provided in Section 5 of the Promissory Note, interest shall accrue on the outstanding principal balance of each Loan at a rate that is equal to the sum of (a) the EURIBOR rate that was in effect at 10:00 A.M. on August 2, 1999 (and which is applicable to loans with a maturity date of one year); and (b) 1.57%. Interest on the outstanding principal balance of the Loans shall be paid annually, on the last business day in December of each year, until the entire principal is paid.

ii. Interest shall be calculated on the basis of a 360 day year based upon the actual number of days elapsed. No interest shall accrue on a Loan until the Loan is made to Borrower, and no interest shall accrue after the Maturity Date (as defined in Section 3A(i) above), the Anniversary Cancellation Date (as defined in Section 3A(ii) above), or the Cancellation Date (as defined in Section 8 below).

iii. The total liability of Borrower under the Loans for payment of interest shall not exceed any limitations imposed on the payment of interest by applicable usury laws. If any interest is received or charged in excess of that amount, Borrower shall be entitled to a refund of the excess.

iv. Upon the occurrence of an Event of Default under a Promissory Note, interest shall accrue at the Default Rate thereunder set forth notwithstanding the provisions of this section.

C. Prepayment. The Borrower shall be entitled to prepay the Loans in whole or in part at any time without penalty.

D. Application of Payments. All payments under the Promissory Note shall be applied first to the Lender's costs and expenses, then to fees authorized thereunder, then to interest and then to principal.

E. Grant of Security Interest. To secure the due and punctual payment of the Loans and all of his other liabilities to Lender arising in connection with the Loans, and all reasonable costs and expenses incurred by Lender in connection with enforcement or collection of the Loans or any liability of Borrower in connection therewith (including reasonable legal fees and expenses incurred in trial, appellate, bankruptcy, and judgment-execution proceedings) and all reasonable costs and expenses incurred in connection with realizing on the value of the Collateral (including appraisal fees, broker-dealer fees, and legal fees incurred in trial, appellate, bankruptcy, and judgment-execution proceedings), Borrower shall pledge, hypothecate, assign, convey and grant to Lender a first lien and security interest (collectively, the "Security Interest") in the following:

i. Such number of shares of Lender common stock (the "Shares") which is arrived at as a result of dividing (i) the original principal sum of the Note (stated in U.S. dollars) by (ii) US \$6.375; the denominator of US \$6.375 being the closing price of each share of Lender's common stock (as traded on the NASDAQ National Market) on March 31, 1999.

ii. All dividends, additional shares or other property or securities that are receivable or otherwise distributable at any time and from time to time in respect of, or in exchange or substitution for, the Shares and all profits therefrom; and

iii. All proceeds of the foregoing.

As used herein, the term "Collateral" refers to all the property described in this Section 3E, as well as any portion or any interest in it.

4. PURPOSE OF LOAN. The purpose of the Loan will be to enable Borrower to timely satisfy his obligation to pay certain taxes in the Federal Republic of Germany in connection with Borrower's sale on May 15, 1998 of his Quotas in CATS. As part of the consideration (the "Consideration") paid to Borrower in connection with his sale on May 15, 1998 of his Quotas in CATS, Borrower received 458,334 shares of Lender common stock. The

purpose of the Loans is to pay the amount of taxes that Borrower is required to pay to the German tax authority in connection with and as a result of the 458,334 shares of Lender common stock received by Borrower on May 15, 1998 in connection with the acquisition of CATS.

5. REPRESENTATIONS AND WARRANTIES. Borrower hereby represents and warrants to lender as follows:

A. Authority and Compliance. Borrower has full power and authority to execute and deliver this Agreement and the Loan Documents and to incur and perform the obligations provided for therein. No consent or approval of any public authority or other third party is required as a condition to the validity of this Agreement or any of the Loan Documents, and Borrower is in compliance with all laws and regulatory requirements to which they are subject.

B. Binding Agreement. This Agreement and the Loan Documents executed by Borrower constitute valid and legally binding obligations of Borrower, enforceable in accordance with their terms.

C. Litigation. There is no proceeding involving Borrower pending or, to the knowledge of Borrower, threatened before any court or governmental authority, agency or arbitration authority, except as disclosed to Lender in writing and acknowledged by Lender prior to the date of this Agreement.

D. No Conflicting Agreements. There is no charter, bylaw, stock provision, partnership agreement or other document pertaining to the power or authority of Borrower and no provision of any existing agreement, mortgage, indenture or contract binding on Borrower or affecting his property, which would conflict with or in any way prevent the execution, delivery or carrying out of the terms of this Agreement and the Loan Documents.

E. Ownership of Collateral. Borrower has good title to the collateral that will secure the Loans, and the collateral is, and will be kept, free and clear of liens, except those to be granted to Lender pursuant to the Stock Pledge Agreement attached hereto in the form of Exhibit B.

6. DEFAULT. Borrower shall be in default under this Agreement and under each of the Loan Documents if he shall default in the payment of any amounts due and owing to Lender pursuant to the Loan Documents or should he fail to timely and properly observe, keep or perform any term, covenant, agreement or condition in any Loan Document or in any other loan agreement, promissory note, security agreement, deed of trust, deed to secure debt, mortgage, assignment or other contract securing or evidencing payment of any indebtedness of Borrower to Lender or any affiliate or subsidiary of Lender.

7. REMEDIES UPON DEFAULT. If an event of default shall occur, Lender shall have all rights, powers and remedies available under each of the Loan Documents as well as all rights and remedies available at law or in equity.

8. **BORROWER'S OPTION TO CANCEL LOAN.** Notwithstanding anything to the contrary in any document or agreement between Borrower and Lender, Borrower shall have the option, in his sole discretion, at anytime, to cancel the Loans, and in exchange for such cancellation Borrower shall irrevocably authorize Lender to dispose of the Collateral in accordance with the terms and conditions of Section 9 below. For purposes of this Section 8, the "Date of Cancellation" shall be the date on which Lender receives a written notice from Borrower to cancel a Loan. The written notice shall be furnished in accordance with the notice provisions of Section 10 below. Provided, however, that if on the Date of Cancellation, the value of the Collateral is less than the sum of (i) the outstanding principal balance of such Loan; (ii) any accrued but unpaid interest on such Loan; (iii) any fees authorized and due and owing to Lender pursuant to the Promissory Note; and (iv) any costs and expenses authorized and due and owing to Lender pursuant to the Promissory Note, Borrower shall be required to pay to Lender the amount by which the sum of items (i) through (iv) listed in this Section 8 exceeds the value of the Collateral. Borrower shall have the option of making the payment herein provided for to Lender in either additional cash or additional shares of Lender's issued and outstanding common stock. If on the Date of Cancellation, the value of the Collateral exceeds the sum of items (i) through (iv) listed in this Section 8, Lender shall be required to release and return to Borrower, free and clear of all liens and encumbrances, the portion of the Collateral which exceeds the sum of items (i) through (iv) of this Section 8. For purposes of determining the value of the Collateral and additional shares on the Date of Cancellation, the parties shall utilize the closing price of the shares of Lender's common stock (as traded on the NASDAQ National Market) on the Date of Cancellation. Any Shares used by Borrower to compensate Lender in consideration for the cancellation of the Loan pursuant to the provisions of this Section 8 shall be subject to sale by Lender on Borrower's behalf pursuant to the terms and conditions of Section 9 below, and Borrower shall cooperate with Lender in effecting any such sale.

9. **MECHANISM FOR SALE OF SHARES.** The Shares to be pledged by Borrower to Lender pursuant to the Stock Pledge Agreement will, in part, consist of a portion of the 343,750 shares of Lender common stock registered with the United States Securities and Exchange Commission (the "SEC") pursuant to that certain S-1 Registration Statement dated and filed with the SEC on June 22, 1998 (the "Registered Shares"). The balance of the Shares to be pledged to Lender by Borrower pursuant to the Stock Pledge Agreement shall consist of shares of Lender's common stock that have not been registered with the SEC (the "Non-registered Shares"). It is also contemplated that if Borrower is required to utilize additional shares to compensate Lender pursuant to the provisions of Section 8 above or under any of the Loan Documents, Borrower will utilize Registered Shares and/or Non-registered Shares. If, in order to satisfy any of Borrower's obligations or commitments pursuant to any Loan Document, a sale must be made of any or all of the Registered Shares or Non-registered Shares pledged or otherwise delivered by Borrower to Lender, Borrower shall authorize Lender to make such sale as an agent of Borrower and on Borrower's behalf. Any sale of Registered Shares as provided for in this Section 9 shall be made pursuant to the S-1 Registration Statement, and shall be deemed to be a sale by Borrower through his duly appointed and authorized agent. Any sale of Non-Registered Shares as provided for in this Section 9 shall be made pursuant to and in satisfaction of the requirements of Rule 144 promulgated by the SEC under the Securities Act of 1933, as amended, and shall be deemed to be a sale by Borrower through his duly appointed and



authorized agent. Lender shall have the right to keep and maintain custody of any and all proceeds of any sale of Registered Shares or Non-registered Shares in satisfaction of any sum due and owing to Lender pursuant to the Loan transaction. Borrower's appointment of Lender as his agent for purposes of this Section 9, and the authorization to be granted to Lender to sell Registered Shares and/or Non-registered Shares on behalf of Borrower, shall be set forth in the Promissory Note, Stock Pledge Agreement and Stock Power delivered to Lender along with the pledged Shares (and in the Stock Power alone, in the case of any additional shares delivered to Borrower). Further, Borrower shall covenant and agree to make all such reasonable arrangements, do and perform all such reasonable acts and things, execute and deliver all such certificates, documents and other instruments, and to take such further reasonable actions as Lender may deem necessary or advisable to effect the sale of Registered Shares pursuant to the S-1 Registration Statement, or Non-registered Shares in compliance with the requirements of Rule 144, as the case may be, as Borrower's agent and on Borrower's behalf.

10. NOTICES. All notices, requests or demands which any party is required or may desire to give to any other party under any provision of this Agreement must be in writing, and may be by means of facsimile transmission, delivered to the other party at the following address:

If to Lender:

FARO Technologies, Inc.  
125 Technology Park  
Lake Mary, Florida 32746  
Telecopy: (407) 333-4181

Attention: Gregory A. Fraser

With a copy to:

Foley & Lardner  
100 North Tampa St., Suite 2700  
Tampa, Florida 33602  
Telecopy: (813) 221-4210

Attention: Martin A. Traber

If to Borrower:

Wendelin Karl Johannes Scharbach  
Schwarzwaldstrasse 94  
68163 Mannheim  
Germany  
Telecopy: 001-49-711-2222-444

With a copy to:

Hasche Eschenlohr Peltzer Riesenkampff Fischotter  
Neidenau 68  
60325 Frankfurt/Main  
Germany  
Telecopy: 011-49-69-71-701-230

Attention: Thomas Link

or to such other address as any party may designate by written notice to the other party. Each such notice, request and demand shall be deemed given or made as follows: (i) if sent by mail, upon the earlier of the date of receipt or five (5) days after deposit in the U.S. Mail, first class postage prepaid; (ii) if electronically transmitted, the next business day after transmission (and the sender shall bear the burden of proof of delivery), or (iii) if sent by any other means, upon delivery.

11. COSTS, EXPENSES AND ATTORNEYS' FEES. Borrower shall pay to Lender immediately upon demand the full amount of all costs and expenses, including reasonable attorneys' fees (to include outside counsel fees) incurred by Lender in connection with Lender's enforcement of its rights hereunder or under the Loan Documents.

12. MISCELLANEOUS. Borrower and Lender further covenant and agree as follows, without limiting any requirement of any of the Loan Documents:

A. Cumulative Rights and No Waiver. Each and every right granted to Lender under any Loan Document, or allowed it by law or equity shall be cumulative of each other and may be exercised in addition to any and all other rights of Lender, and no delay in exercising any right shall operate as a waiver thereof, nor shall any single or partial exercise by Lender of any right preclude any other or future exercise thereof or the exercise of any other right. Borrower expressly waives any presentment, demand, protest or other notice of any kind, including but not limited to notice of intent to accelerate and notice of acceleration. No notice to or demand on Borrower in any case shall, of itself, entitle Borrower to any other or future notice or demand in similar or other circumstances.

B. Legal Matters. The validity, construction, enforcement, and interpretation of this Agreement shall be governed by the laws of the State of Florida and the United States of America, without regard to principles of conflict of laws. Each party to this Agreement (a) consents to the personal jurisdiction of the state and federal courts having jurisdiction in Seminole County, Florida, (b) stipulates that the proper, exclusive, and convenient venue for any legal proceeding arising out of this Agreement is Seminole County, Florida, for state court proceedings, and the Middle District of Florida, Orlando Division, for federal district court proceedings, and (c) waives any defense, whether asserted by a motion or pleading, that Seminole County, Florida, or the Middle District of Florida, Orlando Division, is an improper or inconvenient venue. In any mediation, arbitration, or legal proceeding arising out of this Agreement, the losing party shall reimburse the prevailing party, on demand, for all costs

incurred by the prevailing party in enforcing, defending, or prosecuting any claim arising out of this Agreement, including all fees, costs, and expenses of experts, attorneys, witnesses, collection agents, and supersedeas bonds, whether incurred before or after demand or commencement of legal proceedings, and whether incurred pursuant to trial, appellate, mediation, arbitration, bankruptcy, administrative, or judgment-execution proceedings.

C. Loan to be deemed repaid. A Loan shall be deemed to have been repaid effective as of the earliest of: (i) the date on which Borrower prepays such Loan (as allowed under Section 3C above); (ii) the Maturity Date (as defined in Section 3A(i) above); (iii) the Anniversary Cancellation Date (as defined in Section 3A(ii) above); or (iv) the Cancellation Date (as defined in Section 8 above), so long as by the particular date Lender has received from Borrower any combination of cash and/or shares of Lender's stock sufficient to cover the then outstanding Loan obligations in accordance with the provisions of this Agreement. From and after the repayment date, Borrower shall have no obligations to Lender with respect to a Loan pursuant to or under this Agreement or the Loan Documents, except for Borrower's obligation to cooperate with lender in disposing of the Collateral Shares (and any additional shares delivered to Lender) pursuant to the provisions of Section 9 above.

D. Amendment. No modification, consent, amendment or waiver of any provision of this Agreement, nor consent to any departure by Borrower therefrom, shall be effective unless the same shall be in writing and signed by an officer of Lender, and then shall be effective only in the specified instance and for the purpose for which given. This Agreement is binding upon Borrower, his heirs, successors and assigns, and inures to the benefit of Lender, its successors and assigns; however, no assignment or other transfer of Borrower's rights or obligations hereunder shall be made or be effective without Lender's prior written consent, nor shall it relieve Borrower of any obligations hereunder. There is no third party beneficiary of this Agreement.

E. Partial Invalidity. The unenforceability or invalidity of any provision of this Agreement shall not affect the enforceability or validity of any other provision herein and the invalidity or unenforceability of any provision of any Loan Document to any person or circumstance shall not affect the enforceability or validity of such provision as it may apply to other persons or circumstances.

F. This Agreement amends and restates the Original Loan Agreement in its entirety, and the Original Loan Agreement is no longer in effect.

13. NO ORAL AGREEMENT. THIS WRITTEN AGREEMENT AND THE LOAN DOCUMENTS REPRESENT THE FINAL AGREEMENT BETWEEN THE PARTIES AND MAY NOT BE CONTRADICTED BY EVIDENCE OF PRIOR, CONTEMPORANEOUS OR SUBSEQUENT ORAL AGREEMENTS OF THE PARTIES.

To the extent permitted by law, the Borrower agrees to and does hereby waive trial by jury in any action, proceeding, or counterclaim brought by either the Borrower or the Lender on any matters whatsoever arising out of or in any way connected with this Agreement or any claim

of damage resulting from any act or omission of the Borrower or Lender or either of them in any way connected with this Agreement.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be duly executed under seal by their duly authorized representatives as of the date first above written.

LENDER

FARO Technologies, Inc.

By:

-----

Name:

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Title:

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BORROWER

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Wendelin Karl Johannes Scharbach

## PROMISSORY NOTE

U.S. \$563,122.02

Mannheim  
Federal Republic of Germany

June 27, 2000

FOR VALUE RECEIVED, the undersigned, Wendelin Karl Johannes Scharbach, an individual resident of the Federal Republic of Germany (the "Maker"), whose current mailing address is Schwarzwaldstrasse 94, 68163 Mannheim, Germany, hereby promises to pay to the order of FARO Technologies Inc., a Florida corporation (the "Payee"), whose current business address is 125 Technology Park, Lake Mary, FL 32746, the principal sum of Five Hundred Sixty-three Thousand One Hundred Twenty-two and 02/100 United States Dollars (U.S. \$563,122.02), together with interest on the outstanding principal balance hereof at the rate provided for herein. This note (the "Note") shall be governed by the following provisions:

1. Payment.

A. Notwithstanding any contrary provision set forth herein or in any document related hereto, Maker shall be obligated to pay all outstanding principal, together with all then accrued and unpaid interest under the Note, on or before the earlier of (a) June 27, 2003 or (b) that date when the preceding five (5) trading days of the Payee's common stock yields an average closing price of \$11.34 per share (each such date hereinafter referred to as the "Maturity Date"). On such Maturity Date as defined in Section 1(i)(b), it shall be within Maker's discretion to repay the Note either in cash, or, in lieu thereof, with shares of the common stock of Payee at an agreed upon price of \$11.34 per share. For the purpose of repaying the Note with shares of the Payee's common stock, Maker shall be required to utilize that portion of the Collateral (as described in Section 10 below) which is equal in value to the Note obligation being repaid.

B. Notwithstanding the foregoing, in the event the Note is still outstanding as of June 27, 2003, Maker shall have the option of either: (a) requiring Payee to renew or extend the Note for an additional term of three (3) years or (b) canceling the Note, effective as of that date, by providing Payee with written notice in accordance with the notice provisions of the Loan Agreement, and in exchange for such cancellation Maker shall irrevocably authorize Payee to dispose of the Collateral in accordance with the terms and conditions of Section 9 below. If Maker elects to cancel the Note effective as of June 27, 2003, that date shall hereinafter be referred to as the "Anniversary Cancellation Date." If on the Anniversary Cancellation Date, the value of the Collateral is less than the sum of: (i) the outstanding principal balance of the Note; (ii) any accrued but unpaid interest on the Note; (iii) any fees authorized and due and owing to Payee pursuant to the Note; and (iv) any costs and expenses authorized and due and owing to Payee pursuant to the Note, Maker shall not be required to pay to Payee the amount by which the

sum of items (i) through (iv) exceeds the value of the Collateral. On the other hand, if on the Anniversary Cancellation Date, the value of the Collateral exceeds the sum of items (i) through (iv), Payee shall be required to release and return to Maker, free and clear of all liens and encumbrances, the portion of the Collateral which exceeds the sum of items (i) through (iv). For purposes of determining the value of the Collateral on the Anniversary Cancellation Date, the parties shall utilize the closing price of the shares of Payee's common stock (as traded on the NASDAQ National Market) on that particular date, or, if that date is not a trading day on the NASDAQ National Market, the immediately preceding trading day.

C. All Shares used by Maker to repay the Note pursuant to the provisions of Section 1(i) above, as well as all Shares comprising the Collateral used by Maker to compensate Payee for cancellation of the Note pursuant to the provisions of Section 1(ii) above, shall be subject to sale by Payee on Maker's behalf in accordance with the terms and conditions of Section 9 below, and Maker shall cooperate with Payee in effecting any such sale.

2. Interest.

A. Except as otherwise provided in Section 5 below, interest shall accrue on the outstanding principal balance hereof at a rate per annum equal to the sum of (a) the EURIBOR rate that was in effect at 10:00 A.M. on August 2, 1999 (and which is applicable to loans with a maturity date of one year); and (b) 1.57% percent (1.57%). Interest on the outstanding principal balance of the Note shall be paid annually, on the last business day in December of each year, until the entire principal is paid.

B. Interest shall be calculated on the basis of a 360 day year based upon the actual number of days elapsed. No interest shall accrue after the Maturity Date (as defined in Section 1(i) above), the Anniversary Cancellation Date (as defined in Section 1(ii) above), or the Cancellation Date (as defined in Section 8 below).

C. The total liability of the Maker for payment of interest shall not exceed any limitations imposed on the payment of interest by applicable usury laws. If any interest is received or charged by any holder hereof in excess of that amount, the Maker shall be entitled to a refund of the excess.

D. Upon the occurrence of an Event of Default hereunder, interest shall accrue at the Default Rate hereinafter set forth notwithstanding the provisions of this section.

3. Prepayment. The Maker shall be entitled to prepay this Note in whole or in part at any time without penalty.

4. Application of Payments. All payments hereunder shall be applied first to the Payee's costs and expenses, then to fees authorized hereunder, then to interest and then to principal.

5. Default. An Event of Default shall be deemed to have occurred hereunder upon the occurrence of any of the following events: (a) the Maker's failure to pay any principal, interest or other amounts hereunder as and when due and payable; (b) the commencement of any

bankruptcy or insolvency proceedings by the Maker or, if commenced against the Maker and not discharged within 60 days, or if an order for relief is entered by the appropriate bankruptcy court; or (c) material falsity in any certificate, statement, representation, warranty or audit at any time furnished to the Payee by or on behalf of the Maker and including any omission to disclose any substantial contingent or liquidated liabilities or any material adverse change in any facts disclosed by any certificate, statement, representation, warranty or audit furnished to the Payee. If any Event of Default shall occur, all then outstanding principal hereunder, all accrued and unpaid interest hereunder and all other amounts payable under this Note shall be forthwith due and payable without presentment, further demand, protest or further notice of any kind, all of which are hereby expressly waived by the Maker. Upon the occurrence of any Event of Default, the outstanding principal of this Note, and any accrued and unpaid interest, shall bear interest at a rate of either four percent (4%) per annum above the rate specified in subparagraph 2(i) above after default until paid or, if such rate is usurious under the laws of Florida, then at the highest legal rate permissible thereunder (the "Default Rate").

6. Expenses. The Maker agrees to pay the Payee all costs incurred by it in connection with the collection of this Note. Such costs include, without limitation, fees for the services of counsel and legal assistants employed to collect this Note, whether or not suit be brought, and whether incurred in connection with collection, trial, appeal or otherwise. The Maker further agrees to indemnify and hold the Payee harmless against liability for the payment of state documentary stamp taxes, intangible taxes or other taxes (including interest and penalties, if any), excluding income or service taxes of the Payee, which may be determined to be payable with respect to this transaction.

7. Late Charge. The Maker shall pay a late charge on each and every payment due hereunder and not received by the Payee within ten (10) days after it is due. The amount of the late charge shall in each instance equal the greater of: (a) \$100.00; or (b) five percent (5.0%) of the delinquent payment. The late charge is not a penalty, but liquidated damages to defray administrative and related expenses due to such late payment. The late charge shall be immediately due and payable and shall be paid by the Maker to the Payee without notice or demand. Further, the acceptance of a late payment shall not constitute a waiver of any default then existing or thereafter arising under this Note.

8. Maker's Option To Cancel Note. Notwithstanding anything to the contrary in any document or agreement between Maker and Payee, Maker shall have the option, in his sole discretion, at anytime, to cancel the Note, and in exchange for such cancellation Maker shall irrevocably authorize Payee to dispose of the Collateral in accordance with the terms and conditions of Section 9 below. For purposes of this Section 8, the "Date of Cancellation" shall be the date on which Payee receives a written notice from Maker to cancel the Note. The written notice shall be furnished in accordance with the notice provisions of the Loan Agreement. Provided, however, that if on the Date of Cancellation, the value of the Collateral is less than the sum of (i) the outstanding principal balance of the Note; (ii) any accrued but unpaid interest on the Note; (iii) any fees authorized and due and owing to Payee pursuant to the Note; and (iv) any costs and expenses authorized and due and owing to Payee pursuant to the Note, Maker shall be required to pay to Payee the amount by which the sum of items (i) through (iv) listed in this Section 8 exceeds the value of the Collateral. Maker shall have the option of making the

payment herein provided for to Payee in either additional cash or additional shares of Payee's issued and outstanding common stock. If on the Date of Cancellation, the value of the Collateral exceeds the sum of items (i) through (iv) listed in this Section 8, Payee shall be required to release and return to Maker, free and clear of all liens and encumbrances, the portion of the Collateral which exceeds the sum of items (i) through (iv) of this Section 8. For purposes of determining the value of the Collateral and additional shares on the Date of Cancellation, the parties shall utilize the closing price of the shares of Payee's common stock (as traded on the NASDAQ National Market) on the Date of Cancellation. Any Shares used by Maker to compensate Payee in consideration for the cancellation of the Note pursuant to the provisions of this Section 8 shall be subject to sale by Payee on Maker's behalf pursuant to the terms and conditions of Section 9 below, and Maker shall cooperate with Payee in effecting any such sale.

9. Mechanism for Sale of the Shares. The Shares pledged by Maker to Payee pursuant to the Stock Pledge Agreement consists, in part, of a portion of the 343,750 shares of Payee common stock registered with the United States Securities and Exchange Commission (the "SEC") pursuant to that certain S-1 Registration Statement dated and filed with the SEC on June 22, 1998 (the "Registered Shares"). The balance of the Shares pledged to Payee by Maker pursuant to the Stock Pledge Agreement consists of shares of Payee's common stock that have not been registered with the SEC (the "Non-registered Shares"). It is also contemplated that if Maker is required to utilize additional shares to compensate Payee pursuant to the provisions of Section 8 above or under any of the Loan Documents, Maker will utilize Registered Shares and/or Non-registered Shares. If, in order to satisfy any of Maker's obligations or commitments pursuant to any Loan Document, a sale must be made of any or all of the Registered Shares or Non-registered Shares pledged or otherwise delivered by Maker to Payee, Maker hereby authorize Payee to make such sale as the Agent (as defined below) of Maker and on Maker's behalf. Any sale of Registered Shares as provided for in this Section 9 shall be made pursuant to the S-1 Registration Statement, and shall be deemed to be a sale by Maker through his duly appointed and authorized Agent. Any sale of Non-Registered Shares as provided for in this Section 9 shall be made pursuant to and in satisfaction of the requirements of Rule 144 promulgated by the SEC under the Securities Act of 1933, as amended, and shall be deemed to be a sale by Maker through his duly appointed and authorized Agent. Payee is hereby irrevocably granted the right to keep and maintain custody of any and all proceeds of any sale of Registered Shares, Non-registered Shares and other components of the Collateral in satisfaction of any sum due and owing to Payee pursuant to the Loan transaction.

10. Security Interest. In accordance with the terms and conditions of that certain Pledge Agreement dated as of the date hereof (the "Pledge Agreement") between Payee and Maker, this Note is secured by the "Collateral" described and defined in Section 1 of said Pledge Agreement. Without affecting the liability of Maker hereunder, the Payee may, from time to time and without notice, renew or extend the time for payment, accept partial payments, release or impair any collateral security for payment of this Note, or agree not to sue any party liable on it. Maker hereby waives presentment, demand, notice of dishonor and protest.



## 11. Miscellaneous.

A. The Note shall be deemed to have been repaid effective as of the earliest of: (i) the date on which Maker prepays the Note (as allowed under Section 3 above); (ii) the Maturity Date (as defined in Section 1(i) above); (iii) the Anniversary Cancellation Date (as defined in Section 1(ii) above); or (iv) the Cancellation Date (as defined in Section 8 above), so long as by the particular date Payee has received from Maker any combination of cash and/or shares of Payee's stock sufficient to cover the then outstanding Loan obligations in accordance with the provisions of the Agreement and the Loan Documents. From and after the repayment date, Maker shall have no obligations to Payee pursuant to or under the Agreement or the Loan Documents, except for Maker's obligation to cooperate with Payee in disposing of the Collateral Shares (and any additional shares delivered to Payee) pursuant to the provisions of Section 9 above.

B. Except as otherwise provided herein or in any other Loan Document, the Maker shall make all payments hereunder in lawful money of the United States of America at the Payee's principal address in the Federal Republic of Germany or at such other place as the Payee may from time to time designate in writing.

C. The remedies of the Payee as provided herein shall be cumulative and concurrent, and may be pursued singly, successively or together, at the sole discretion of the Payee and may be exercised as often as occasion therefor shall arise.

D. No act of omission or commission of the Payee, including specifically any failure to exercise any right, remedy or recourse, shall be effective, unless set forth in a written document executed by the Payee and then only to the extent specifically recited therein. A waiver or release with reference to one event shall not be construed as continuing, as a bar to, or as a waiver or release of any subsequent right, remedy or recourse as to any subsequent event.

E. The validity, construction, enforcement, and interpretation of this Note shall be governed by the laws of the State of Florida and the United States of America, without regard to principles of conflict of laws.

F. The Maker (a) consents to the personal jurisdiction of the state and federal courts having jurisdiction in Seminole County, Florida, (b) stipulates that the proper, exclusive, and convenient venue for any legal proceeding arising out of this Note is Seminole County, Florida, for state court proceedings, and the Middle District of Florida, Orlando Division, for federal district court proceedings, and (c) waives any defense, whether asserted by a motion or pleading, that Seminole County, Florida, or the Middle District of Florida, Orlando Division, is an improper or inconvenient venue.

G. Maker's obligations to Payee hereunder and under the other Loan Documents are secured by the Collateral, based on the fact that the parties hereto have mutually agreed that the shares of stock pledged as collateral are to be valued at \$6.375 each as of the date hereof. For so long as the value of the Collateral is sufficient to cover Maker's obligations to Payee hereunder and under the other Loan Documents (regardless of whether such obligations

become due on the dates provided for herein or as a result of Maker's Default hereunder or otherwise), then Maker shall not be personally liable to Payee, and Payee shall not seek personal judgment against Maker or any of Maker's heirs or assigns for such obligations. For so long as the value of the Collateral is sufficient to cover Maker's obligations to Payee hereunder and under the other Loan Documents, any judgment or decree in any action brought to enforce such obligations shall be enforceable against Maker only to the extent of his interest in the Collateral, and any such judgment or decree shall not be subject to execution upon or be a lien upon the assets of Maker, other than his interest in the Collateral. In determining whether the value of the Collateral is sufficient to cover Maker's obligations to Payee on any particular day, the parties shall utilize the closing price of the shares of Payee's common stock (as traded on the NASDAQ National Market) on such day. By way of illustration only: If the sum of (a) the outstanding principal balance of the Note; (b) any accrued but unpaid interest on the Note; (c) any fees authorized and due and owing to Payee pursuant to the Note; and (d) any costs and expenses authorized and due and owing to Payee pursuant to the Note on any particular day is equal to \$1,000,000.00, then Maker shall not be personally liable to Payee if the value of the Collateral on such day is also \$1,000,000.00. If however, the value of the Collateral on the hypothetical day is only \$750,000.00 (perhaps due to a closing price of less than \$6.375 per share on such day), then maker shall be personally liable for the shortfall of \$250,000.00; and Payee shall be entitled to seek personal judgment against Maker or any of Maker's heirs or assigns for such shortfall. Accordingly, if the value of the Collateral exceeds Maker's obligations to Payee on the hypothetical day, Payee shall be required to return any such excess amount to Maker. Nothing contained in this paragraph shall affect or limit the ability of Payee to enforce any of its rights or remedies with respect to the Collateral.

H. In any mediation, arbitration, or legal proceeding arising out of this Note, the losing party shall reimburse the prevailing party, on demand, for all costs incurred by the prevailing party in enforcing, defending, or prosecuting any claim arising out of this Note, including all fees, costs, and expenses of experts, attorneys, witnesses, collection agents, and supersedeas bonds, whether incurred before or after demand or commencement of legal proceedings, and whether incurred pursuant to trial, appellate, mediation, arbitration, bankruptcy, administrative, or judgement-execution proceedings.

I. The term "Payee" as used herein shall mean any lawful holder of this Note. To the extent permitted by law, the Maker agrees to and does hereby waive trial by jury in any action, proceeding, or counterclaim brought by either the Maker or the Payee on any matters whatsoever arising out of or in any way connected with this Note or any claim of damage resulting from any act or omission of the Maker or Payee or either of them in any way connected with this Note.

IN WITNESS WHEREOF, the Maker has executed this Note as of the date first written above.

WITNESSES:

Signature: \_\_\_\_\_

By: \_\_\_\_\_  
Wendelin Karl Johannes Scharbach

Print Name: \_\_\_\_\_

Print Name: \_\_\_\_\_

MAKER'S APPOINTMENT OF PAYEE AS AGENT

In consideration of the covenants contained above, and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged by both Maker and Payee, Maker hereby appoints Payee as his agent and attorney-in-fact (the "Agent") to sell or otherwise dispose of (i) any portion or all of the Collateral (as referred to in Section 10 above) including, but not limited to, the Registered Shares and Non-registered Shares that are components thereof; and (ii) any additional Registered Shares and/or Non-registered Shares that Maker delivers to Payee pursuant to the terms and conditions of the Loan Documents. Maker covenants and agrees to make all such reasonable arrangements, do and perform all such reasonable acts and things, execute and deliver all such certificates, documents and other instruments, and to take such further reasonable actions as Payee may deem necessary or advisable to effect the sale of Registered Shares pursuant to the S-1 Registration Statement, or Non-registered Shares in compliance with the requirements of Rule 144, as the case may be, as Maker's Agent and on Maker's behalf. Maker grants Payee full and unfettered authorization to dispose of the Collateral, and any portion thereof, in accordance with the terms and conditions of Section 9 above, as well as any other applicable provision of the Loan Documents. Further, Maker agrees to indemnify and hold Payee harmless from liability for any and all losses or damages asserted or suffered by any party as a result of Payer's performance as Maker's Agent. Payee's appointment hereunder is irrevocable and shall remain in full force and effect for so long as Maker has not satisfied all of his obligations pursuant to the Loan Documents. Payee hereby accepts its appointment as Maker's Agent under the terms and conditions hereof. The appointment and authorization effected hereby, and the indemnification provided for herein, shall (i) inure to the benefit of Payee, its successors and assigns; and (ii) be binding upon Maker, his heirs and assigns.

FARO Technologies, Inc.

By:

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Wendelin Karl Johannes Scharbach

Name:

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Title:

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## STOCK PLEDGE AGREEMENT

Mannheim, Germany

June 27, 2000

THIS STOCK PLEDGE AGREEMENT (this "Agreement") is executed and made effective as of June 27, 2000, by Wendelin Karl Johannes Scharbach, an individual resident of Germany ("Borrower") whose current mailing address is Schwarzwaldstrasse 94, 68163 Mannheim, Germany in favor of FARO Technologies, Inc., a corporation organized and existing under the laws of the State of Florida ("FARO") whose current mailing address is 125 Technology Park, Lake Mary, FL 32746.

## RECITALS

WHEREAS, contemporaneously herewith, Borrower has made and delivered to FARO a Promissory Note in the original principal amount of U.S. \$563,122.02 (the "Note"); and

WHEREAS, to secure the prompt payment and performance of all of the liabilities, obligations, and indebtedness of Borrower to FARO under the Note (the "Liabilities"), Borrower desires to pledge, grant, hypothecate, assign, and convey to FARO a first lien and security interest in and to: (a) the "Shares" of FARO common stock described and defined on Schedule A attached hereto; and (b) the property described in Sections 1(ii) and 1(iii) of this Agreement.

NOW, THEREFORE, in consideration of the premises and of the mutual representations, warranties, covenants, and agreements set forth herein, the parties hereto hereby agree as follows:

1. Grant of Security Interest. To secure the due and punctual payment of the Liabilities, and all reasonable costs and expenses incurred by FARO in connection with enforcement or collection of the Liabilities (including reasonable legal fees and expenses incurred in trial, appellate, bankruptcy, and judgment-execution proceedings) and all reasonable costs and expenses incurred in connection with realizing on the value of the security provided by this Agreement (including appraisal fees, broker-dealer fees, and legal fees incurred in trial, appellate, bankruptcy, and judgment-execution proceedings), Borrower hereby pledges, grants, hypothecates, assigns, conveys, and grants to FARO a first lien and security interest (collectively, the "Security Interest") in the following:

A. all of the Shares listed on Schedule A to this Agreement;

B. all dividends, additional shares or other property or securities that are receivable or otherwise distributable at any time and from time to time in respect of, or in exchange or substitution for, the Shares and all profits therefrom; and

C. all proceeds of the foregoing.

As used in this Agreement, the term "Collateral" refers to all the property described in this Section 1, as well as any portion or any interest in it.

2. Representations and Warranties. Borrower covenants to FARO that, except for the Security Interest granted to FARO by this Agreement:

A. Borrower is and will be the sole legal and equitable owner of the Collateral;

B. the Collateral is and will be free and clear of all liens, encumbrances, security interests, assessments, and adverse claims of every kind and nature;

C. the grant of this Security Interest does not and will not violate the terms of any agreement applicable to Borrower; and

D. Borrower has not, and will not, sell, assign, convey, pledge, transfer, hypothecate, or in any other way dispose of or encumber the Collateral, other than as provided in this Agreement.

3. Delivery of Collateral. Upon execution of this Agreement, Borrower shall deliver the Shares to FARO. Borrower shall immediately provide notice to the transfer agent of FARO of the Security Interest and shall cause such Security Interest to be noted in the transfer records of such transfer agent. Borrower shall deliver to FARO immediately upon receipt any Collateral which is subsequently acquired by Borrower, or which is delivered to Borrower, in exchange or substitution for any or all of the Collateral.

4. Maintenance of Security Interest. Borrower shall, upon request, take any action reasonably deemed advisable by FARO to preserve the Collateral or to establish, determine priority of, perfect, continue perfection of, terminate or enforce FARO's Security Interest or its rights under this Agreement.

5. Rights of FARO. FARO may at any time, upon or after the occurrence of a default under the Note that is not cured within any applicable grace or cure period, or after maturity of any of the Liabilities and without notice or demand of any kind (a) transfer any of the Collateral into its name or that of its nominee, (b) notify obligors on or issuers of any Collateral to make payment or delivery to FARO of any amounts, securities, or rights due or distributable thereon or notices given in connection therewith, (c) in Borrower's name or otherwise, enforce collection of any Collateral by suit or otherwise, or surrender, release or exchange all or part of it, or compromise, extend or renew for any period any obligation evidenced by the Collateral, (d) receive proceeds of the Collateral and exercise all rights as a holder of the Collateral, (e) hold any increase or profits (including money) received from the Collateral and exercise all rights as a holder of the Collateral, (f) hold any increase or profits (including money) received from the Collateral as additional security for the Liabilities, and (g) sign or endorse Borrower's name on the Collateral.

6. Default. A default under the Note or Borrower's failure to perform its obligations under this Agreement shall constitute a default under this Agreement.

7. Irrevocable Proxy on Default. In addition to FARO's other rights, Borrower irrevocably appoints FARO as proxy, with full power of substitution and revocation (upon the

occurrence of a default under the Note or hereunder that is not cured within any applicable grace or cure period) to exercise Borrower's rights to attend meetings, vote, consent to, and take any action respecting the Collateral as fully as Borrower might do. This proxy shall become effective upon the occurrence of a default that is not cured within any applicable grace or cure periods and shall remain effective for so long as any of the Liabilities are unpaid.

8. Termination. This Agreement and the Security Interest of FARO under it will terminate when all the Liabilities are paid in full. Upon termination of this Agreement, FARO shall reassign and deliver to Borrower the Collateral that is then held by FARO under this Agreement and has not been sold or otherwise applied pursuant to the terms of this Agreement; provided, however, in the event that another creditor of Borrower has been granted a pledge of the Collateral subordinate to FARO, and FARO has actual notice of such pledge, Borrower authorizes FARO to deliver the Collateral to such other creditor.

9. Legal Matters. The validity, construction, enforcement, and interpretation of this Agreement shall be governed by the laws of the State of Florida and the United States of America, without regard to principles of conflict of laws. Each party to this Agreement (a) consents to the personal jurisdiction of the state and federal courts having jurisdiction in Seminole County, Florida, (b) stipulates that the proper, exclusive, and convenient venue for any legal proceeding arising out of this Agreement is Seminole County, Florida, for state court proceedings, and the Middle District of Florida, Orlando Division, for federal district court proceedings, and (c) waives any defense, whether asserted by a motion or pleading, that Seminole County, Florida, or the Middle District of Florida, Orlando Division, is an improper or inconvenient venue. In any mediation, arbitration, or legal proceeding arising out of this Agreement, the losing party shall reimburse the prevailing party, on demand, for all costs incurred by the prevailing party in enforcing, defending, or prosecuting any claim arising out of this Agreement, including all fees, costs, and expenses of experts, attorneys, witnesses, collection agents, and supersedeas bonds, whether incurred before or after demand or commencement of legal proceedings, and whether incurred pursuant to trial, appellate, mediation, arbitration, bankruptcy, administrative, or judgment-execution proceedings.

10. Entire Understanding; Waiver. This Agreement records the final, complete, and exclusive understanding among the parties regarding the subjects addressed herein and supersede any prior or contemporaneous agreement, understanding, or representation, oral or written by any of them on such subjects. The provisions hereof may not be changed, modified, waived, or altered except by an agreement in writing signed by the party entitled to the benefit of the provision to be waived hereto. A waiver by any party of any of the terms or conditions of this Agreement, or of any breach thereof, shall not be deemed a waiver of such term or condition for the future, or of any other term or condition hereof, or of any subsequent breach thereof.

11. Severability. Whenever possible, each provision of this Agreement should be construed and interpreted so that it is valid and enforceable under applicable law. If a provision of this Agreement is held to be invalid or unenforceable under applicable law, however, that provision will be deemed separable from the remaining provisions of this Agreement and will not affect the validity or interpretation of the other provisions of this Agreement or the application of that provision to other circumstances in which it is valid and enforceable.

12. Notices. All notices, requests or demands which any party is required or may desire to give to any other party under any provision of this Agreement must be in writing, and may be by means of facsimile transmission, delivered to the other party at the following address:

If to FARO:

FARO Technologies, Inc.  
125 Technology Park  
Lake Mary, Florida 32746  
Telecopy: (407) 333-4181

Attention: Gregory A. Fraser

With a copy to:

Foley & Lardner  
100 North Tampa St., Suite 2700  
Tampa, Florida 33602  
Telecopy: (813) 221-4210

Attention: Martin A. Traber

If to Borrower:

Wendelin Karl Johannes Scharbach  
Schwarzwaldstrasse 94  
68163 Mannheim  
Germany  
Telecopy: 011-49-711-2222-444



With a copy to:

Hasche Eschenlohr Peltzer Riesenkampff Fischotter  
Neidenau 68  
60325 Frankfurt/Main  
Germany  
Telecopy: 011-49-69-71-701-230

Attention: Thomas Link

or to such other address as any party may designate by written notice to the other party. Each such notice, request and demand shall be deemed given or made as follows: (i) if sent by mail, upon the earlier of the date of receipt or five (5) days after deposit in the U.S. Mail, first class postage prepaid; (ii) if electronically transmitted, the next business day after transmission (and the sender shall bear the burden of proof of delivery); or (iii) if sent by any other means, upon delivery.

13. Effectiveness. This Agreement will become effective with respect to the original parties to it, as of its stated execution date, when each of those parties has executed and delivered to the others a counterpart of this Agreement.

14. Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which, together, shall constitute one and the same instrument.

15. Miscellaneous. Time is of the essence of this Agreement. A delay, omission, or course of dealing on the part of FARO in exercising any right, power, or remedy will not operate as a waiver of it. A single or partial exercise by FARO of any right, power, or remedy does not preclude any further exercise or non-exercise of it or the exercise or non-exercise of any other right, power or remedy. The exercise or non-exercise by FARO of any right, power, or remedy does not constitute a waiver of a default under this Agreement.

16. Cancellation of Loan. Notwithstanding any provision contained herein, or in any other document or agreement between FARO and Borrower, Borrower shall have the option, in his sole discretion, at any time, to cancel the Note pursuant to and in compliance with the provisions of Section 8 thereof.

IN WITNESS WHEREOF, the Borrower has executed this Agreement as of the date first written above.

WITNESSES:

Signature: \_\_\_\_\_ By: \_\_\_\_\_  
Wendelin Karl Johannes Scharbach

Print Name: \_\_\_\_\_ Print Name: \_\_\_\_\_

Signature: \_\_\_\_\_

Print Name: \_\_\_\_\_

BORROWER'S APPOINTMENT OF FARO AS AGENT

In consideration of the covenants contained above, and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged by both Borrower and FARO, Borrower hereby appoints FARO as his agent and attorney-in-fact (the "Agent") to sell or otherwise dispose of (i) any portion or all of the Collateral (as referred to and defined in Section 1 above) including, but not limited to, the Registered Shares and Non-registered Shares that are components thereof; and (ii) any additional Registered Shares and/or Non-registered Shares that Borrower delivers to FARO pursuant to the terms and conditions of the Loan Documents. Borrower covenants and agrees to make all such reasonable arrangements, do and perform all such reasonable acts and things, execute and deliver all such certificates, documents and other instruments, and to take such further reasonable actions as FARO may deem necessary or advisable to effect the sale of Registered Shares pursuant to the S-1 Registration Statement, or Non-registered Shares in compliance with the requirements of Rule 144, as the case may be, as Borrower's Agent and on Borrower's behalf. Borrower grants FARO full and unfettered authorization to dispose of the Collateral, and any portion thereof, in accordance with the terms and conditions of the Note, as well as any other applicable provision of the Loan Documents. Further, Borrower agrees to indemnify and hold FARO harmless from liability for any and all losses or damages asserted or suffered by any party as a result of FARO's performance as Borrower's Agent. FARO's appointment hereunder is irrevocable and shall remain in full force and effect for so long as Borrower has not satisfied all of his obligations pursuant to the Loan Documents. FARO hereby accepts its appointment as Borrower's Agent under the terms and conditions hereof. The appointment and authorization effected hereby, and the indemnification provided for herein, shall (i) inure to the benefit of FARO, its successors and assigns; and (ii) be binding upon Borrower, his heirs and assigns.

FARO Technologies, Inc.

By: \_\_\_\_\_  
Wendelin Karl Johannes Scharbach Name: \_\_\_\_\_  
Title: \_\_\_\_\_

SCHEDULE A

THE SHARES

88,333 shares of the issued and outstanding common stock of FARO Technologies, Inc., a Florida corporation, which is arrived at as a result of dividing the original principal sum of the Note (stated in US dollars) by US \$6.375 (the "Shares").

AFFIDAVIT  
AND  
INDEMNITY AGREEMENT

Mannheim, Germany

June 27, 2000

I, the undersigned, Wendelin Karl Johannes Scharbach, an individual resident of Germany (the "Affiant") whose current mailing address is Schwarzwaldstrabe 94, 68163 Mannheim, Germany, hereby represent and warrant as follows:

That Affiant is the sole record owner and entitled to the possession of the Certificate(s) described below representing an aggregate of one hundred eighty-one thousand eighty-two (181,082) shares of the issued and outstanding common stock of FARO Technologies, Inc., a Florida corporation (the "Company"), such Certificate(s) being referred to hereafter as the "Original Certificate(s)".

Certificate Number	Date of Certificate	Registered in the Name of	Number of Shares
_____	_____	Wendelin Karl Johannes Scharbach	_____
_____	_____	Wendelin Karl Johannes Scharbach	_____

Affiant hereby certifies that, apart from the security interest granted to the Company pursuant to that certain Pledge Agreement dated and made effective as of the date of this Agreement by Affiant in favor of Company, no other person has any right, title or interest in the Original Certificate(s) or the securities represented thereby. Affiant will not hereafter sell, assign, transfer, hypothecate, pledge or otherwise dispose of, either in whole or in part, such Original Certificate(s) or the securities represented thereby, nor give any person any power of attorney, order or other authority of any kind or nature whatsoever to transfer such Original Certificate(s) or the securities represented thereby, or any part or portion thereof or interest therein, without first obtaining the written consent of the Company. Further, Affiant says that this affidavit and agreement are made in order to introduce the Company to extend credit and other financial accommodations to Affiant.

IN CONSIDERATION THEREFOR, Affiant hereby agrees for Affiant and Affiant's heirs, legal representatives and assigns that in case any of Affiant's representations herein are materially false or misleading, or in the event that Affiant breaches or violates any of his undertakings herein, Affiant agrees for Affiant and Affiant's heirs, legal representatives and assigns to indemnify and save harmless the Company, the Company's successors or assigns and the Company's directors, officers and employees from and against any and all liabilities, losses, damages, costs, charges, counsel fees and other expenses of every nature and character which they sustain or incur by reason of their reliance on any such false or misleading representation, or due to any breach or violation by Affiant.

All obligations of the Affiant hereunder shall be binding upon the Affiant, his heirs, legal representatives, successors or assigns.

IN WITNESS WHEREOF, the Affiant has executed this document as of the date first written above.

WITNESSES:

Signature: -----

By: -----

Wendelin Karl Johannes Scharbach

Print Name: -----

Print Name: -----

Signature: -----

Print Name: -----

## AMENDED AND RESTATED LOAN AGREEMENT

THIS AMENDED AND RESTATED LOAN AGREEMENT (the "Agreement") is dated and entered into as of June 20, 2000, by and between FARO Technologies, Inc., a Florida corporation ("Lender"), whose current mailing address is 125 Technology Park, Lake Mary, Florida 32746, and Siegfried Kurt Buss, an individual resident of the Federal Republic of Germany ("Borrower"), whose current mailing address is Erich Kaestner Strasse 73, Ditzingen, Hirschlanden 71254.

WHEREAS, on May 15, 1998, Lender acquired CATS computer aided technologies, Computeranwendungen in der Fertigungssteuerung GmbH, a limited liability company under the laws of the Federal Republic of Germany ("CATS"). Borrower was a holder of Quotas in CATS.

WHEREAS, pursuant to a Loan Agreement dated August 2, 1999 between Lender and Borrower (the "Original Loan Agreement"), Lender has agreed to loan to Borrower an amount equal to his tax obligation to the German tax authority in connection with the acquisition of CATS. The maximum amount of the loans is estimated to be approximately \$2 million.

WHEREAS, the German tax authority have indicated to Borrower that they would be willing to issue a preliminary tax assessment for fiscal year 1998 based on a value of U.S. \$4.875 per share of Common Stock of Lender (using an exchange rate of U.S. Dollars to Deutsche Marks ("DM") of 1:1.8403 for May 1999).

WHEREAS, Borrower received 458,334 shares of Lender common stock as part of the purchase price for the acquisition of CATS. Using a price of \$4.875 per share of Lender common stock, the value of the shares of Lender common stock received by Borrower would equal DM 4,111,926. The tax payable with respect to such shares based on such value would equal DM 1,159,733.36.

WHEREAS, based on a stock price per share of Lender common stock on May 15, 1998 of U.S. \$11.125, the value of the shares of Lender common stock received by Borrower would equal DM 9,048,634 (using an exchange rate of U.S. Dollars to DM of 1:1.7746 for May 1998). The tax payable with respect to such shares based on such value would equal DM 2,552,683.73.

WHEREAS, because the tax assessment received by Borrower is only preliminary, the German tax authority could at any time revise the tax assessment based on the price per share of Lender common stock on May 15, 1998.

WHEREAS, the parties wish to amend the Original Loan Agreement to provide that Lender will loan to Borrower an initial amount of DM 1,159,733.36 resulting from the preliminary tax assessment as provided for in the Original Loan Agreement, and that Lender will pay an additional amount of DM 1,392,950.37 (DM 2,552,683.73 less DM 1,159,733.36) into an escrow account to cover possible additional taxes payable because of a higher value of the 458,334 shares of Lender common stock issued to Borrower in connection with the acquisition of

CATS. The amount paid into escrow would increase the amount of the Loan under this Agreement if distributed to pay additional taxes.

WHEREAS, once the German tax authority have issued a final tax assessment, the amount in the escrow account will be used to pay such amount of additional tax or, to the extent the amount in the escrow account is not needed to pay additional taxes, will be repaid to Lender. To the extent the amount in the escrow account is used to pay additional taxes, such amount would be evidenced by a new promissory note issued by Borrower to Lender and such note would be secured by shares of common stock of Lender.

WHEREAS, this Agreement amends and restates the Original Loan Agreement.

In consideration of the loan described below and the mutual covenants and agreements contained herein, Borrower and Lender agree as follows:

1. LOANS.

A. Initial Loan.

i. Lender hereby agrees to make a loan to Borrower in the principal amount of DM 1,159,733.36 (the "Initial Loan").

ii. The amount of the Initial Loan is equal to the tax payable by Borrower (based on the preliminary tax assessment issued to Borrower by the German tax authority for fiscal year 1998, which used a value of U.S. \$4.875 per share of Lender common stock, and based on an exchange rate of U.S. Dollars to DM of 1:1.8403 for May 1999) with respect to Borrower's receipt of 458,334 shares of Lender common stock in connection with Lender's acquisition of CATS.

iii. To evidence his obligation to repay the Initial Loan, and to otherwise induce Lender to make the Initial Loan, Borrower shall execute and deliver to Lender a Promissory Note, Stock Pledge Agreement, Affidavit and Indemnity Agreement, Stock Power and UCC-1 Financing Statement in the forms attached hereto as Exhibits A, B, C, D and E, respectively (together, the "Loan Documents") with respect to the Initial Loan at such time that the Initial Loan is made.

iv. Lender will be obligated to make the Initial Loan to Borrower within three (3) business days after Borrower presents written evidence to Lender that the German tax authority has requested payment of the tax obligations described in Section 4 of this Agreement.

B. Additional Loan.

i. Lender hereby agrees to make an additional loan to Borrower in the principal amount of up to DM 1,392,950.37 (the "Additional Loan"), as is necessary to enable Borrower to satisfy his tax obligations to the German tax authority as a result of Borrower's receipt of 458,334 shares of Lender common

stock of the Lender that Borrower received in connection with Lender's acquisition of CATS. Lender will be obligated to make the Additional Loan only if the German tax authority issues a final tax assessment that assesses a greater tax obligation on Borrower than the preliminary tax assessment issued to Borrower by the German tax authority for fiscal year 1998 with respect to Borrower's receipt of 458,334 shares of Lender common stock in connection with Lender's acquisition of CATS.

ii. The maximum amount of the Additional Loan is equal to (i) DM 2,552,683.73, which is the tax payable by Borrower (based on a stock price per share of Lender common stock on May 15, 1998 of U.S. \$11.125 and using an exchange rate of U.S. Dollars to DM of 1:1.7746 for May 1998) with respect to Borrower's receipt of 458,334 shares of Lender common stock in connection with Lender's acquisition of CATS, less (ii) the amount of the Initial Loan.

iii. To evidence his obligation to repay the Additional Loan, and to otherwise induce Lender to make the Additional Loan, Borrower shall execute and deliver to Lender the Loan Documents with respect to the Additional Loan at such time as the Additional Loan is made.

iv. To secure Lender's obligation pursuant to this Agreement to make the Additional Loan to Borrower, Lender shall deposit U.S. \$679,487.99 (DM 1,392,950.37 divided by 2.05, the exchange rate of U.S. Dollars to DM on June 9, 2000) in an escrow account (the "Escrow Account") with Firststar Bank Milwaukee, N.A. (the "Escrow Agent") pursuant to an Escrow Agreement dated on or about the date of this Agreement among Lender, Borrower, and the Escrow Agent, a copy of which is attached as Exhibit F to this Agreement. Any interest on the funds in the Escrow Account shall be paid to the Lender.

v. All funds shall remain in the Escrow Account until the earlier of (i) July 1, 2004 or (ii) the date that Borrower presents written evidence to Lender and the Escrow Agent that the German tax authority has requested payment of the final tax assessment with respect to the tax obligations for the 458,334 shares of Lender common stock that Borrower received in connection with Lender's acquisition of CATS. Lender will be obligated to make the Additional Loan, and funds from the Escrow Account shall be paid to Borrower to fund the Additional Loan, within three (3) business days after Borrower presents written evidence to Lender that the German tax authority has requested payment of the tax obligations described in Section 4 of this Agreement.

vi. The Escrow Agent is obligated to pay to the Borrower funds from the Escrow Account (without permission of the Lender) as are necessary to enable Borrower to satisfy his tax obligations to the German tax authority as described in Section 4 of this Agreement upon presentation by Borrower to the Escrow Agent of (i) copies of the Loan Documents for the Additional Loan executed by Borrower and delivered to Lender, and (ii) written evidence to Lender that the



German tax authority has requested payment of the tax obligations described in Section 4 of this Agreement.

- vii. Any funds remaining in the Escrow Account after July 1, 2004 or any funds not needed to pay the final tax assessment with respect to the tax obligations for the 458,334 shares of Lender common stock that Borrower received in connection with Lender's acquisition of CATS shall be returned immediately to Lender.

C. Definition of the Loans. The Initial Loan and the

Additional Loan are each referred to as a "Loan" and collectively are referred to as the "Loans."

2. LENDER'S COMMITMENT. Lender's obligation to extend the Loans to Borrower is a valid, legal, irrevocable and binding corporate obligation which shall not be rescinded or withdrawn in the event of a change of Lender's present management or ownership.

3. TERMS AND CONDITIONS OF LOAN. The Loans shall be governed by the following terms and conditions in addition to all terms and conditions set forth in the Loan Documents.

A. Payment.

i. Notwithstanding any contrary provision set forth herein or in any document related hereto, Borrower shall be obligated to pay all outstanding principal, together with all then accrued and unpaid interest under each Loan, on or before the earlier of (a) the end of the three year period that commences on the date the Borrower executes and delivers the Loan Documents to Lender with respect to each Loan, or (b) that date when the preceding five (5) trading days of the Lender's common stock yields an average closing price of \$11.34 per share (each such date hereinafter referred to as the "Maturity Date"). On such Maturity Date as defined in Section 3A(i)(b), it shall be within Borrower's discretion to repay the Loans either in cash, or, in lieu thereof, with shares of the common stock of Lender at an agreed upon price of \$11.34 per share. For the purpose of repaying the Loans with shares of the Lender's common stock as provided for in this Section 3A(i), Borrower shall be required to utilize that portion of the Collateral (as defined in Section 3E below) which is equal in value to the amount of Loans being repaid.

ii. Notwithstanding the foregoing, in the event a Loan is still outstanding at end of the three year period that commences on the date Borrower executes and delivers the Loan Documents to the Lender with respect to such Loan, Borrower shall have the option of either: (a) requiring Lender to renew or extend the Loan for an additional term of three (3) years or (b) canceling the Loan, effective as of the three year anniversary date, by providing Lender with written notice in accordance with the provisions of Section 10 below, and in exchange for such cancellation Borrower shall irrevocably authorize Lender to dispose of the

Collateral in accordance with the terms and conditions of Section 9 below. The parties hereby agree that the three year anniversary date shall be the date which coincides with the end of the three year period that commences on the date Borrower executes and delivers the Loan Documents to the Lender with respect to a Loan, and if Borrower elects to cancel such Loan effective as of such date, the date shall hereinafter be referred to as the "Anniversary Cancellation Date." If on the Anniversary Cancellation Date, the value of the Collateral is less than the sum of: (i) the outstanding principal balance of the Loan; (ii) any accrued but unpaid interest on the Loan; (iii) any fees authorized and due and owing to Lender pursuant to the Promissory Note with respect to the Loan; and (iv) any costs and expenses authorized and due and owing to Lender pursuant to the Promissory Note with respect to the Loan, Borrower shall not be required to pay to Lender the amount by which the sum of items (i) through (iv) exceeds the value of the Collateral. On the other hand, if on the Anniversary Cancellation Date, the value of the Collateral exceeds the sum of items (i) through (iv), Lender shall be required to release and return to Borrower, free and clear of all liens and encumbrances, the portion of the Collateral which exceeds the sum of items (i) through (iv). For purposes of determining the value of the Collateral on the Anniversary Cancellation Date, the parties shall utilize the closing price of the shares of Lender's common stock (as traded on the NASDAQ National Market) on that particular date, or, if that date is not a trading day on the NASDAQ National Market, the immediately preceding trading day.

iii. All Shares used by Borrower to repay the Loan pursuant to the provisions of Section 3A(i) above, as well as all Shares comprising the Collateral used by Borrower to compensate Lender for the cancellation of the Loan pursuant to the provisions of Section 3A(ii) above, shall be subject to sale by Lender on Borrower's behalf in accordance with the terms and conditions of Section 9 below, and Borrower shall cooperate with Lender in effecting any such sale.

B. Interest.

i. Except as otherwise provided in Section 5 of the Promissory Note, interest shall accrue on the outstanding principal balance of each Loan at a rate that is equal to the sum of (a) the EURIBOR rate that was in effect at 10:00 A.M. on August 2, 1999 (and which is applicable to loans with a maturity date of one year); and (b) 1.57%. Interest on the outstanding principal balance of the Loans shall be paid annually, on the last business day in December of each year, until the entire principal is paid.

ii. Interest shall be calculated on the basis of a 360 day year based upon the actual number of days elapsed. No interest shall accrue on a Loan until the Loan is made to Borrower, and no interest shall accrue after the Maturity Date (as defined in Section 3A(i) above), the Anniversary Cancellation Date (as defined in Section 3A(ii) above), or the Cancellation Date (as defined in Section 8 below).

iii. The total liability of Borrower under the Loans for payment of interest shall not exceed any limitations imposed on the payment of interest by applicable usury laws. If any interest is received or charged in excess of that amount, Borrower shall be entitled to a refund of the excess.

iv. Upon the occurrence of an Event of Default under a Promissory Note, interest shall accrue at the Default Rate thereunder set forth notwithstanding the provisions of this section.

C. Prepayment. The Borrower shall be entitled to prepay the Loans in whole or in part at any time without penalty.

D. Application of Payments. All payments under the Promissory Note shall be applied first to the Lender's costs and expenses, then to fees authorized thereunder, then to interest and then to principal.

E. Grant of Security Interest. To secure the due and punctual payment of the Loans and all of his other liabilities to Lender arising in connection with the Loans, and all reasonable costs and expenses incurred by Lender in connection with enforcement or collection of the Loans or any liability of Borrower in connection therewith (including reasonable legal fees and expenses incurred in trial, appellate, bankruptcy, and judgment-execution proceedings) and all reasonable costs and expenses incurred in connection with realizing on the value of the Collateral (including appraisal fees, broker-dealer fees, and legal fees incurred in trial, appellate, bankruptcy, and judgment-execution proceedings), Borrower shall pledge, hypothecate, assign, convey and grant to Lender a first lien and security interest (collectively, the "Security Interest") in the following:

i. Such number of shares of Lender common stock (the "Shares") which is arrived at as a result of dividing (i) the original principal sum of the Note (stated in U.S. dollars) by (ii) US \$6.375; the denominator of US \$6.375 being the closing price of each share of Lender's common stock (as traded on the NASDAQ National Market) on March 31, 1999.

ii. All dividends, additional shares or other property or securities that are receivable or otherwise distributable at any time and from time to time in respect of, or in exchange or substitution for, the Shares and all profits therefrom; and

iii. All proceeds of the foregoing.

As used herein, the term "Collateral" refers to all the property described in this Section 3E, as well as any portion or any interest in it.

4. PURPOSE OF LOAN. The purpose of the Loan will be to enable Borrower to timely satisfy his obligation to pay certain taxes in the Federal Republic of Germany in connection with Borrower's sale on May 15, 1998 of his Quotas in CATS. As part of the consideration (the "Consideration") paid to Borrower in connection with his sale on May 15, 1998 of his Quotas in CATS, Borrower received 458,334 shares of Lender common stock. The

purpose of the Loans is to pay the amount of taxes that Borrower is required to pay to the German tax authority in connection with and as a result of the 458,334 shares of Lender common stock received by Borrower on May 15, 1998 in connection with the acquisition of CATS.

5. REPRESENTATIONS AND WARRANTIES. Borrower hereby represents and warrants to lender as follows:

A. Authority and Compliance. Borrower has full power and authority to execute and deliver this Agreement and the Loan Documents and to incur and perform the obligations provided for therein. No consent or approval of any public authority or other third party is required as a condition to the validity of this Agreement or any of the Loan Documents, and Borrower is in compliance with all laws and regulatory requirements to which they are subject.

B. Binding Agreement. This Agreement and the Loan Documents executed by Borrower constitute valid and legally binding obligations of Borrower, enforceable in accordance with their terms.

C. Litigation. There is no proceeding involving Borrower pending or, to the knowledge of Borrower, threatened before any court or governmental authority, agency or arbitration authority, except as disclosed to Lender in writing and acknowledged by Lender prior to the date of this Agreement.

D. No Conflicting Agreements. There is no charter, bylaw, stock provision, partnership agreement or other document pertaining to the power or authority of Borrower and no provision of any existing agreement, mortgage, indenture or contract binding on Borrower or affecting his property, which would conflict with or in any way prevent the execution, delivery or carrying out of the terms of this Agreement and the Loan Documents.

E. Ownership of Collateral. Borrower has good title to the collateral that will secure the Loans, and the collateral is, and will be kept, free and clear of liens, except those to be granted to Lender pursuant to the Stock Pledge Agreement attached hereto in the form of Exhibit B.

6. DEFAULT. Borrower shall be in default under this Agreement and under each of the Loan Documents if he shall default in the payment of any amounts due and owing to Lender pursuant to the Loan Documents or should he fail to timely and properly observe, keep or perform any term, covenant, agreement or condition in any Loan Document or in any other loan agreement, promissory note, security agreement, deed of trust, deed to secure debt, mortgage, assignment or other contract securing or evidencing payment of any indebtedness of Borrower to Lender or any affiliate or subsidiary of Lender.

7. REMEDIES UPON DEFAULT. If an event of default shall occur, Lender shall have all rights, powers and remedies available under each of the Loan Documents as well as all rights and remedies available at law or in equity.

8. **BORROWER'S OPTION TO CANCEL LOAN.** Notwithstanding anything to the contrary in any document or agreement between Borrower and Lender, Borrower shall have the option, in his sole discretion, at anytime, to cancel the Loans, and in exchange for such cancellation Borrower shall irrevocably authorize Lender to dispose of the Collateral in accordance with the terms and conditions of Section 9 below. For purposes of this Section 8, the "Date of Cancellation" shall be the date on which Lender receives a written notice from Borrower to cancel a Loan. The written notice shall be furnished in accordance with the notice provisions of Section 10 below. Provided, however, that if on the Date of Cancellation, the value of the Collateral is less than the sum of (i) the outstanding principal balance of such Loan; (ii) any accrued but unpaid interest on such Loan; (iii) any fees authorized and due and owing to Lender pursuant to the Promissory Note; and (iv) any costs and expenses authorized and due and owing to Lender pursuant to the Promissory Note, Borrower shall be required to pay to Lender the amount by which the sum of items (i) through (iv) listed in this Section 8 exceeds the value of the Collateral. Borrower shall have the option of making the payment herein provided for to Lender in either additional cash or additional shares of Lender's issued and outstanding common stock. If on the Date of Cancellation, the value of the Collateral exceeds the sum of items (i) through (iv) listed in this Section 8, Lender shall be required to release and return to Borrower, free and clear of all liens and encumbrances, the portion of the Collateral which exceeds the sum of items (i) through (iv) of this Section 8. For purposes of determining the value of the Collateral and additional shares on the Date of Cancellation, the parties shall utilize the closing price of the shares of Lender's common stock (as traded on the NASDAQ National Market) on the Date of Cancellation. Any Shares used by Borrower to compensate Lender in consideration for the cancellation of the Loan pursuant to the provisions of this Section 8 shall be subject to sale by Lender on Borrower's behalf pursuant to the terms and conditions of Section 9 below, and Borrower shall cooperate with Lender in effecting any such sale.

9. **MECHANISM FOR SALE OF SHARES.** The Shares to be pledged by Borrower to Lender pursuant to the Stock Pledge Agreement will, in part, consist of a portion of the 343,750 shares of Lender common stock registered with the United States Securities and Exchange Commission (the "SEC") pursuant to that certain S-1 Registration Statement dated and filed with the SEC on June 22, 1998 (the "Registered Shares"). The balance of the Shares to be pledged to Lender by Borrower pursuant to the Stock Pledge Agreement shall consist of shares of Lender's common stock that have not been registered with the SEC (the "Non-registered Shares"). It is also contemplated that if Borrower is required to utilize additional shares to compensate Lender pursuant to the provisions of Section 8 above or under any of the Loan Documents, Borrower will utilize Registered Shares and/or Non-registered Shares. If, in order to satisfy any of Borrower's obligations or commitments pursuant to any Loan Document, a sale must be made of any or all of the Registered Shares or Non-registered Shares pledged or otherwise delivered by Borrower to Lender, Borrower shall authorize Lender to make such sale as an agent of Borrower and on Borrower's behalf. Any sale of Registered Shares as provided for in this Section 9 shall be made pursuant to the S-1 Registration Statement, and shall be deemed to be a sale by Borrower through his duly appointed and authorized agent. Any sale of Non-Registered Shares as provided for in this Section 9 shall be made pursuant to and in satisfaction of the requirements of Rule 144 promulgated by the SEC under the Securities Act of 1933, as amended, and shall be deemed to be a sale by Borrower through his duly appointed and

authorized agent. Lender shall have the right to keep and maintain custody of any and all proceeds of any sale of Registered Shares or Non-registered Shares in satisfaction of any sum due and owing to Lender pursuant to the Loan transaction. Borrower's appointment of Lender as his agent for purposes of this Section 9, and the authorization to be granted to Lender to sell Registered Shares and/or Non-registered Shares on behalf of Borrower, shall be set forth in the Promissory Note, Stock Pledge Agreement and Stock Power delivered to Lender along with the pledged Shares (and in the Stock Power alone, in the case of any additional shares delivered to Borrower). Further, Borrower shall covenant and agree to make all such reasonable arrangements, do and perform all such reasonable acts and things, execute and deliver all such certificates, documents and other instruments, and to take such further reasonable actions as Lender may deem necessary or advisable to effect the sale of Registered Shares pursuant to the S-1 Registration Statement, or Non-registered Shares in compliance with the requirements of Rule 144, as the case may be, as Borrower's agent and on Borrower's behalf.

10. NOTICES. All notices, requests or demands which any party is required or may desire to give to any other party under any provision of this Agreement must be in writing, and may be by means of facsimile transmission, delivered to the other party at the following address:

If to Lender:

FARO Technologies, Inc.  
125 Technology Park  
Lake Mary, Florida 32746  
Telecopy: (407) 333-4181

Attention: Gregory A. Fraser

With a copy to:

Foley & Lardner  
100 North Tampa St., Suite 2700  
Tampa, Florida 33602  
Telecopy: (813) 221-4210

Attention: Martin A. Traber

If to Borrower:

Siegfried Kurt Buss  
Erich Kaestner Strasse 73,  
Ditzingen, Hirschlanden 71254  
Telecopy: 011-49-711-2222-444

With a copy to:

Hasche Eschenlohr Peltzer Riesenkampff Fischotter  
Neidenau 68  
60325 Frankfurt/Main  
Germany  
Telecopy: 011-49-69-71-701-230

Attention: Thomas Link

or to such other address as any party may designate by written notice to the other party. Each such notice, request and demand shall be deemed given or made as follows: (i) if sent by mail, upon the earlier of the date of receipt or five (5) days after deposit in the U.S. Mail, first class postage prepaid; (ii) if electronically transmitted, the next business day after transmission (and the sender shall bear the burden of proof of delivery), or (iii) if sent by any other means, upon delivery.

11. COSTS, EXPENSES AND ATTORNEYS' FEES. Borrower shall pay to Lender immediately upon demand the full amount of all costs and expenses, including reasonable attorneys' fees (to include outside counsel fees) incurred by Lender in connection with Lender's enforcement of its rights hereunder or under the Loan Documents.

12. MISCELLANEOUS. Borrower and Lender further covenant and agree as follows, without limiting any requirement of any of the Loan Documents:

A. Cumulative Rights and No Waiver. Each and every right granted to Lender under any Loan Document, or allowed it by law or equity shall be cumulative of each other and may be exercised in addition to any and all other rights of Lender, and no delay in exercising any right shall operate as a waiver thereof, nor shall any single or partial exercise by Lender of any right preclude any other or future exercise thereof or the exercise of any other right. Borrower expressly waives any presentment, demand, protest or other notice of any kind, including but not limited to notice of intent to accelerate and notice of acceleration. No notice to or demand on Borrower in any case shall, of itself, entitle Borrower to any other or future notice or demand in similar or other circumstances.

B. Legal Matters. The validity, construction, enforcement, and interpretation of this Agreement shall be governed by the laws of the State of Florida and the United States of America, without regard to principles of conflict of laws. Each party to this Agreement (a) consents to the personal jurisdiction of the state and federal courts having jurisdiction in Seminole County, Florida, (b) stipulates that the proper, exclusive, and convenient venue for any legal proceeding arising out of this Agreement is Seminole County, Florida, for state court proceedings, and the Middle District of Florida, Orlando Division, for federal district court proceedings, and (c) waives any defense, whether asserted by a motion or pleading, that Seminole County, Florida, or the Middle District of Florida, Orlando Division, is an improper or inconvenient venue. In any mediation, arbitration, or legal proceeding arising out of this Agreement, the losing party shall reimburse the prevailing party, on demand, for all costs

incurred by the prevailing party in enforcing, defending, or prosecuting any claim arising out of this Agreement, including all fees, costs, and expenses of experts, attorneys, witnesses, collection agents, and supersedeas bonds, whether incurred before or after demand or commencement of legal proceedings, and whether incurred pursuant to trial, appellate, mediation, arbitration, bankruptcy, administrative, or judgment-execution proceedings.

C. Loan to be deemed repaid. A Loan shall be deemed to have been repaid effective as of the earliest of: (i) the date on which Borrower prepays such Loan (as allowed under Section 3C above); (ii) the Maturity Date (as defined in Section 3A(i) above); (iii) the Anniversary Cancellation Date (as defined in Section 3A(ii) above); or (iv) the Cancellation Date (as defined in Section 8 above), so long as by the particular date Lender has received from Borrower any combination of cash and/or shares of Lender's stock sufficient to cover the then outstanding Loan obligations in accordance with the provisions of this Agreement. From and after the repayment date, Borrower shall have no obligations to Lender with respect to a Loan pursuant to or under this Agreement or the Loan Documents, except for Borrower's obligation to cooperate with lender in disposing of the Collateral Shares (and any additional shares delivered to Lender) pursuant to the provisions of Section 9 above.

D. Amendment. No modification, consent, amendment or waiver of any provision of this Agreement, nor consent to any departure by Borrower therefrom, shall be effective unless the same shall be in writing and signed by an officer of Lender, and then shall be effective only in the specified instance and for the purpose for which given. This Agreement is binding upon Borrower, his heirs, successors and assigns, and inures to the benefit of Lender, its successors and assigns; however, no assignment or other transfer of Borrower's rights or obligations hereunder shall be made or be effective without Lender's prior written consent, nor shall it relieve Borrower of any obligations hereunder. There is no third party beneficiary of this Agreement.

E. Partial Invalidity. The unenforceability or invalidity of any provision of this Agreement shall not affect the enforceability or validity of any other provision herein and the invalidity or unenforceability of any provision of any Loan Document to any person or circumstance shall not affect the enforceability or validity of such provision as it may apply to other persons or circumstances.

F. This Agreement amends and restates the Original Loan Agreement in its entirety, and the Original Loan Agreement is no longer in effect.

13. NO ORAL AGREEMENT. THIS WRITTEN AGREEMENT AND THE LOAN DOCUMENTS REPRESENT THE FINAL AGREEMENT BETWEEN THE PARTIES AND MAY NOT BE CONTRADICTED BY EVIDENCE OF PRIOR, CONTEMPORANEOUS OR SUBSEQUENT ORAL AGREEMENTS OF THE PARTIES.

To the extent permitted by law, the Borrower agrees to and does hereby waive trial by jury in any action, proceeding, or counterclaim brought by either the Borrower or the Lender on any matters whatsoever arising out of or in any way connected with this Agreement or any claim



of damage resulting from any act or omission of the Borrower or Lender or either of them in any way connected with this Agreement.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be duly executed under seal by their duly authorized representatives as of the date first above written.

LENDER

FARO Technologies, Inc.

By:

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Name:

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Title:

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BORROWER

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Siegfried Kurt Buss

## PROMISSORY NOTE

U.S. \$565,723.59

Karlsruhe  
Federal Republic of Germany

July 5, 2000

FOR VALUE RECEIVED, the undersigned, Siegfried Kurt Buss, an individual resident of the Federal Republic of Germany (the "Maker"), whose current mailing address is Erich Kaestner Strasse 73, Ditzingen, Hirschlanden 71254, hereby promises to pay to the order of FARO Technologies Inc., a Florida corporation (the "Payee"), whose current business address is 125 Technology Park, Lake Mary, FL 32746, the principal sum of Five Hundred Sixty-five Thousand Seven Hundred Twenty-three and 59/100 United States Dollars (U.S. \$565,723.59), together with interest on the outstanding principal balance hereof at the rate provided for herein. This note (the "Note") shall be governed by the following provisions:

1. Payment.

A. Notwithstanding any contrary provision set forth herein or in any document related hereto, Maker shall be obligated to pay all outstanding principal, together with all then accrued and unpaid interest under the Note, on or before the earlier of (a) July 5, 2003 or (b) that date when the preceding five (5) trading days of the Payee's common stock yields an average closing price of \$11.34 per share (each such date hereinafter referred to as the "Maturity Date"). On such Maturity Date as defined in Section 1(i)(b), it shall be within Maker's discretion to repay the Note either in cash, or, in lieu thereof, with shares of the common stock of Payee at an agreed upon price of \$11.34 per share. For the purpose of repaying the Note with shares of the Payee's common stock, Maker shall be required to utilize that portion of the Collateral (as described in Section 10 below) which is equal in value to the Note obligation being repaid.

B. Notwithstanding the foregoing, in the event the Note is still outstanding as of July 5, 2003, Maker shall have the option of either: (a) requiring Payee to renew or extend the Note for an additional term of three (3) years or (b) canceling the Note, effective as of that date, by providing Payee with written notice in accordance with the notice provisions of the Loan Agreement, and in exchange for such cancellation Maker shall irrevocably authorize Payee to dispose of the Collateral in accordance with the terms and conditions of Section 9 below. If Maker elects to cancel the Note effective as of July 5, 2003, that date shall hereinafter be referred to as the "Anniversary Cancellation Date." If on the Anniversary Cancellation Date, the value of the Collateral is less than the sum of: (i) the outstanding principal balance of the Note; (ii) any accrued but unpaid interest on the Note; (iii) any fees authorized and due and owing to Payee pursuant to the Note; and (iv) any costs and expenses authorized and due and owing to Payee pursuant to the Note, Maker shall not be required to pay to Payee the amount by which the

sum of items (i) through (iv) exceeds the value of the Collateral. On the other hand, if on the Anniversary Cancellation Date, the value of the Collateral exceeds the sum of items (i) through (iv), Payee shall be required to release and return to Maker, free and clear of all liens and encumbrances, the portion of the Collateral which exceeds the sum of items (i) through (iv). For purposes of determining the value of the Collateral on the Anniversary Cancellation Date, the parties shall utilize the closing price of the shares of Payee's common stock (as traded on the NASDAQ National Market) on that particular date, or, if that date is not a trading day on the NASDAQ National Market, the immediately preceding trading day.

C. All Shares used by Maker to repay the Note pursuant to the provisions of Section 1(i) above, as well as all Shares comprising the Collateral used by Maker to compensate Payee for cancellation of the Note pursuant to the provisions of Section 1(ii) above, shall be subject to sale by Payee on Maker's behalf in accordance with the terms and conditions of Section 9 below, and Maker shall cooperate with Payee in effecting any such sale.

2. Interest.

A. Except as otherwise provided in Section 5 below, interest shall accrue on the outstanding principal balance hereof at a rate per annum equal to the sum of (a) the EURIBOR rate that was in effect at 10:00 A.M. on August 2, 1999 (and which is applicable to loans with a maturity date of one year); and (b) 1.57% percent (1.57%). Interest on the outstanding principal balance of the Note shall be paid annually, on the last business day in December of each year, until the entire principal is paid.

B. Interest shall be calculated on the basis of a 360 day year based upon the actual number of days elapsed. No interest shall accrue after the Maturity Date (as defined in Section 1(i) above), the Anniversary Cancellation Date (as defined in Section 1(ii) above), or the Cancellation Date (as defined in Section 8 below).

C. The total liability of the Maker for payment of interest shall not exceed any limitations imposed on the payment of interest by applicable usury laws. If any interest is received or charged by any holder hereof in excess of that amount, the Maker shall be entitled to a refund of the excess.

D. Upon the occurrence of an Event of Default hereunder, interest shall accrue at the Default Rate hereinafter set forth notwithstanding the provisions of this section.

3. Prepayment. The Maker shall be entitled to prepay this Note in whole or in part at any time without penalty.

4. Application of Payments. All payments hereunder shall be applied first to the Payee's costs and expenses, then to fees authorized hereunder, then to interest and then to principal.

5. Default. An Event of Default shall be deemed to have occurred hereunder upon the occurrence of any of the following events: (a) the Maker's failure to pay any principal, interest or other amounts hereunder as and when due and payable; (b) the commencement of any

bankruptcy or insolvency proceedings by the Maker or, if commenced against the Maker and not discharged within 60 days, or if an order for relief is entered by the appropriate bankruptcy court; or (c) material falsity in any certificate, statement, representation, warranty or audit at any time furnished to the Payee by or on behalf of the Maker and including any omission to disclose any substantial contingent or liquidated liabilities or any material adverse change in any facts disclosed by any certificate, statement, representation, warranty or audit furnished to the Payee. If any Event of Default shall occur, all then outstanding principal hereunder, all accrued and unpaid interest hereunder and all other amounts payable under this Note shall be forthwith due and payable without presentment, further demand, protest or further notice of any kind, all of which are hereby expressly waived by the Maker. Upon the occurrence of any Event of Default, the outstanding principal of this Note, and any accrued and unpaid interest, shall bear interest at a rate of either four percent (4%) per annum above the rate specified in subparagraph 2(i) above after default until paid or, if such rate is usurious under the laws of Florida, then at the highest legal rate permissible thereunder (the "Default Rate").

6. Expenses. The Maker agrees to pay the Payee all costs incurred by it in connection with the collection of this Note. Such costs include, without limitation, fees for the services of counsel and legal assistants employed to collect this Note, whether or not suit be brought, and whether incurred in connection with collection, trial, appeal or otherwise. The Maker further agrees to indemnify and hold the Payee harmless against liability for the payment of state documentary stamp taxes, intangible taxes or other taxes (including interest and penalties, if any), excluding income or service taxes of the Payee, which may be determined to be payable with respect to this transaction.

7. Late Charge. The Maker shall pay a late charge on each and every payment due hereunder and not received by the Payee within ten (10) days after it is due. The amount of the late charge shall in each instance equal the greater of: (a) \$100.00; or (b) five percent (5.0%) of the delinquent payment. The late charge is not a penalty, but liquidated damages to defray administrative and related expenses due to such late payment. The late charge shall be immediately due and payable and shall be paid by the Maker to the Payee without notice or demand. Further, the acceptance of a late payment shall not constitute a waiver of any default then existing or thereafter arising under this Note.

8. Maker's Option To Cancel Note. Notwithstanding anything to the contrary in any document or agreement between Maker and Payee, Maker shall have the option, in his sole discretion, at anytime, to cancel the Note, and in exchange for such cancellation Maker shall irrevocably authorize Payee to dispose of the Collateral in accordance with the terms and conditions of Section 9 below. For purposes of this Section 8, the "Date of Cancellation" shall be the date on which Payee receives a written notice from Maker to cancel the Note. The written notice shall be furnished in accordance with the notice provisions of the Loan Agreement. Provided, however, that if on the Date of Cancellation, the value of the Collateral is less than the sum of (i) the outstanding principal balance of the Note; (ii) any accrued but unpaid interest on the Note; (iii) any fees authorized and due and owing to Payee pursuant to the Note; and (iv) any costs and expenses authorized and due and owing to Payee pursuant to the Note, Maker shall be required to pay to Payee the amount by which the sum of items (i) through (iv) listed in this Section 8 exceeds the value of the Collateral. Maker shall have the option of making the

payment herein provided for to Payee in either additional cash or additional shares of Payee's issued and outstanding common stock. If on the Date of Cancellation, the value of the Collateral exceeds the sum of items (i) through (iv) listed in this Section 8, Payee shall be required to release and return to Maker, free and clear of all liens and encumbrances, the portion of the Collateral which exceeds the sum of items (i) through (iv) of this Section 8. For purposes of determining the value of the Collateral and additional shares on the Date of Cancellation, the parties shall utilize the closing price of the shares of Payee's common stock (as traded on the NASDAQ National Market) on the Date of Cancellation. Any Shares used by Maker to compensate Payee in consideration for the cancellation of the Note pursuant to the provisions of this Section 8 shall be subject to sale by Payee on Maker's behalf pursuant to the terms and conditions of Section 9 below, and Maker shall cooperate with Payee in effecting any such sale.

9. Mechanism for Sale of the Shares. The Shares pledged by Maker to Payee pursuant to the Stock Pledge Agreement consists, in part, of a portion of the 343,750 shares of Payee common stock registered with the United States Securities and Exchange Commission (the "SEC") pursuant to that certain S-1 Registration Statement dated and filed with the SEC on June 22, 1998 (the "Registered Shares"). The balance of the Shares pledged to Payee by Maker pursuant to the Stock Pledge Agreement consists of shares of Payee's common stock that have not been registered with the SEC (the "Non-registered Shares"). It is also contemplated that if Maker is required to utilize additional shares to compensate Payee pursuant to the provisions of Section 8 above or under any of the Loan Documents, Maker will utilize Registered Shares and/or Non-registered Shares. If, in order to satisfy any of Maker's obligations or commitments pursuant to any Loan Document, a sale must be made of any or all of the Registered Shares or Non-registered Shares pledged or otherwise delivered by Maker to Payee, Maker hereby authorize Payee to make such sale as the Agent (as defined below) of Maker and on Maker's behalf. Any sale of Registered Shares as provided for in this Section 9 shall be made pursuant to the S-1 Registration Statement, and shall be deemed to be a sale by Maker through his duly appointed and authorized Agent. Any sale of Non-Registered Shares as provided for in this Section 9 shall be made pursuant to and in satisfaction of the requirements of Rule 144 promulgated by the SEC under the Securities Act of 1933, as amended, and shall be deemed to be a sale by Maker through his duly appointed and authorized Agent. Payee is hereby irrevocably granted the right to keep and maintain custody of any and all proceeds of any sale of Registered Shares, Non-registered Shares and other components of the Collateral in satisfaction of any sum due and owing to Payee pursuant to the Loan transaction.

10. Security Interest. In accordance with the terms and conditions of that certain Pledge Agreement dated as of the date hereof (the "Pledge Agreement") between Payee and Maker, this Note is secured by the "Collateral" described and defined in Section 1 of said Pledge Agreement. Without affecting the liability of Maker hereunder, the Payee may, from time to time and without notice, renew or extend the time for payment, accept partial payments, release or impair any collateral security for payment of this Note, or agree not to sue any party liable on it. Maker hereby waives presentment, demand, notice of dishonor and protest.

## 11. Miscellaneous.

A. The Note shall be deemed to have been repaid effective as of the earliest of: (i) the date on which Maker prepays the Note (as allowed under Section 3 above); (ii) the Maturity Date (as defined in Section 1(i) above); (iii) the Anniversary Cancellation Date (as defined in Section 1(ii) above); or (iv) the Cancellation Date (as defined in Section 8 above), so long as by the particular date Payee has received from Maker any combination of cash and/or shares of Payee's stock sufficient to cover the then outstanding Loan obligations in accordance with the provisions of the Agreement and the Loan Documents. From and after the repayment date, Maker shall have no obligations to Payee pursuant to or under this Agreement or the Loan Documents, except for Maker's obligation to cooperate with Payee in disposing of the Collateral Shares (and any additional shares delivered to Payee) pursuant to the provisions of Section 9 above.

B. Except as otherwise provided herein or in any other Loan Document, the Maker shall make all payments hereunder in lawful money of the United States of America at the Payee's principal address in the Federal Republic of Germany or at such other place as the Payee may from time to time designate in writing.

C. The remedies of the Payee as provided herein shall be cumulative and concurrent, and may be pursued singly, successively or together, at the sole discretion of the Payee and may be exercised as often as occasion therefor shall arise.

D. No act of omission or commission of the Payee, including specifically any failure to exercise any right, remedy or recourse, shall be effective, unless set forth in a written document executed by the Payee and then only to the extent specifically recited therein. A waiver or release with reference to one event shall not be construed as continuing, as a bar to, or as a waiver or release of any subsequent right, remedy or recourse as to any subsequent event.

E. The validity, construction, enforcement, and interpretation of this Note shall be governed by the laws of the State of Florida and the United States of America, without regard to principles of conflict of laws.

F. The Maker (a) consents to the personal jurisdiction of the state and federal courts having jurisdiction in Seminole County, Florida, (b) stipulates that the proper, exclusive, and convenient venue for any legal proceeding arising out of this Note is Seminole County, Florida, for state court proceedings, and the Middle District of Florida, Orlando Division, for federal district court proceedings, and (c) waives any defense, whether asserted by a motion or pleading, that Seminole County, Florida, or the Middle District of Florida, Orlando Division, is an improper or inconvenient venue.

G. Maker's obligations to Payee hereunder and under the other Loan Documents are secured by the Collateral, based on the fact that the parties hereto have mutually agreed that the shares of stock pledged as collateral are to be valued at \$6.375 each as of the date hereof. For so long as the value of the Collateral is sufficient to cover Maker's obligations to Payee hereunder and under the other Loan Documents (regardless of whether such obligations

become due on the dates provided for herein or as a result of Maker's Default hereunder or otherwise), then Maker shall not be personally liable to Payee, and Payee shall not seek personal judgment against Maker or any of Maker's heirs or assigns for such obligations. For so long as the value of the Collateral is sufficient to cover Maker's obligations to Payee hereunder and under the other Loan Documents, any judgment or decree in any action brought to enforce such obligations shall be enforceable against Maker only to the extent of his interest in the Collateral, and any such judgment or decree shall not be subject to execution upon or be a lien upon the assets of Maker, other than his interest in the Collateral. In determining whether the value of the Collateral is sufficient to cover Maker's obligations to Payee on any particular day, the parties shall utilize the closing price of the shares of Payee's common stock (as traded on the NASDAQ National Market) on such day. By way of illustration only: If the sum of (a) the outstanding principal balance of the Note; (b) any accrued but unpaid interest on the Note; (c) any fees authorized and due and owing to Payee pursuant to the Note; and (d) any costs and expenses authorized and due and owing to Payee pursuant to the Note on any particular day is equal to \$1,000,000.00, then Maker shall not be personally liable to Payee if the value of the Collateral on such day is also \$1,000,000.00. If however, the value of the Collateral on the hypothetical day is only \$750,000.00 (perhaps due to a closing price of less than \$6.375 per share on such day), then maker shall be personally liable for the shortfall of \$250,000.00; and Payee shall be entitled to seek personal judgment against Maker or any of Maker's heirs or assigns for such shortfall. Accordingly, if the value of the Collateral exceeds Maker's obligations to Payee on the hypothetical day, Payee shall be required to return any such excess amount to Maker. Nothing contained in this paragraph shall affect or limit the ability of Payee to enforce any of its rights or remedies with respect to the Collateral.

H. In any mediation, arbitration, or legal proceeding arising out of this Note, the losing party shall reimburse the prevailing party, on demand, for all costs incurred by the prevailing party in enforcing, defending, or prosecuting any claim arising out of this Note, including all fees, costs, and expenses of experts, attorneys, witnesses, collection agents, and supersedeas bonds, whether incurred before or after demand or commencement of legal proceedings, and whether incurred pursuant to trial, appellate, mediation, arbitration, bankruptcy, administrative, or judgement-execution proceedings.

I. The term "Payee" as used herein shall mean any lawful holder of this Note.

To the extent permitted by law, the Maker agrees to and does hereby waive trial by jury in any action, proceeding, or counterclaim brought by either the Maker or the Payee on any matters whatsoever arising out of or in any way connected with this Note or any claim of damage resulting from any act or omission of the Maker or Payee or either of them in any way connected with this Note.

IN WITNESS WHEREOF, the Maker has executed this Note as of the date first written above.

WITNESSES:

Signature: \_\_\_\_\_

By: \_\_\_\_\_

Siegfried Kurt Buss

Print Name: \_\_\_\_\_

Print Name: \_\_\_\_\_



MAKER'S APPOINTMENT OF PAYEE AS AGENT

In consideration of the covenants contained above, and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged by both Maker and Payee, Maker hereby appoints Payee as his agent and attorney-in-fact (the "Agent") to sell or otherwise dispose of (i) any portion or all of the Collateral (as referred to in Section 10 above) including, but not limited to, the Registered Shares and Non-registered Shares that are components thereof; and (ii) any additional Registered Shares and/or Non-registered Shares that Maker delivers to Payee pursuant to the terms and conditions of the Loan Documents. Maker covenants and agrees to make all such reasonable arrangements, do and perform all such reasonable acts and things, execute and deliver all such certificates, documents and other instruments, and to take such further reasonable actions as Payee may deem necessary or advisable to effect the sale of Registered Shares pursuant to the S-1 Registration Statement, or Non-registered Shares in compliance with the requirements of Rule 144, as the case may be, as Maker's Agent and on Maker's behalf. Maker grants Payee full and unfettered authorization to dispose of the Collateral, and any portion thereof, in accordance with the terms and conditions of Section 9 above, as well as any other applicable provision of the Loan Documents. Further, Maker agrees to indemnify and hold Payee harmless from liability for any and all losses or damages asserted or suffered by any party as a result of Payer's performance as Maker's Agent. Payee's appointment hereunder is irrevocable and shall remain in full force and effect for so long as Maker has not satisfied all of his obligations pursuant to the Loan Documents. Payee hereby accepts its appointment as Maker's Agent under the terms and conditions hereof. The appointment and authorization effected hereby, and the indemnification provided for herein, shall (i) inure to the benefit of Payee, its successors and assigns; and (ii) be binding upon Maker, his heirs and assigns.

FARO Technologies, Inc.

By:

-----  
Siegfried Kurt Buss

Name:

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Title:

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## STOCK PLEDGE AGREEMENT

Karlsruhe, Germany

July 5, 2000

THIS STOCK PLEDGE AGREEMENT (this "Agreement") is executed and made effective as of July 5, 2000, by Siegfried Kurt Buss, an individual resident of Germany ("Borrower") whose current mailing address is Erich Kaestner Strasse 73, Ditzingen, Hirschlanden 71254 in favor of FARO Technologies, Inc., a corporation organized and existing under the laws of the State of Florida ("FARO") whose current mailing address is 125 Technology Park, Lake Mary, FL 32746.

## RECITALS

WHEREAS, contemporaneously herewith, Borrower has made and delivered to FARO a Promissory Note in the original principal amount of U.S. \$565,723.59 (the "Note"); and

WHEREAS, to secure the prompt payment and performance of all of the liabilities, obligations, and indebtedness of Borrower to FARO under the Note (the "Liabilities"), Borrower desires to pledge, grant, hypothecate, assign, and convey to FARO a first lien and security interest in and to: (a) the "Shares" of FARO common stock described and defined on Schedule A attached hereto; and (b) the property described in Sections 1(ii) and 1(iii) of this Agreement.

NOW, THEREFORE, in consideration of the premises and of the mutual representations, warranties, covenants, and agreements set forth herein, the parties hereto hereby agree as follows:

1. Grant of Security Interest. To secure the due and punctual payment of the Liabilities, and all reasonable costs and expenses incurred by FARO in connection with enforcement or collection of the Liabilities (including reasonable legal fees and expenses incurred in trial, appellate, bankruptcy, and judgment-execution proceedings) and all reasonable costs and expenses incurred in connection with realizing on the value of the security provided by this Agreement (including appraisal fees, broker-dealer fees, and legal fees incurred in trial, appellate, bankruptcy, and judgment-execution proceedings), Borrower hereby pledges, grants, hypothecates, assigns, conveys, and grants to FARO a first lien and security interest (collectively, the "Security Interest") in the following:

A. all of the Shares listed on Schedule A to this Agreement;

B. all dividends, additional shares or other property or securities that are receivable or otherwise distributable at any time and from time to time in respect of, or in exchange or substitution for, the Shares and all profits therefrom; and

C. all proceeds of the foregoing.

As used in this Agreement, the term "Collateral" refers to all the property described in this Section 1, as well as any portion or any interest in it.

2. Representations and Warranties. Borrower covenants to FARO that, except for the Security Interest granted to FARO by this Agreement:

A. Borrower is and will be the sole legal and equitable owner of the Collateral;

B. the Collateral is and will be free and clear of all liens, encumbrances, security interests, assessments, and adverse claims of every kind and nature;

C. the grant of this Security Interest does not and will not violate the terms of any agreement applicable to Borrower; and

D. Borrower has not, and will not, sell, assign, convey, pledge, transfer, hypothecate, or in any other way dispose of or encumber the Collateral, other than as provided in this Agreement.

3. Delivery of Collateral. Upon execution of this Agreement, Borrower shall deliver the Shares to FARO. Borrower shall immediately provide notice to the transfer agent of FARO of the Security Interest and shall cause such Security Interest to be noted in the transfer records of such transfer agent. Borrower shall deliver to FARO immediately upon receipt any Collateral which is subsequently acquired by Borrower, or which is delivered to Borrower, in exchange or substitution for any or all of the Collateral.

4. Maintenance of Security Interest. Borrower shall, upon request, take any action reasonably deemed advisable by FARO to preserve the Collateral or to establish, determine priority of, perfect, continue perfection of, terminate or enforce FARO's Security Interest or its rights under this Agreement.

5. Rights of FARO. FARO may at any time, upon or after the occurrence of a default under the Note that is not cured within any applicable grace or cure period, or after maturity of any of the Liabilities and without notice or demand of any kind (a) transfer any of the Collateral into its name or that of its nominee, (b) notify obligors on or issuers of any Collateral to make payment or delivery to FARO of any amounts, securities, or rights due or distributable thereon or notices given in connection therewith, (c) in Borrower's name or otherwise, enforce collection of any Collateral by suit or otherwise, or surrender, release or exchange all or part of it, or compromise, extend or renew for any period any obligation evidenced by the Collateral, (d) receive proceeds of the Collateral and exercise all rights as a holder of the Collateral, (e) hold any increase or profits (including money) received from the Collateral and exercise all rights as a holder of the Collateral, (f) hold any increase or profits (including money) received from the Collateral as additional security for the Liabilities, and (g) sign or endorse Borrower's name on the Collateral.

6. Default. A default under the Note or Borrower's failure to perform its obligations under this Agreement shall constitute a default under this Agreement.

7. Irrevocable Proxy on Default. In addition to FARO's other rights, Borrower irrevocably appoints FARO as proxy, with full power of substitution and revocation (upon the occurrence of a default under the Note or hereunder that is not cured within any applicable grace or cure period) to exercise Borrower's rights to attend meetings, vote, consent to, and take any action respecting the Collateral as fully as Borrower might do. This proxy shall become effective upon the occurrence of a default that is not cured within any applicable grace or cure periods and shall remain effective for so long as any of the Liabilities are unpaid.

8. Termination. This Agreement and the Security Interest of FARO under it will terminate when all the Liabilities are paid in full. Upon termination of this Agreement, FARO shall reassign and deliver to Borrower the Collateral that is then held by FARO under this Agreement and has not been sold or otherwise applied pursuant to the terms of this Agreement; provided, however, in the event that another creditor of Borrower has been granted a pledge of the Collateral subordinate to FARO, and FARO has actual notice of such pledge, Borrower authorizes FARO to deliver the Collateral to such other creditor.

9. Legal Matters. The validity, construction, enforcement, and interpretation of this Agreement shall be governed by the laws of the State of Florida and the United States of America, without regard to principles of conflict of laws. Each party to this Agreement (a) consents to the personal jurisdiction of the state and federal courts having jurisdiction in Seminole County, Florida, (b) stipulates that the proper, exclusive, and convenient venue for any legal proceeding arising out of this Agreement is Seminole County, Florida, for state court proceedings, and the Middle District of Florida, Orlando Division, for federal district court proceedings, and (c) waives any defense, whether asserted by a motion or pleading, that Seminole County, Florida, or the Middle District of Florida, Orlando Division, is an improper or inconvenient venue. In any mediation, arbitration, or legal proceeding arising out of this Agreement, the losing party shall reimburse the prevailing party, on demand, for all costs incurred by the prevailing party in enforcing, defending, or prosecuting any claim arising out of this Agreement, including all fees, costs, and expenses of experts, attorneys, witnesses, collection agents, and supersedeas bonds, whether incurred before or after demand or commencement of legal proceedings, and whether incurred pursuant to trial, appellate, mediation, arbitration, bankruptcy, administrative, or judgment-execution proceedings.

10. Entire Understanding; Waiver. This Agreement records the final, complete, and exclusive understanding among the parties regarding the subjects addressed herein and supersede any prior or contemporaneous agreement, understanding, or representation, oral or written by any of them on such subjects. The provisions hereof may not be changed, modified, waived, or altered except by an agreement in writing signed by the party entitled to the benefit of the provision to be waived hereto. A waiver by any party of any of the terms or conditions of this Agreement, or of any breach thereof, shall not be deemed a waiver of such term or condition for the future, or of any other term or condition hereof, or of any subsequent breach thereof.

11. Severability. Whenever possible, each provision of this Agreement should be construed and interpreted so that it is valid and enforceable under applicable law. If a provision of this Agreement is held to be invalid or unenforceable under applicable law, however, that provision will be deemed separable from the remaining provisions of this Agreement and will not

affect the validity or interpretation of the other provisions of this Agreement or the application of that provision to other circumstances in which it is valid and enforceable.

12. Notices. All notices, requests or demands which any party is required or may desire to give to any other party under any provision of this Agreement must be in writing, and may be by means of facsimile transmission, delivered to the other party at the following address:

If to FARO:

FARO Technologies, Inc.  
125 Technology Park  
Lake Mary, Florida 32746  
Telecopy: (407) 333-4181

Attention: Gregory A. Fraser

With a copy to:

Foley & Lardner  
100 North Tampa St., Suite 2700  
Tampa, Florida 33602  
Telecopy: (813) 221-4210

Attention: Martin A. Traber

If to Borrower:

Siegfried Kurt Buss  
Erbprinzenstr. 31  
Karlsruhe, Deutschland 76133  
Telecopy: 011-49-711-2222-444

With a copy to:

Hasche Eschenlohr Peltzer Riesenkampff Fischotter  
Neidenau 68  
60325 Frankfurt/Main  
Germany  
Telecopy: 011-49-69-71-701-230

Attention: Thomas Link

or to such other address as any party may designate by written notice to the other party. Each such notice, request and demand shall be deemed given or made as follows: (i) if sent by mail, upon the earlier of the date of receipt or five (5) days after deposit in the U.S. Mail, first class postage prepaid; (ii) if electronically transmitted, the next business day after transmission (and the sender shall bear the burden of proof of delivery); or (iii) if sent by any other means, upon delivery.

13. Effectiveness. This Agreement will become effective with respect to the original parties to it, as of its stated execution date, when each of those parties has executed and delivered to the others a counterpart of this Agreement.

14. Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which, together, shall constitute one and the same instrument.

15. Miscellaneous. Time is of the essence of this Agreement. A delay, omission, or course of dealing on the part of FARO in exercising any right, power, or remedy will not operate as a waiver of it. A single or partial exercise by FARO of any right, power, or remedy does not preclude any further exercise or non-exercise of it or the exercise or non-exercise of any other right, power or remedy. The exercise or non-exercise by FARO of any right, power, or remedy does not constitute a waiver of a default under this Agreement.

16. Cancellation of Loan. Notwithstanding any provision contained herein, or in any other document or agreement between FARO and Borrower, Borrower shall have the option, in his sole discretion, at any time, to cancel the Note pursuant to and in compliance with the provisions of Section 8 thereof.

IN WITNESS WHEREOF, the Borrower has executed this Agreement as of the date first written above.

WITNESSES:

Signature: \_\_\_\_\_ By: \_\_\_\_\_  
Siegfried Kurt Buss

Print Name: \_\_\_\_\_ Print Name: \_\_\_\_\_

Signature: \_\_\_\_\_

Print Name: \_\_\_\_\_

BORROWER'S APPOINTMENT OF FARO AS AGENT

In consideration of the covenants contained above, and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged by both Borrower and FARO, Borrower hereby appoints FARO as his agent and attorney-in-fact (the "Agent") to sell or otherwise dispose of (i) any portion or all of the Collateral (as referred to and defined in Section 1 above) including, but not limited to, the Registered Shares and Non-registered Shares that are components thereof; and (ii) any additional Registered Shares and/or Non-registered Shares that Borrower delivers to FARO pursuant to the terms and conditions of the Loan Documents. Borrower covenants and agrees to make all such reasonable arrangements, do and perform all such reasonable acts and things, execute and deliver all such certificates, documents and other instruments, and to take such further reasonable actions as FARO may deem necessary or advisable to effect the sale of Registered Shares pursuant to the S-1 Registration Statement, or Non-registered Shares in compliance with the requirements of Rule 144, as the case may be, as Borrower's Agent and on Borrower's behalf. Borrower grants FARO full and unfettered authorization to dispose of the Collateral, and any portion thereof, in accordance with the terms and conditions of the Note, as well as any other applicable provision of the Loan Documents. Further, Borrower agrees to indemnify and hold FARO harmless from liability for any and all losses or damages asserted or suffered by any party as a result of FARO's performance as Borrower's Agent. FARO's appointment hereunder is irrevocable and shall remain in full force and effect for so long as Borrower has not satisfied all of his obligations pursuant to the Loan Documents. FARO hereby accepts its appointment as Borrower's Agent under the terms and conditions hereof. The appointment and authorization effected hereby, and the indemnification provided for herein, shall (i) inure to the benefit of FARO, its successors and assigns; and (ii) be binding upon Borrower, his heirs and assigns.

FARO Technologies, Inc.

By: \_\_\_\_\_  
Siegfried Kurt Buss Name: \_\_\_\_\_  
Title: \_\_\_\_\_

SCHEDULE A

THE SHARES

88,741 shares of the issued and outstanding common stock of FARO Technologies, Inc., a Florida corporation, which is arrived at as a result of dividing the original principal sum of the Note (stated in US dollars) by US \$6.375 (the "Shares").



AFFIDAVIT  
AND  
INDEMNITY AGREEMENT

Karlsruhe, Germany

July 5, 2000

I, the undersigned, Siegfried Kurt Buss, an individual resident of Germany (the "Affiant") whose current mailing address is Erbprinzenstr. 31, Karlsruhe, Deutschland 76133, hereby represent and warrant as follows:

That Affiant is the sole record owner and entitled to the possession of the Certificate(s) described below representing an aggregate of one hundred eighty-one thousand nine hundred nineteen (181,919) shares of the issued and outstanding common stock of FARO Technologies, Inc., a Florida corporation (the "Company"), such Certificate(s) being referred to hereafter as the "Original Certificate(s)".

Certificate Number	Date of Certificate	Registered in the Name of	Number of Shares
-----	-----	-----	-----
_____	_____	Siegfried Kurt Buss	_____
_____	_____	Siegfried Kurt Buss	_____

Affiant hereby certifies that, apart from the security interest granted to the Company pursuant to that certain Pledge Agreement dated and made effective as of the date of this Agreement by Affiant in favor of Company, no other person has any right, title or interest in the Original Certificate(s) or the securities represented thereby. Affiant will not hereafter sell, assign, transfer, hypothecate, pledge or otherwise dispose of, either in whole or in part, such Original Certificate(s) or the securities represented thereby, nor give any person any power of attorney, order or other authority of any kind or nature whatsoever to transfer such Original Certificate(s) or the securities represented thereby, or any part or portion thereof or interest therein, without first obtaining the written consent of the Company. Further, Affiant says that this affidavit and agreement are made in order to introduce the Company to extend credit and other financial accommodations to Affiant.

IN CONSIDERATION THEREFOR, Affiant hereby agrees for Affiant and Affiant's heirs, legal representatives and assigns that in case any of Affiant's representations herein are materially false or misleading, or in the event that Affiant breaches or violates any of his undertakings herein, Affiant agrees for Affiant and Affiant's heirs, legal representatives and assigns to indemnify and save harmless the Company, the Company's successors or assigns and the Company's directors, officers and employees from and against any and all liabilities, losses, damages, costs, charges, counsel fees and other expenses of every nature and character which they sustain or incur by reason of their reliance on any such false or misleading representation, or due to any breach or violation by Affiant.

All obligations of the Affiant hereunder shall be binding upon the Affiant, his heirs, legal representatives, successors or assigns.

IN WITNESS WHEREOF, the Affiant has executed this document as of the date first written above.

WITNESSES:

Signature: -----

By: -----

Siegfried Kurt Buss

Print Name: -----

Print Name: -----

Signature: -----

Print Name: -----

[MERRILL LYNCH LETTERHEAD]

Dr. Gregory Fraser  
FARO TECHNOLOGIES, INC.  
125 TECHNOLOGY PARK  
LAKE MARY, FL 32746

Re: WCMA Line of Credit No. 740-07K27

Dear Dr. Fraser,

It is a pleasure to inform you that we have approved an extension of the above-numbered WCMA Line of Credit for FARO TECHNOLOGIES, INC.

As extended, the new Maturity Date will be May 31, 2003, with all other terms and conditions remaining unchanged. In connection with this extension, a \$7,500.00 fee will be charged to the WCMA Account.

Once again, we are pleased to provide you with this extension of your WCMA Line of Credit. Should you have any questions, please contact Stephen A. Ackoury at (813) 273-8529.

Very truly yours,

Merrill Lynch Business Financial Services Inc.

By: /s/ Kelly Engelke

-----  
Kelly Engelke  
Senior Credit Manager

cc: Stephen A. Ackoury  
Hunter/Stewart Group

Consent of Independent Certified Public Accountants

We consent to the incorporation by reference in the Registration Statements (Form S-8 No. 333-41115) pertaining to the 1997 Employee Stock Option Plan, (Form S-8 No. 333-41125) pertaining to the 1997 Non-Employee Director Stock Option Plan, (Form S-8 No. 333-41131) pertaining to the 1997 Non-Employee Directors' Fee Plan, (Form S-8 No. 333-41135) pertaining to the 1993 Stock Option Plan of FARO Technologies, Inc, of our report dated March 19, 2003, with respect to the consolidated financial statements included in the Annual Report (Form 10-K) for the year ended December 31, 2002.

/s/ ERNST & YOUNG LLP

Orlando, Florida  
March 25, 2003

Written Statement of the Chief Executive Officer  
Pursuant to 18 U.S.C. Section 1350

Solely for the purposes of complying with 18 U.S.C. Section 1350, I, the undersigned Chairman of the Board, President, Chief Executive Officer and Director of FARO Technologies, Inc. (the "Company"), hereby certify, based on my knowledge, that the Annual Report on Form 10-K of the Company for the year ended December 31, 2002 (the "Report") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and that information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Simon Raab

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Simon Raab  
March 31, 2003

Written Statement of the Chief Executive Officer  
Pursuant to 18 U.S.C. Section 1350

Solely for the purposes of complying with 18 U.S.C. Section 1350, I, the undersigned Executive Vice President, Secretary, Treasurer and Director of FARO Technologies, Inc. (the "Company"), hereby certify, based on my knowledge, that the Annual Report on Form 10-K of the Company for the year ended December 31, 2002 (the "Report") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and that information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Gregory A. Fraser

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Gregory A. Fraser  
March 31, 2003