
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549**

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2020

OR

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

For the transition period from _____ to _____

Commission File Number: 0-23081

FARO TECHNOLOGIES, INC.

(Exact Name of Registrant as Specified in Its Charter)

Florida

(State or other Jurisdiction of Incorporation or Organization)

59-3157093

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

**250 Technology Park,
(Address of Principal Executive Offices)**

Lake Mary, Florida

**32746
(Zip Code)**

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

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

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common Stock, par value \$.001	FARO	Nasdaq Global Select Market

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

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

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
Emerging growth company

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

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

There were 17,719,333 shares of the registrant's common stock outstanding as of April 24, 2020.



FARO TECHNOLOGIES, INC.

Quarterly Report on Form 10-Q
Quarter Ended March 31, 2020

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PART I. FINANCIAL INFORMATION**Item 1. Financial Statements****FARO TECHNOLOGIES, INC. AND SUBSIDIARIES**
CONDENSED CONSOLIDATED BALANCE SHEETS

<u>(in thousands, except share and per share data)</u>	March 31, 2020 (unaudited)	December 31, 2019
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 157,240	\$ 133,634
Short-term investments	15,955	24,870
Accounts receivable, net	58,834	76,162
Inventories, net	55,044	58,554
Prepaid expenses and other current assets	21,237	28,996
Total current assets	<u>308,310</u>	<u>322,216</u>
Non-current assets:		
Plant and equipment, net	24,515	26,954
Operating lease right-of-use asset	16,534	18,418
Goodwill	48,661	49,704
Intangible assets, net	13,820	14,471
Service and sales demonstration inventory, net	34,355	33,349
Deferred income tax assets, net	21,036	18,766
Other long-term assets	2,818	2,964
Total assets	<u>\$ 470,049</u>	<u>\$ 486,842</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 11,396	\$ 13,718
Accrued liabilities	44,360	38,072
Income taxes payable	3,826	5,182
Current portion of unearned service revenues	38,561	39,211
Customer deposits	2,115	3,108
Lease liability	5,947	6,674
Total current liabilities	<u>106,205</u>	<u>105,965</u>
Unearned service revenues - less current portion	19,985	20,578
Lease liability - less current portion	12,745	13,698
Deferred income tax liabilities	173	357
Income taxes payable - less current portion	13,177	13,177
Other long-term liabilities	974	1,075
Total liabilities	<u>153,259</u>	<u>154,850</u>
Commitments and contingencies - See Note 14		
Shareholders' equity:		
Common stock - par value \$0.001, 50,000,000 shares authorized; 19,116,870 and 18,988,379 issued, respectively; 17,718,179 and 17,576,618 outstanding, respectively	19	19
Additional paid-in capital	270,940	267,868
Retained earnings	98,056	112,879
Accumulated other comprehensive loss	(21,177)	(17,399)
Common stock in treasury, at cost; 1,398,691 and 1,411,761 shares, respectively	(31,048)	(31,375)
Total shareholders' equity	<u>316,790</u>	<u>331,992</u>
Total liabilities and shareholders' equity	<u>\$ 470,049</u>	<u>\$ 486,842</u>

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

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

(in thousands, except share and per share data)	Three Months Ended	
	March 31, 2020	March 31, 2019
Sales		
Product	\$ 56,525	\$ 71,577
Service	22,990	22,040
Total sales	79,515	93,617
Cost of Sales		
Product	23,066	27,951
Service	12,576	12,647
Total cost of sales	35,642	40,598
Gross Profit	43,873	53,019
Operating Expenses		
Selling, general and administrative	36,324	41,020
Research and development	10,415	11,641
Restructuring costs	13,688	—
Total operating expenses	60,427	52,661
(Loss) income from operations	(16,554)	358
Other (income) expense		
Interest expense (income), net	34	(144)
Other expense, net	473	195
(Loss) income before income tax (benefit) expense	(17,061)	307
Income tax (benefit) expense	(2,238)	155
Net (loss) income	\$ (14,823)	\$ 152
Net (loss) income per share - Basic	\$ (0.84)	\$ 0.01
Net (loss) income per share - Diluted	\$ (0.84)	\$ 0.01
Weighted average shares - Basic	17,616,964	17,280,365
Weighted average shares - Diluted	17,616,964	17,868,816

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

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

(in thousands)	Three Months Ended	
	March 31, 2020	March 31, 2019
Net (loss) income	\$ (14,823)	\$ 152
Currency translation adjustments, net of income taxes	(3,778)	(1,564)
Comprehensive loss	\$ (18,601)	\$ (1,412)

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

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

(in thousands)	Three Months Ended	
	March 31, 2020	March 31, 2019
Cash flows from:		
Operating activities:		
Net (loss) income	\$ (14,823)	\$ 152
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	3,759	4,749
Stock-based compensation	2,178	2,564
Provisions for bad debts, net of recoveries	(15)	(100)
Loss on disposal of assets	10	57
Provision for excess and obsolete inventory	204	896
Deferred income tax benefit	(2,326)	8
Change in operating assets and liabilities:		
Decrease (Increase) in:		
Accounts receivable	16,084	12,410
Inventories	1,795	(10,908)
Prepaid expenses and other current assets	7,408	4,463
(Decrease) Increase in:		
Accounts payable and accrued liabilities	4,756	(9,172)
Income taxes payable	(1,389)	(1,323)
Customer deposits	(961)	(310)
Unearned service revenues	(365)	2,324
Net cash provided by operating activities	<u>16,315</u>	<u>5,810</u>
Investing activities:		
Purchases of property and equipment	(757)	(1,543)
Proceeds from sale of investments	9,000	—
Payments for intangible assets	(435)	(529)
Net cash provided by (used in) investing activities	<u>7,808</u>	<u>(2,072)</u>
Financing activities:		
Payments on finance leases	(82)	(90)
Payments of contingent consideration for acquisitions	—	(250)
Payments for taxes related to net share settlement of equity awards	(1,581)	(1,138)
Proceeds from issuance of stock related to stock option exercises	2,802	292
Net cash provided by (used in) financing activities	<u>1,139</u>	<u>(1,186)</u>
Effect of exchange rate changes on cash and cash equivalents	<u>(1,656)</u>	<u>(639)</u>
Increase in cash and cash equivalents	23,606	1,913
Cash and cash equivalents, beginning of period	133,634	108,783
Cash and cash equivalents, end of period	<u>\$ 157,240</u>	<u>\$ 110,696</u>

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

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(UNAUDITED)

(in thousands, except share data)	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Common Stock in Treasury	Total
	Shares	Amounts					
BALANCE JANUARY 1, 2020	17,576,618	\$ 19	\$ 267,868	\$ 112,879	\$ (17,399)	\$ (31,375)	\$ 331,992
Net loss				(14,823)			(14,823)
Currency translation adjustment					(3,778)		(3,778)
Stock-based compensation			2,178				2,178
Common stock issued, net of shares withheld for employee taxes	141,561		894			327	1,221
BALANCE MARCH 31, 2020	17,718,179	\$ 19	\$ 270,940	\$ 98,056	\$ (21,177)	\$ (31,048)	\$ 316,790

(in thousands, except share data)	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Common Stock in Treasury	Total
	Shares	Amounts					
BALANCE JANUARY 1, 2019	17,253,011	\$ 19	\$ 251,329	\$ 175,353	\$ (18,483)	\$ (31,609)	\$ 376,609
Net income				152			152
Currency translation adjustment					(1,564)		(1,564)
Stock-based compensation			2,564				2,564
Common stock issued, net of shares withheld for employee taxes	64,864		(1,053)			207	(846)
Cumulative effect of the adoption of ASU 2014-09				(327)			(327)
BALANCE MARCH 31, 2019	17,317,875	\$ 19	\$ 252,840	\$ 175,178	\$ (20,047)	\$ (31,402)	\$ 376,588

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

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)
(in thousands, except share and per share data, or as otherwise noted)

NOTE 1 – DESCRIPTION OF BUSINESS

FARO Technologies, Inc. and its subsidiaries (collectively “FARO,” the “Company,” “us,” “we” or “our”) design, develop, manufacture, market and support software driven, three-dimensional (“3D”) measurement and imaging solutions. This technology permits high-precision 3D measurement, imaging and comparison of parts and complex structures within production and quality assurance processes. Our devices are used for inspection of components and assemblies, rapid prototyping, reverse engineering, documenting large volume or structures in 3D, surveying and construction, as well as for investigation and reconstruction of accident sites or crime scenes. We sell the majority of our products through a direct sales force across a broad number of customers in a range of manufacturing, industrial, architecture, surveying, building information modeling, construction, public safety forensics, cultural heritage, and other applications. Our FaroArm[®], FARO ScanArm[®], FARO Laser Tracker[™], FARO Laser Projector, and their companion CAM2[®], BuildIT, and BuildIT Projector software solutions, provide for Computer-Aided Design (“CAD”) based inspection, factory-level statistical process control, high-density surveying, and laser-guided assembly and production. Together, these products integrate the measurement, quality inspection, and reverse engineering functions with CAD and 3D software to improve productivity, enhance product quality, and decrease rework and scrap in the manufacturing process, mainly supporting applications in the automotive, aerospace, metal and machine fabrication and other industrial manufacturing markets. Our FARO Focus and FARO ScanPlan, and their companion FARO SCENE, BuildIT, FARO As-Built[™], and FARO Zone public safety forensics software offerings, are utilized for a wide variety of 3D modeling, documentation and high-density surveying applications primarily in the architecture, engineering and construction and public safety markets. Our FARO ScanArm[®] and its companion SCENE software also enable a fully digital workflow used to capture real world geometry for the purpose of empowering design, enabling innovation, and speeding up the design cycle.

Since the fourth quarter of 2016 to the fourth quarter of 2019, we had operated in five verticals—3D Manufacturing, Construction Building Information Modeling (“Construction BIM”), Public Safety Forensics, 3D Design and Photonics—and had three reporting segments—3D Manufacturing, Construction BIM and Emerging Verticals. As discussed in our Quarterly Report on Form 10-Q for the third quarter of 2019, our new management team, led by our new Chief Executive Officer (“CEO”), formulated and began to implement a new comprehensive strategic plan for our business. As part of our strategic planning process, we identified areas of our business that needed enhanced focus or change in order to improve our efficiency and cost structure. In the fourth quarter of 2019, we reassessed and redefined our go-to-market strategy, refocused our marketing engagement with our customers and re-evaluated our hardware product portfolio.

As part of our new strategic plan, and based on the recommendation of our CEO, who is also our Chief Operating Decision Maker (“CODM”), in the fourth quarter of 2019, we eliminated our vertical structure and began reorganizing the Company into a functional structure. Our executive leadership team is now comprised of functional leaders in areas such as sales, marketing, operations, research and development and general and administrative, and resources are allocated to each function at a consolidated unit level. We no longer have separate business units, or segment managers or vertical leaders who report to the CODM with respect to operations, operating results or planning for levels or components below the total Company level. Instead, our CODM now allocates resources and evaluates performance on a Company-wide basis. Based on these changes, commencing with the fourth quarter of 2019, we are now reporting as one reporting segment that develops, manufactures, markets, supports and sells CAD-based quality assurance products integrated with CAD-based inspection and statistical process control software and 3D documentation systems. Our reporting segment sells into a variety of end markets, including automotive, aerospace, metal and machine fabrication, architecture, engineering, construction and public safety.

Reclassification and Related Changes to Presentation

Certain prior year amounts have been reclassified in the accompanying consolidated financial statements to conform to the current period presentation:

- Commencing with the third quarter of 2019, depreciation and amortization expenses are being reported in the accompanying statements of operations to reflect departmental costs. Previously, those expenses were reported as a separate line item under operating expenses. Amounts related to depreciation and amortization expenses for the three months ended March 31, 2019 have been reclassified throughout this Quarterly Report on Form 10-Q to reflect this reclassification of depreciation and amortization expenses and to conform to the current period presentation, as set forth in the following table;

- Selling and marketing expenses and general and administrative expenses are now being reported in the accompanying statements of operations together in one line as Selling, general and administrative. Previously, those expenses were reported as two separate line items under operating expenses. Amounts related to selling, general and administrative expenses for the three months ended March 31, 2019 have been reclassified throughout this Quarterly Report on Form 10-Q to reflect this reclassification of selling, general and administrative expenses and to conform to the current period presentation, as set forth in the following table;
- Software maintenance revenue is now being reported in the accompanying statements of operations as a component of product sales. Previously, these revenues were reported in service sales. Amounts related to software maintenance revenue for the three months ended March 31, 2019 have been reclassified throughout this Quarterly Report on Form 10-Q to reflect this reclassification of software maintenance revenue and to conform to the current period presentation, as set forth in the following table; and
- Software maintenance cost of sales is now being reported in the accompanying statements of operations as a component of product cost of sales. Previously, these cost of sales was reported in service cost of sales. Amounts related to software maintenance cost of sales for the three months ended March 31, 2019 have been reclassified throughout this Quarterly Report on Form 10-Q to reflect this reclassification of software maintenance cost of sales and to conform to the current period presentation, as set forth in the following table.

For the three months ended, March 31, 2019

	As Reported	Depreciation and Amortization Adjustment	Selling, General and Administrative Adjustment	Software Maintenance and Other Adjustments	As Adjusted
Sales					
Product	\$ 68,800	\$ —	\$ —	\$ 2,777	\$ 71,577
Service	24,817	—	—	(2,777)	22,040
Total sales	\$ 93,617	\$ —	\$ —	\$ —	\$ 93,617
Cost of Sales					
Product	\$ 26,128	\$ 1,176	\$ —	\$ 647	\$ 27,951
Service	12,470	824	—	(647)	12,647
Total cost of sales	\$ 38,598	\$ 2,000	\$ —	\$ —	\$ 40,598
Operating Expenses					
Selling, general and administrative	\$ —	\$ 1,043	\$ 39,977	\$ —	\$ 41,020
Selling and marketing	26,753	—	(26,753)	—	—
General and administrative	13,224	—	(13,224)	—	—
Depreciation and amortization	4,749	(4,749)	—	—	—
Research and development	9,935	1,706	—	—	11,641
Total operating expenses	\$ 54,661	\$ (2,000)	\$ —	\$ —	\$ 52,661

NOTE 2 – PRINCIPLES OF CONSOLIDATION

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

NOTE 3 – BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements and notes thereto have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) for interim financial information and with the instructions of Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These condensed consolidated financial statements include all normal recurring accruals and adjustments considered necessary by management for a fair presentation in conformity with U.S. GAAP. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates. The condensed consolidated results of operations for the three months ended March 31, 2020 are not necessarily indicative of results that may be expected for the year ending December 31, 2020 or any future period.

The information included in this Quarterly Report on Form 10-Q, including the interim condensed consolidated financial statements and the accompanying notes, should be read in conjunction with the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2019. The accompanying December 31, 2019 condensed consolidated balance sheet has been derived from those audited consolidated financial statements. As described in Note 1 – Description of Business, commencing with the third quarter of 2019, depreciation and amortization expenses are being reported in the accompanying statements of operations to reflect departmental costs. Previously, those expenses were reported as a separate line item under operating expenses. Amounts related to depreciation and amortization expenses for the three months ended March 31, 2020 have been reclassified throughout this Quarterly Report on Form 10-Q to reflect this reclassification of depreciation and amortization expenses and to conform to the current period presentation.

NOTE 4 – IMPACT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

Impact of Recently Issued Accounting Standards

In December 2019, the FASB issued ASU No. 2019-12, Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes which amends and aims to simplify accounting disclosure requirements regarding a number of topics including: intraperiod tax allocation, accounting for deferred taxes when there are changes in consolidation of certain investments, tax basis step up in an acquisition and the application of effective rate changes during interim periods, amongst other improvements. This standard is effective for fiscal years beginning after December 15, 2020 and allows for early adoption. We are currently assessing the impact of this new standard on our condensed consolidated financial statements.

Impact of Recently Adopted Accounting Standards

In February 2016, the FASB issued Accounting Standards Update (“ASU”) No. 2016-02, *Leases (Topic 842)* (“ASU 2016-02”), which is intended to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements to enable users of financial statements to assess the amount, timing and uncertainty of cash flows arising from leases. ASU No. 2018-11, *Leases (Topic 842): Targeted Improvements*, was issued by the FASB in July 2018 and allows for a cumulative-effect adjustment transition method of adoption. The new guidance is effective for fiscal years beginning after December 15, 2018 and interim periods within those years. We adopted ASU 2016-02 effective as of January 1, 2019 utilizing the cumulative-effect adjustment transition method of adoption, which resulted in the recognition on our condensed consolidated balance sheet as of March 31, 2019 of \$18.9 million of right-of-use assets for operating leases, \$19.9 million of lease liability for operating leases, \$0.9 million of property and equipment, net for finance leases and \$0.9 million of lease liability for finance leases under which we function as a lessee. We elected certain practical expedients available under the transition provisions to (i) allow aggregation of non-lease components with the related lease components when evaluating accounting treatment, (ii) apply the modified retrospective adoption method, utilizing the simplified transition option, which allows us to continue to apply the legacy guidance in FASB ASC Topic 840, including its disclosure requirements, in the comparative periods presented in the year of

adoption, and (iii) use hindsight in determining the lease term (that is, when considering our options to extend or terminate the lease and to purchase the underlying asset) and in assessing impairment of our right-of-use assets. The adoption of ASU 2016-02 also required us to include any initial direct costs, which are incremental costs that would not have been incurred had the lease not been obtained, in the right-of-use assets. The recognition of these costs in connection with our adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* (“ASU 2016-13”), which requires the measurement and recognition of expected credit losses for financial assets held at amortized cost. ASU 2016-13, and subsequent related amendments to ASU 2016-13, replaced the existing incurred loss impairment model with an expected loss model that requires the use of forward-looking information to calculate credit loss estimates. It also eliminates the concept of other-than-temporary impairment and requires credit losses related to available-for-sale debt securities to be recorded through an allowance for credit losses rather than as a reduction in the amortized cost basis of the securities. These changes will result in earlier recognition of credit losses. We performed an analysis to identify the Company's financial instruments which would be impacted by the promulgated amendment and identified both our trade receivables and our U.S. Treasury Bill investments. We adopted ASU 2016-13 prospectively, effective January 1, 2020, by evaluating the qualitative and quantitative characteristics of our credit-based customer portfolio. We extend credit to a customer based on an evaluation of the customer's financial condition and, generally, collateral is not required. Trade receivables are generally due within 30 to 90 days and accounts outstanding longer than the contractual payment terms are considered past due. As part of our analysis, we calculated an allowance for all trade receivables based on our review of historical trends and future expectations for the regions we sell within, current outstanding customer balances, and the length of time balances have been outstanding. We also evaluated an allowance for our U.S. Treasury Bill investments but as they are low risk and short-term, these allowances were approximated to be zero. The adoption of ASU 2016-13 did not have a material impact on our condensed consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04, *Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment* (“ASU 2017-04”), which is intended to simplify the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Under the current guidance, performance of Step 2 requires us to calculate the implied fair value of goodwill by following procedures that would be required to determine the fair value of assets acquired and liabilities assumed in a business combination. Under the new guidance, we will perform our goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge will be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value up to the amount of the goodwill allocated to the reporting unit. The new guidance also eliminates the requirements for any reporting unit with a zero or negative carrying amount to perform Step 2 of the goodwill impairment test if it fails the qualitative assessment. As a result, all reporting units will be subject to the same impairment assessment. We will still have the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. We early adopted this guidance in fiscal 2019. The adoption of ASU 2017-04 did not have a material impact on our condensed consolidated financial statements.

NOTE 5 – REVENUES

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

	For the Three Months Ended March 31,	
	2020	2019
Product sales		
Product transferred to customers at a point in time	\$ 53,554	\$ 68,975
Product transferred to customers over time	2,971	2,603
	<u>\$ 56,525</u>	<u>\$ 71,578</u>
Service sales		
Service transferred to customers at a point in time	\$ 10,996	\$ 11,680
Service transferred to customers over time	11,994	10,359
	<u>\$ 22,990</u>	<u>\$ 22,039</u>

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

	For the Three Months Ended March 31,	
	2020	2019
Total sales to external customers		
United States	\$ 33,091	\$ 35,848
EMEA ⁽¹⁾	23,690	31,100
Other APAC ⁽¹⁾	15,487	15,042
China	4,748	8,295
Other Americas ⁽¹⁾	2,499	3,332
	<u>\$ 79,515</u>	<u>\$ 93,617</u>

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

For revenue related to our measurement and imaging equipment and related software, we allocate the contract price to performance obligations based on our best estimate of the standalone selling price. We make this allocation estimate utilizing data from the sale of our applicable products and services to customers separately in similar circumstances, with the exception of software licenses. With respect to software licenses, we use the residual method for allocating the contract price to performance obligations. Revenue related to our measurement and imaging equipment and related software is generally recognized upon shipment from our facilities or when delivered to the customer location, as determined by the agreed upon shipping terms, at which time we are entitled to payment and title and control has passed to the customer. Software arrangements generally include short-term maintenance that is considered post-contract support (“PCS”), which is considered to be a separate performance obligation. We generally establish a standalone sales price for this PCS component based on our maintenance renewal rate. Maintenance renewals, when sold, are recognized on a straight-line basis over the term of the maintenance agreement. Payments for products and services are collected within a short period of time following transfer of control or commencement of delivery of services, as applicable.

Further, customers frequently purchase extended warranties with the purchase of measurement equipment and related software. Warranties are considered a performance obligation when services are transferred to a customer over time, and, as such, we recognize revenue on a straight-line basis over the warranty term. Extended warranty sales primarily include contract periods that extend between one month and three years.

We capitalize commission expenses related to deliverables transferred to a customer over time and amortize such costs ratably over the term of the contract. As of March 31, 2020, the deferred cost asset related to deferred commissions was approximately \$3.0 million. For classification purposes, \$2.0 million and \$1.0 million are comprised within the Prepaid expenses and other current assets and Other long-term assets, respectively, on our condensed consolidated balance sheet as of March 31, 2020. As of December 31, 2019, the deferred cost asset related to deferred commissions was approximately \$3.1 million. For classification purposes, \$2.1 million and \$1.0 million were comprised within the Prepaid expenses and other current assets and Other long-term assets, respectively, on our condensed consolidated balance sheet as of December 31, 2019.

The unearned service revenue liabilities reported on our condensed consolidated balance sheets reflect the contract liabilities to satisfy the remaining performance obligations for extended warranties and software maintenance. The current portion of unearned service revenues on our condensed consolidated balance sheets is what we expect to recognize to revenue within twelve months after the applicable balance sheet date relating to extended warranty and software maintenance contract liabilities. The unearned service revenues - less current portion on our condensed consolidated balance sheets is what we expect to recognize to revenue extending beyond twelve months after the applicable balance sheet date relating to extended warranty and software maintenance contract liabilities. During the three months ended March 31, 2020, we recognized \$12.2 million of revenue that was deferred on our condensed consolidated balance sheet as of December 31, 2019. During the three months ended March 31, 2019, we recognized \$10.8 million of revenue that was deferred on our consolidated balance sheet as of December 31, 2018.

The nature of certain of our contracts gives rise to variable consideration, which may be constrained, primarily related to an allowance for sales returns and contracts with certain government customers. We are required to estimate the contract asset related to sales returns and record a corresponding adjustment to Cost of Sales. Our allowance for sales returns was approximately \$0.1 million as of both March 31, 2020 and March 31, 2019.

Shipping and handling fees billed to customers in a sales transaction are recorded in Product Sales and shipping and handling costs incurred are recorded in Cost of Sales. We exclude from Sales any value-added sales and other taxes that we collect concurrently with revenue-producing activities.

NOTE 6 – STOCK-BASED COMPENSATION

Stock-based compensation expense reflects the fair value of stock-based awards measured at the grant date. For awards with only a service condition, we expense stock-based compensation using the straight-line method over the requisite service period for the entire award. For awards with both performance and service conditions, we expense the stock-based compensation on a straight-line basis over the requisite service period taking into account the probability that we will satisfy the performance condition.

We have two compensation plans that provide for the granting of stock options and other share-based awards to key employees and non-employee members of the Board of Directors (the “Board”). The 2009 Equity Incentive Plan (the “2009 Plan”) and the 2014 Equity Incentive Plan (the “2014 Plan”) provide for granting options, restricted stock, restricted stock units or stock appreciation rights to employees and non-employee directors. In May 2018, our shareholders approved an amendment to the 2014 Plan, which increased the number of shares available for issuance under the 2014 Plan by 1,000,000 shares. A maximum of 2,974,543 shares are available for issuance under the 2014 Plan, as amended, plus the number of shares (not to exceed 891,960) that were underlying awards outstanding under the 2004 Equity Incentive Plan (the “2004 Plan”) and the 2009 Plan as of May 29, 2014 that thereafter terminate or expire unexercised or are canceled, forfeited or lapse for any reason. No awards were outstanding under the 2004 Plan as of March 31, 2020, and no further grants will be made under the 2004 Plan or the 2009 Plan.

Upon election to the Board, each non-employee director receives an initial equity grant of shares of restricted common stock with a value equal to \$100,000, calculated using the closing price of our common stock on the date of the non-employee director's election to the Board. The initial restricted stock grant vests on the third anniversary of the grant date, subject to the non-employee director's continued membership on the Board. Annually, the non-employee directors are granted restricted shares with a value equal to \$100,000 on the first business day following the annual meeting of shareholders, calculated using the closing price of our common stock on that day. In addition, the independent Chairman of the Board is annually granted restricted shares with a value equal to \$50,000, and the Lead Director, if one has been appointed, would be annually granted restricted shares with a value of \$40,000, on the first business day following the annual meeting of shareholders, calculated using the closing price of our common stock on that day. The shares of restricted stock granted annually to our non-employee directors, our independent Chairman of the Board and, if applicable, our Lead Director vest on the day prior to the following year's annual meeting date, subject to the non-employee director's continued membership on the Board. We record compensation expense associated with our restricted stock grants on a straight-line basis over the vesting term. Also, beginning in October 2018, our non-employee directors may elect to have their annual cash retainers and annual equity retainers paid in the form of deferred stock units pursuant to the 2014 Plan and the 2018 Non-Employee Director Deferred Compensation Plan. Each deferred stock unit represents the right to receive one share of our common stock upon the non-employee director's separation of service from the Company. We record compensation expense associated with our deferred stock units over the period of service.

Annually, upon approval by our Compensation Committee, we grant stock-based awards, which historically have been in the form of stock options and/or restricted stock units, to certain employees. We also grant stock-based awards, which historically have been in the form of stock options and/or restricted stock units, to certain new employees throughout the year. The fair value of these stock-based awards is determined by using (a) the current market price of our common stock on the grant date in the case of restricted stock units without a market condition, (b) the Monte Carlo Simulation valuation model in the case of performance-based restricted stock units with a market condition, or (c) the Black-Scholes option valuation model in the case of stock options.

Our annual grants in both February 2020 and 2019 consisted of performance-based restricted stock units and time-based restricted stock units. The number of restricted stock units granted was based on the employee's individual objectives, performance against operational metrics assigned to the employee and overall contribution to the Company over the last year.

For the stock-based awards granted in 2020 and 2019, the time-based restricted stock units vest in three equal annual installments beginning one year after the grant date. The performance-based restricted stock unit awards vest at the end of the 3-year performance period if the applicable performance measure is achieved. The related stock-based compensation expense will be recognized over the requisite service period, taking into account the probability that we will satisfy the performance measure. The performance-based restricted stock units granted in 2020 and 2019 will be earned and will vest based upon our total shareholder return ("TSR") relative to the TSR attained by companies within our defined benchmark group, the Russell 2000 Growth Index. Due to the TSR presence in these performance-based restricted stock units, the fair value of these awards was determined using the Monte Carlo Simulation valuation model. We expense these market condition awards over the three-year vesting period regardless of the value the award recipients ultimately receive.

The Monte Carlo Simulation valuation models incorporate assumptions as to stock price volatility, the expected life of options or awards, a risk-free interest rate and dividend yield. The weighted-average grant-date fair value of the performance-based restricted stock units that were granted during the three months ended March 31, 2020 and valued using the Monte Carlo Simulation valuation model was \$80.38. The weighted-average grant-date fair value of the performance-based restricted stock units that were granted during the three months ended March 31, 2019 and valued using the Monte Carlo Simulation valuation model was \$62.74. For performance-based restricted stock units granted during the three months ended March 31, 2020 valued using the Monte Carlo Simulation valuation model, we used the following assumptions:

	Three Months Ended March 31, 2020	Three Months Ended March 31, 2019
Risk-free interest rate	1.16 %	2.48 %
Expected dividend yield	— %	— %
Term	3 years	3 years
Expected volatility	40.0 %	45.0 %
Weighted-average expected volatility	40.0 %	45.0 %

The following table summarizes stock option activity and weighted-average exercise prices during the three months ended March 31, 2020:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value as of March 31, 2020
Outstanding at January 1, 2020	486,682	\$ 52.37		
Granted	—	—		
Forfeited or expired	(9,740)	50.74		
Exercised	(57,180)	39.18		
Outstanding at March 31, 2020	419,762	\$ 54.20	3.2	\$ 1,000
Options exercisable at March 31, 2020	408,489	\$ 54.00	2.0	\$ 1,000

The total intrinsic value of stock options exercised during the three months ended March 31, 2020 and March 31, 2019 was \$1.0 million and \$0.1 million, respectively. The fair value of stock options vested during the three months ended March 31, 2020 and March 31, 2019 was \$0.8 million and \$2.7 million, respectively.

The following table summarizes the restricted stock and restricted stock unit activity and weighted average grant-date fair values for the three months ended March 31, 2020:

	Shares	Weighted-Average Grant Date Fair Value
Non-vested at January 1, 2020	398,318	\$ 49.53
Granted	167,161	66.77
Forfeited	(16,449)	48.67
Vested	(125,399)	39.16
Non-vested at March 31, 2020	423,631	\$ 59.44

We recorded total stock-based compensation expense of \$2.2 million and \$2.6 million for the three months ended March 31, 2020 and March 31, 2019, respectively.

As of March 31, 2020, there was \$20.2 million of total unrecognized stock-based compensation expense related to non-vested stock-based compensation arrangements. The expense is expected to be recognized over a weighted average period of 2.5 years.

The following table summarizes total stock-based compensation expense for each of the line items on our condensed consolidated statement of operations:

	Three Months Ended	
	March 31, 2020	March 31, 2019
Cost of Sales		
Product	\$ 154	\$ 153
Service	117	80
Total cost of sales	\$ 271	\$ 233
Operating Expenses		
Selling, general and administrative	\$ 1,523	\$ 2,134
Research and development	382	197
Total operating expenses	\$ 1,905	\$ 2,331

NOTE 7 – SHORT-TERM INVESTMENTS

Short-term investments at March 31, 2020 were composed of U.S. Treasury Bills totaling \$16.0 million maturing on June 11, 2020 carrying an interest rate of 1.4%. Short-term investments at December 31, 2019 were composed of U.S. Treasury Bills totaling \$24.8 million, consisting of \$8.9 million that matured on March 12, 2020 and \$15.9 million maturing on June 11, 2020. The interest rates on the U.S. Treasury Bills held on December 31, 2019 that matured on March 12, 2020 and maturing on June 11, 2020 were 1.8%, and 1.4%, respectively. These investments are classified as held-to-maturity and recorded at cost plus accrued interest, which approximates fair value. We do not intend to sell these investments, and it is not more likely than not that we will be required to sell the investments before we recover their amortized cost bases.

NOTE 8 – ACCOUNTS RECEIVABLE

Accounts receivable consist of the following:

	As of March 31, 2020	As of December 31, 2019
Accounts receivable	\$ 62,268	\$ 79,611
Allowance for credit losses	(3,434)	(3,449)
Total	\$ 58,834	\$ 76,162

Activity related to the allowance for credit losses was as follows:

	Three Months Ended March 31, 2020
Beginning balance of the allowance for credit losses	\$ (3,449)
Current period provision for expected credit losses	(608)
Recoveries of amounts previously written off	623
Ending balance of the allowance for credit losses	\$ (3,434)

NOTE 9 – INVENTORIES

Inventories are stated at the lower of cost or net realizable value using the first-in first-out (FIFO) method. We have three principal categories of inventory: 1) manufactured product to be sold; 2) sales demonstration inventory - completed product used to support our sales force for demonstrations and held for sale; and 3) service inventory - completed product and parts used to support our service department and held for sale. Shipping and handling costs are classified as a component of Cost of Sales in our condensed consolidated statements of operations. Sales demonstration inventory is held by our sales representatives for up to three years, at which time it would be refurbished and transferred to finished goods as used equipment, stated at the lower of cost or net realizable value. We expect these refurbished units to remain in finished goods inventory and sold within 12 months at prices that produce reduced gross margins. Service inventory is used to provide a temporary replacement product to a customer covered by a premium warranty when the customer's unit requires service or repair and as training equipment. Service inventory is available for sale; however, management does not expect service inventory to be sold within 12 months and, as such, classifies this inventory as a long-term asset. Service inventory that we utilize for training or repairs and which we deem as no longer available for sale is transferred to fixed assets at the lower of cost or net realizable value and depreciated over its remaining life, typically three years.

Inventories consist of the following:

	As of March 31, 2020	As of December 31, 2019
Raw materials	\$ 32,659	\$ 36,956
Finished goods	22,385	21,598
Inventories, net	\$ 55,044	\$ 58,554
Service and sales demonstration inventory, net	\$ 34,355	\$ 33,349

NOTE 10 – (LOSS) EARNINGS PER SHARE

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

For the three months ended March 31, 2020, there were approximately 676,232 shares issuable upon the exercise of options and the contingent vesting of performance-based restricted stock units that were excluded from the dilutive calculations, as they were anti-dilutive. For the three ended March 31, 2019, there were approximately 372,326 issuable upon the exercise of options that were excluded from the dilutive calculations, as they were anti-dilutive.

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

	Three Months Ended			
	March 31, 2020		March 31, 2019	
	Shares	Per-Share Amount	Shares	Per-Share Amount
Basic (loss) earnings per share	17,616,964	\$ (0.84)	17,280,365	\$ 0.01
Effect of dilutive securities	—	—	588,451	—
Diluted (loss) earnings per share	17,616,964	\$ (0.84)	17,868,816	\$ 0.01

NOTE 11 – ACCRUED LIABILITIES

Accrued liabilities consist of the following:

	As of March 31, 2020	As of December 31, 2019
Accrued compensation and benefits	\$ 11,734	\$ 15,366
Accrued restructuring costs	12,761	—
Accrued warranties	2,044	2,090
Professional and legal fees	1,609	1,793
Taxes other than income	2,440	4,077
General services administration contract contingent liability (see Note 14)	12,034	11,886
Other accrued liabilities	1,738	2,860
	<u>\$ 44,360</u>	<u>\$ 38,072</u>

Activity related to accrued warranties was as follows:

	Three Months Ended	
	March 31, 2020	March 31, 2019
Balance, beginning of period	\$ 2,090	\$ 2,571
Provision for warranty expense	659	878
Fulfillment of warranty obligations	(705)	(975)
Balance, end of period	<u>\$ 2,044</u>	<u>\$ 2,474</u>

NOTE 12 – FAIR VALUE MEASUREMENTS

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

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

	As of March 31, 2020		
	Level 1	Level 2	Level 3
Liabilities:			
Contingent consideration ⁽¹⁾	\$ —	\$ —	\$ 733
Total	\$ —	\$ —	\$ 733
	As of December 31, 2019		
	Level 1	Level 2	Level 3
Liabilities:			
Contingent consideration ⁽¹⁾	\$ —	\$ —	\$ 733
Total	\$ —	\$ —	\$ 733

(1) Contingent consideration liability represents arrangements to pay the former owners of certain companies we acquired based on the former owners attaining future product release milestones and is reported in current accrued liabilities. We use a probability-weighted discounted cash flow model to estimate the fair value of contingent consideration liabilities. These probability weightings are developed internally and assessed on a quarterly basis. The remaining undiscounted maximum payment under these arrangements was \$2.2 million as of March 31, 2020.

NOTE 13 – RESTRUCTURING

In the first quarter of 2020, our Board of Directors approved a global restructuring plan (the “Restructuring Plan”), which is intended to support our strategic plan in an effort to improve operating performance and ensure that we are appropriately structured and resourced to deliver increased and sustainable value to our shareholders and customers. Key activities under the Restructuring Plan include a continued focus on efficiency and cost-saving efforts, which includes decreasing total headcount by approximately 500 employees upon the completion of the Restructuring Plan.

These activities are expected to be substantially completed by the end of 2021. In total, we estimate the implementation of the Restructuring Plan will result in first half 2020 pre-tax charges of approximately \$26 million to \$36 million, which are in addition to the pre-tax charges of approximately \$49 million recorded in the fourth quarter of 2019 in connection with the implementation of our new strategic plan and included the following:

- \$21.2 million impairment of goodwill;
- \$12.8 million charge, increasing our reserve for excess and obsolete inventory;
- \$10.5 million impairment of intangible assets associated with recent acquisitions;
- \$1.4 million impairment of intangible assets related to capitalized patents;
- \$3.4 million impairment of other assets and other charges.

In connection with the Restructuring Plan, we recorded a pre-tax charge of approximately \$13.7 million during the first quarter 2020 primarily consisting of severance and related benefits. We estimate total additional pre-tax charges of \$13 million to \$26 million for the remainder of fiscal year 2020.

At this time, we are continuing to evaluate the future key activities by which these additional charges will originate. Actual results, including the costs of the Restructuring Plan, may differ materially from our expectations, resulting in our inability to realize the expected benefits of the Restructuring Plan and our new strategic plan and negatively impacting our ability to execute our future plans and strategies, which could have a material adverse effect on our business, financial condition and results of operations.

In connection with the Restructuring Plan, we paid \$0.9 million during the first quarter 2020 primarily consisting of severance and related benefits. We expect an additional \$17 million to \$21 million of cash payments to be made for the remainder of fiscal year 2020 related to the Restructuring Plan. Activity related to the accrued restructuring charge and cash payments during the first quarter was as follows:

	Severance and other benefits	Professional fees and other related charges	Total
Balance at February 14, 2020	\$ —	\$ —	\$ —
Additions charged to expense	12,956	732	13,688
Cash payments	(853)	(74)	(927)
Balance at March 31, 2020	<u>12,103</u>	<u>658</u>	<u>12,761</u>

NOTE 14 – COMMITMENTS AND CONTINGENCIES

Purchase Commitments — We enter into purchase commitments for products and services in the ordinary course of business. These purchases generally cover production requirements for 60 to 120 days as well as materials necessary to service customer units through the product lifecycle and for warranty commitments. As of March 31, 2020, we had approximately \$54.0 million in purchase commitments that are expected to be delivered within the next 12 months.

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

U.S. Government Contracting Matter — We have sold our products and related services to the U.S. Government (the “Government”) under General Services Administration (“GSA”) Federal Supply Schedule contracts (the “GSA Contracts”) since 2002 and are currently selling our products and related services to the Government under two such GSA Contracts. Each GSA Contract is subject to extensive legal and regulatory requirements and includes, among other provisions, a price reduction clause (the “Price Reduction Clause”), which generally requires us to reduce the prices billed to the Government under the GSA Contracts to correspond to the lowest prices billed to certain benchmark customers.

Late in the fourth quarter of 2018, during an internal review we preliminarily determined that certain of our pricing practices may have resulted in the Government being overcharged under the Price Reduction Clauses of the GSA Contracts (the “GSA Matter”). As a result, we performed remediation efforts, including but not limited to, the identification of additional controls and procedures to ensure future compliance with the pricing and other requirements of the GSA Contracts. We also retained outside legal counsel and forensic accountants to assist with these efforts and to conduct a comprehensive review of our pricing and other practices under the GSA Contracts (the “Review”). On February 14, 2019, we reported the GSA Matter to the GSA and its Office of Inspector General.

As a result of the GSA Matter, for the fourth quarter 2018, we reduced our total sales by a \$4.8 million estimated cumulative sales adjustment, representative of the last six years of estimated overcharges to the Government under the GSA Contracts. In addition, for the fourth quarter of 2018, we recorded \$0.5 million of imputed interest related to the estimated cumulative sales adjustment, which increased Interest expense, net and resulted in an estimated total liability of \$5.3 million for the GSA Matter. This adjustment was based on our preliminary review as of February 20, 2019, the date of our Annual Report on Form 10-K for the year ended December 31, 2018. In addition, in first quarter 2019, we recorded an additional \$0.1 million of imputed interest related to the estimated cumulative sales adjustment.

On July 15, 2019, we submitted a report to the GSA and its Office of Inspector General setting forth the findings of the Review conducted by our outside legal counsel and forensic accountants. Based on the results of the Review, we reduced our total sales for second quarter 2019 by an incremental \$5.8 million sales adjustment, reflecting an estimated aggregate overcharge of \$10.6 million under the GSA Contracts for the period from July 2011 to March 2019. In addition, we recorded an incremental \$0.7 million of imputed interest related to the estimated cumulative sales adjustment for the remainder of 2019, which increased Interest expense, net and resulted in a \$6.5 million total incremental increase in the estimated total liability for the GSA Matter. We recorded an incremental \$0.1 million of imputed interest related to the estimated cumulative sales adjustment for the first quarter of 2020. As of the date of the filing of this Quarterly Report on Form 10-Q, we have recorded an aggregate estimated total liability for the GSA Matter of \$12.0 million.

In January 2020, we received requests for additional information from the GSA and its Office of Inspector General, and we are working with the GSA in responding to such inquiries. We intend to cooperate fully with this and any other Government inquiries. The Government's review of, or investigation into, this matter could result in civil and criminal penalties, administrative sanctions, and contract remedies being imposed on us, including but not limited to, termination of the GSA Contracts, repayments of amounts already received under the GSA Contracts, forfeiture of profits, damages, suspension of payments, fines, and suspension or debarment from doing business with the Government and possibly U.S. state and local governments. We may also be subject to litigation and recovery under the federal False Claims Act and possibly similar state laws, which could include claims for treble damages, penalties, fees and costs. As a result, we cannot reasonably predict the outcome of the Government's review of, or investigation into, this matter at this time or the resulting future financial impact on us. Any of these outcomes could have a material adverse effect on our reputation, our sales, results of operations, cash flows and financial condition, and the trading price of our common stock. In addition, we have incurred, and will continue to incur, legal and related costs in connection with the Review and the Government's response to this matter.

NOTE 15 – LEASES

We have operating and finance leases for manufacturing facilities, corporate offices, research and development facilities, sales and training facilities, vehicles, and certain equipment under which we assume the role of lessee. We do not lease assets as a lessor. Our leases have remaining lease terms of less than one year to approximately seven years, some of which include options to extend the leases for up to eight years, and some of which include options to terminate the leases within three months. We currently do not sublease any of our leased assets.

We determine if an arrangement is a lease at inception. Operating leases are included in Operating lease right-of-use (“ROU”) asset, Lease liability, and Lease liability - less current portion in our condensed consolidated balance sheets. Finance leases are included in Property and equipment, net, Lease liability, and Lease liability - less current portion in our condensed consolidated balance sheets.

ROU assets represent our right to use an underlying asset for the lease term and lease liabilities represent our obligation to make lease payments arising from the lease. Operating lease ROU assets and lease liabilities are recognized on the commencement date of the lease based on the present value of lease payments over the lease term. Variable lease payments that depend on an index or rate include the variable portion when calculating ROU assets and lease liabilities. Variable lease payments that do not depend on an index or rate are expensed as incurred. As most of our leases do not provide an implicit rate, we use our incremental borrowing rate based on the information available on the commencement date of the lease to determine the present value of lease payments. We use the implicit rate when readily determinable. The operating lease ROU assets also include any lease payments made and lease incentives. Our lease terms may include options to extend or terminate the lease when it is reasonably certain that we will exercise that option at the time the lease is commenced. Lease expense for lease payments is recognized on a straight-line basis over the lease term.

While we have lease agreements with lease and non-lease components, we account for the lease and non-lease components as a single lease component.

The components of lease expense were as follows:

	Three Months Ended March 31, 2020	Three Months Ended March 31, 2019
Operating lease cost	\$ 2,055	\$ 1,969
Finance lease cost:		
Amortization of ROU assets	\$ 82	\$ 92
Interest on lease liabilities	\$ 9	\$ 12
Total finance lease cost	\$ 91	\$ 104

We recognize lease payments made for short-term leases where terms are 12 months or less as the payments are incurred. Our short-term lease cost for the three months ended March 31, 2020 and March 31, 2019 was less than \$0.1 million and \$0.1 million, respectively.

Supplemental balance sheet information related to leases was as follows:

	As of March 31, 2020	As of December 31, 2019
Operating leases:		
Operating lease right-of-use asset	\$ 16,534	\$ 18,418
Current operating lease liability	\$ 5,617	\$ 6,349
Operating lease liability - less current portion	12,382	13,272
Total operating lease liability	\$ 17,999	\$ 19,621
Finance leases:		
Property and equipment, at cost	\$ 1,553	\$ 1,870
Accumulated depreciation	(890)	(1,150)
Property and equipment, net	\$ 663	\$ 720
Current finance lease liability	\$ 330	\$ 325
Finance lease liability - less current portion	363	426
Total finance lease liability	\$ 693	\$ 751
Weighted Average Remaining Lease Term (in years):		
Operating leases	4.42	4.48
Finance leases	2.36	2.48
Weighted Average Discount Rate:		
Operating leases	5.28 %	5.10 %
Finance leases	5.06 %	5.09 %

Supplemental cash flow information related to leases was as follows:

	Three Months Ended March 31, 2020	Three Months Ended March 31, 2019
Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash flows from operating leases	\$ 2,098	\$ 2,029
Operating cash flows from finance leases	\$ 9	\$ 12
Financing cash flows from finance leases	\$ 82	\$ 90
ROU assets obtained in exchange for lease obligations:		
Operating leases	\$ 395	\$ 5,400

Maturities of lease liabilities are as follows:

Year Ending December 31,	Operating leases	Finance leases
2020 (excluding the first 3 months)	\$ 5,270	\$ 269
2021	4,012	320
2022	3,139	93
2023	2,829	43
2024	2,700	12
Thereafter	2,354	—
Total lease payments	\$ 20,304	\$ 737
Less imputed interest	(2,305)	(44)
Total	\$ 17,999	\$ 693

NOTE 16 – SUBSEQUENT EVENTS

We are significantly vulnerable to the economic effects of pandemics and other public health crises, including the ongoing novel coronavirus (“COVID-19”) outbreak that has surfaced in every country of our global operating footprint. We are not able to forecast the impact that COVID-19 will have on our revenues, operations, business and financial position due to many uncertainties. We will continue to assess the impact of COVID-19, including future events and developments, such as the duration and magnitude of the outbreak, impact on our suppliers and customers, the demand for our products and services, and whether the pandemic leads to recessionary conditions in any of our key markets.

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

The following information should be read in conjunction with the condensed consolidated financial statements, including the notes thereto, included elsewhere in this Form 10-Q and Management’s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2019.

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

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

- an economic downturn in the manufacturing industry or the domestic and international economies in the regions of the world where we operate;
- the effect of the COVID-19 pandemic, including on our business operations, as well as its impact on general economic and financial market conditions;
- our inability to realize the intended benefits of our undertaking to transition to a company that is reorganized around functions to improve the efficiency of our sales organization and to improve operational effectiveness;
- our inability to successfully execute our new strategic plan and restructuring plan, including but not limited to additional impairment charges and/or higher than expected severance costs and exist costs, and our inability to realize the expected benefits of such plans;
- our inability to further penetrate our customer base and target markets;
- development by others of new or improved products, processes or technologies that make our products less competitive or obsolete;
- our inability to maintain what we believe to be our technological advantage by developing new products and enhancing our existing products;
- the outcome of the U.S. Government’s review of, or investigation into, our potential overcharging of the U.S. Government under our General Services Administration Federal Supply Schedule contracts, any resulting penalties, damages or sanctions imposed on us and the outcome of any resulting litigation to which we may become a party, loss of future government sales and potential impacts on customer and supplier relationships and our reputation;
- risks associated with expanding international operations, such as difficulties in staffing and managing foreign operations, increased political and economic instability, compliance with potentially evolving import and export regulations, and the burdens and potential exposure of complying with a wide variety of U.S. and foreign laws and labor practices;
- changes in trade regulation, which result in rising prices of imported steel, steel byproducts, aluminum and aluminum byproducts and various other raw materials that we use in the production of measurement devices, and our ability to pass those costs on to our customers or require our suppliers to absorb such costs;
- changes in foreign regulation which may result in rising prices of our measurement devices sold as exports to our international customers, our customers’ willingness to absorb incremental import tariffs, and the corresponding impact on our profitability;
- our inability to successfully identify and acquire target companies and achieve expected benefits from, and effectively integrate, acquisitions that are consummated;
- the cyclical nature of the industries of our customers and material adverse changes in our customers’ access to liquidity and capital;
- changes in the potential for the computer-aided measurement market and the potential adoption rate for our products, which are difficult to quantify and predict;

- our inability to protect our patents and other proprietary rights in the United States and foreign countries;
- our inability to adequately establish and maintain effective internal controls over financial reporting;
- fluctuations in our annual and quarterly operating results and the inability to achieve our financial operating targets as a result of a number of factors including, without limitation (i) litigation and regulatory action brought against us, (ii) quality issues with our products, (iii) excess or obsolete inventory, shrinkage or other inventory losses due to product obsolescence, change in demand for our products, scrap or material price changes, (iv) raw material price fluctuations and other inflationary pressures, (v) expansion of our manufacturing capability, (vi) the size and timing of customer orders, (vii) the amount of time that it takes to fulfill orders and ship our products, (viii) the length of our sales cycle to new customers and the time and expense incurred in further penetrating our existing customer base, (ix) manufacturing inefficiencies associated with new product introductions, (x) costs associated with new product introductions, such as product development, marketing, assembly line start-up costs and low introductory period production volumes, (xi) the timing and market acceptance of new products and product enhancements, (xii) customer order deferrals in anticipation of new products and product enhancements, (xiii) the inability of our sales and marketing programs to achieve their sales targets, (xiv) start-up costs associated with opening new sales offices outside of the United States, (xv) fluctuations in revenue without proportionate adjustments in fixed costs, (xvi) inefficiencies in the management of our inventories and fixed assets, (xvii) compliance with government regulations including health, safety, and environmental matters, and (xviii) costs associated with the training and ramp-up time for new sales people;
- changes in gross margins due to a changing mix of products sold and the different gross margins on different products and sales channels;
- changes in applicable laws, rules or regulations, or their interpretation or enforcement, or the enactment of new laws, rules or regulations that apply to our business operations or require us to incur significant expenses for compliance;
- our inability to successfully comply with the requirements of the Restriction of Hazardous Substances Directive and the Waste Electrical and Electronic Equipment Directive in the European Union;
- the inability of our products to displace traditional measurement devices and attain broad market acceptance;
- the impact of competitive products and pricing on our current offerings;
- our ability to successfully complete our executive officer transitions and the loss of any of our executive officers or other key personnel;
- difficulties in recruiting research and development engineers and application engineers;
- the failure to effectively manage the effects of any future growth;
- the impact of reductions or projected reductions in government spending, or uncertainty regarding future levels of government expenditures, particularly in the defense sector;
- variations in our effective income tax rate, which makes it difficult to predict our effective income tax rate on a quarterly and annual basis, and the impact of the U.S. Tax Cuts and Jobs Act of 2017 on the global intangible low-taxed income of foreign subsidiaries;
- the loss of key suppliers and the inability to find sufficient alternative suppliers in a reasonable period of time or on commercially reasonable terms;
- the impact of fluctuations in exchange rates;
- the effect of estimates and assumptions with respect to critical accounting policies and the impact of the adoption of recently issued accounting pronouncements;
- the magnitude of increased warranty costs from new product introductions and enhancements to existing products;
- the sufficiency of our plants to meet manufacturing requirements;
- the continuation of our share repurchase program;
- the sufficiency of our working capital and cash flow from operations to fund our long-term liquidity requirements;
- the impact of geographic changes in the manufacturing or sales of our products on our effective income tax rate;
- our ability to comply with the requirements for favorable tax rates in foreign jurisdictions; and
- other risks and uncertainties discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2019 and risks identified on this Quarterly Report on Form 10-Q.

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

Overview

We are a global technology company that designs, develops, manufactures, markets and supports software driven, three-dimensional (“3D”) measurement and imaging solutions. This technology permits high-precision 3D measurement, imaging and comparison of parts and complex structures within production and quality assurance processes. Our devices are used for inspection of components and assemblies, rapid prototyping, reverse engineering, documenting large volume or structures in 3D, surveying and construction, as well as for investigation and reconstruction of accident sites or crime scenes. We sell the majority of our products through a direct sales force across a broad number of customers in a range of manufacturing, industrial, architecture, surveying, building information modeling, construction, public safety forensics, cultural heritage, and other applications. Our FaroArm®, FARO ScanArm®, FARO Laser Tracker™, FARO Laser Projector, and their companion CAM2®, BuildIT, and BuildIT Projector software solutions, provide for Computer-Aided Design (“CAD”) based inspection, factory-level statistical process control, high-density surveying, and laser-guided assembly and production. Together, these products integrate the measurement, quality inspection, and reverse engineering functions with CAD and 3D software to improve productivity, enhance product quality, and decrease rework and scrap in the manufacturing process, mainly supporting applications in the automotive, aerospace, metal and machine fabrication and other industrial manufacturing markets. Our FARO Focus and FARO ScanPlan laser scanners, and their companion FARO SCENE, BuildIT, FARO As-Built™, and FARO Zone public safety forensics software offerings, are utilized for a wide variety of 3D modeling, documentation and high-density surveying applications primarily in the architecture, engineering, and construction and public safety markets. Our FARO ScanArm® and its companion SCENE software also enable a fully digital workflow used to capture real world geometry for the purpose of empowering design, enabling innovation, and speeding up the design cycle.

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

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

We manufacture our FaroArm® and FARO ScanArm® products in our manufacturing facility located in Switzerland for customer orders from Europe, the Middle East and Africa (“EMEA”), in our manufacturing facility located in Singapore for customer orders from the Asia-Pacific region, and in our manufacturing facility located in Florida for customer orders from the Americas. We manufacture our FARO Focus in our manufacturing facilities located in Germany and Switzerland for customer orders from EMEA and the Asia-Pacific region, and in our manufacturing facility located in Pennsylvania for customer orders from the Americas. We manufacture our FARO Laser Tracker™ and our FARO Laser Projector products in our facility located in Pennsylvania. We expect all of our existing manufacturing facilities to have the production capacity necessary to support our volume requirements during 2020.

We account for wholly-owned foreign subsidiaries in the currency of the respective foreign jurisdiction; therefore, fluctuations in exchange rates may have an impact on the value of the intercompany account balances denominated in different currencies and reflected in our condensed consolidated financial statements. We are aware of the availability of off-balance sheet financial instruments to hedge exposure to foreign currency exchange rates, including cross-currency swaps, forward contracts and foreign currency options. However, we have not used such instruments in the past, and none were utilized in 2019 or the three months ended March 31, 2020.

Change in Organizational Structure and Segment Reporting

From the fourth quarter of 2016 through the fourth quarter of 2019, we operated in five market verticals—3D Manufacturing, Construction Building Information Modeling (“Construction BIM”), Public Safety Forensics, 3D Design and Photonics—and had three reporting segments—3D Manufacturing, Construction BIM and Emerging Verticals. As discussed in our Quarterly Report on Form 10-Q for the third quarter of 2019, our new management team, led by our new Chief Executive Officer (“CEO”), formulated and began to implement a new comprehensive strategic plan for our business. As part of our strategic planning process, we identified areas of our business that needed enhanced focus or change in order to improve our efficiency and cost structure. In the fourth quarter of 2019, we reassessed and redefined our go-to-market strategy, refocused our marketing engagement with our customers and re-evaluated our hardware product portfolio. We also began to focus on other organizational optimization efforts, including the simplification of our overly complex management structure.

As part of our new strategic plan, and based on the recommendation of our CEO, who is also our Chief Operating Decision Maker (“CODM”), in the fourth quarter of 2019, we eliminated our vertical operating structure and reorganized the Company into a functional structure. Our executive leadership team is now comprised of global functional leaders in areas such as sales, marketing, operations, research and development and general and administrative, and resources are allocated to each function at a consolidated unit level. We no longer have separate business units, or segment managers or vertical leaders who report to the CODM with respect to operations, operating results or planning for levels or components below the total Company level. Instead, our CODM now allocates resources and evaluates performance on a Company-wide basis. Based on these changes, commencing with the fourth quarter of 2019, we now report as one reporting segment that develops, manufactures, markets, supports and sells CAD-based quality assurance products integrated with CAD-based inspection and statistical process control software and 3D documentation systems. Our reporting segment sells into a variety of end markets, including automotive, aerospace, metal and machine fabrication, architecture, engineering, construction and public safety.

New Strategic Plan and Restructuring Plan

In addition to the reorganization of the Company’s structure, as part of our strategic planning process, we also evaluated our hardware product portfolio and the operations of certain of our recent acquisitions. As a result of this evaluation, we are simplifying our hardware product portfolio, ceasing to sell certain products and evaluating whether or not we will divest or shut down the related operations.

In addition to the implementation of our new strategic plan, on February 14, 2020, our Board of Directors approved a global restructuring plan (the “Restructuring Plan”), which is intended to support our strategic plan in an effort to improve operating performance and ensure that we are appropriately structured and resourced to deliver increased and sustainable value to our shareholders and customers. Key activities under the Restructuring Plan include a continued focus on efficiency and cost-saving efforts, which includes decreasing total headcount by approximately 500 employees upon the completion of the Restructuring Plan.

These activities are expected to be substantially completed by the end of 2021. We estimate the Restructuring Plan will reduce gross annual pre-tax expenses by approximately \$40 million, to be realized in the fourth quarter of 2020 on an annualized basis. In total, we estimate the implementation of the Restructuring Plan will result in first half 2020 pre-tax charges of approximately \$26 million to \$36 million, which are in addition to the pre-tax charges of approximately \$49 million recorded in the fourth quarter of 2019 in connection with the implementation of our new strategic plan and included the following:

- \$21.2 million impairment of goodwill;
- \$12.8 million charge, increasing our reserve for excess and obsolete inventory;
- \$10.5 million impairment of intangible assets associated with recent acquisitions;
- \$1.4 million impairment of intangible assets related to capitalized patents;
- \$3.4 million impairment of other assets and other charges.

In connection with the Restructuring Plan, we recorded a pre-tax charge of approximately \$13.7 million during the first quarter 2020 primarily consisting of severance and related benefits. We estimate an additional \$13 million to \$26 million of pre-tax charges during the remainder of fiscal year 2020.

Actual results, including the costs of the Restructuring Plan, may differ materially from our expectations, resulting in our inability to realize the expected benefits of the Restructuring Plan and our new strategic plan and negatively impacting our ability to execute our future plans and strategies, which could have a material adverse effect on our business, financial condition and results of operations.

Reclassification and Related Changes to Presentation

Certain prior year amounts have been reclassified in the accompanying consolidated financial statements to conform to the current period presentation:

- Commencing with the third quarter of 2019, depreciation and amortization expenses are being reported in our statements of operations to reflect departmental costs. Previously, those expenses were reported as a separate line item under operating expenses. Amounts related to depreciation and amortization expenses for the three months ended March 31, 2020 have been reclassified throughout this Quarterly Report on Form 10-Q to reflect this reclassification of depreciation and amortization expenses and to conform to the current period presentation.

- Selling and marketing expenses and general and administrative expenses are now being reported in the accompanying statements of operations together in one line as Selling, general and administrative. Previously, those expenses were reported as two separate line items under operating expenses. Amounts related to selling, general and administrative expenses for the three months ended March 31, 2019 have been reclassified throughout this Quarterly Report on Form 10-Q to reflect this reclassification of selling, general and administrative expenses and to conform to the current period presentation, as set forth in the following table;
- Software maintenance revenue is now being reported in the accompanying statements of operations as a component of product sales. Previously, these revenues were reported in service sales. Amounts related to software maintenance revenue for the three months ended March 31, 2019 have been reclassified throughout this Quarterly Report on Form 10-Q to reflect this reclassification of software maintenance revenue and to conform to the current period presentation, as set forth in the following table; and
- Software maintenance cost of sales is now being reported in the accompanying statements of operations as a component of product cost of sales. Previously, these cost of sales was reported in service cost of sales. Amounts related to software maintenance cost of sales for the three months ended March 31, 2019 have been reclassified throughout this Quarterly Report on Form 10-Q to reflect this reclassification of software maintenance cost of sales and to conform to the current period presentation, as set forth in the following table.

For the three months ended, March 31, 2019

	As Reported	Depreciation and Amortization Adjustment	Selling, General and Administrative Adjustment	Software Maintenance and Other Adjustments	As Adjusted
Sales					
Product	\$ 68,800	\$ —	\$ —	\$ 2,777	\$ 71,577
Service	24,817	—	—	(2,777)	22,040
Total sales	\$ 93,617	\$ —	\$ —	\$ —	\$ 93,617
Cost of Sales					
Product	\$ 26,128	\$ 1,176	\$ —	\$ 647	\$ 27,951
Service	12,470	824	—	(647)	12,647
Total cost of sales	\$ 38,598	\$ 2,000	\$ —	\$ —	\$ 40,598
Operating Expenses					
Selling, general and administrative	\$ —	\$ 1,043	\$ 39,977	\$ —	\$ 41,020
Selling and marketing	26,753	—	(26,753)	—	—
General and administrative	13,224	—	(13,224)	—	—
Depreciation and amortization	4,749	(4,749)	—	—	—
Research and development	9,935	1,706	—	—	11,641
Total operating expenses	\$ 54,661	\$ (2,000)	\$ —	\$ —	\$ 52,661

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

Results of Operations

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

(dollars in thousands)	Three months ended March 31,			
	2020	% of Sales	2019	% of Sales
Sales				
Product	\$ 56,525	71.1 %	\$ 71,577	76.5 %
Service	22,990	28.9 %	22,040	23.5 %
Total sales	79,515	100.0 %	93,617	100.0 %
Cost of Sales				
Product	23,066	29.0 %	27,951	29.9 %
Service	12,576	15.8 %	12,647	13.5 %
Total cost of sales	35,642	44.8 %	40,598	43.4 %
Gross Profit	43,873	55.2 %	53,019	56.6 %
Operating Expenses				
Selling, general and administrative	36,324	45.7 %	41,020	43.8 %
Research and development	10,415	13.1 %	11,641	12.4 %
Restructuring costs	13,688	17.2 %	—	— %
Total operating expenses	60,427	76.0 %	52,661	56.3 %
(Loss) income from operations	(16,554)	(20.8)%	358	0.4 %
Other (income) expense				
Interest expense (income), net	34	— %	(144)	(0.2) %
Other expense, net	473	0.6 %	195	0.2 %
(Loss) income before income tax (benefit) expense	(17,061)	(21.5)%	307	0.3 %
Income tax (benefit) expense	(2,238)	(2.8)%	155	0.2 %
Net (loss) income	\$ (14,823)	(18.6)%	\$ 152	0.2 %

Consolidated Results

Three Months Ended March 31, 2020 Compared to the Three Months Ended March 31, 2019

Sales. Total sales decreased by \$14.1 million, or 15.1%, to \$79.5 million for the three months ended March 31, 2020 from \$93.6 million for the three months ended March 31, 2019. Total product sales decreased by \$15.1 million, or 21.0%, to \$56.5 million for the three months ended March 31, 2020 from \$71.6 million for the three months ended March 31, 2019. Our product sales decreased primarily due to the continuing market softness in many of our served markets, along with deterioration in the macro-economic environment and orders pushed out in March due to COVID-19 uncertainty. Service revenue increased by \$1.0 million, or 4.3%, to \$23.0 million for the three months ended March 31, 2020 from \$22.0 million for the three months ended March 31, 2019, primarily due to an increase in warranty revenue driven by the growth of our installed base and our focused sales initiatives to maintain customer relationships after the initial purchase of our measurement devices. Foreign exchange rates had a negative impact on total sales of \$1.2 million, increasing the percent that our overall sales declined by approximately 1.3 percentage points, primarily due to the weakening of the Euro relative to the U.S. dollar.

Gross profit. Gross profit decreased by \$9.1 million, or 17.3%, to \$43.9 million for the three months ended March 31, 2020 from \$53.0 million for the three months ended March 31, 2019, and gross margin decreased to 55.2% for the three months ended March 31, 2020 from 56.6% for the three months ended March 31, 2019, primarily due to a negative impact from hardware product mix, partially offset by a positive impact from software product mix driven by a shift from third party to FARO owned software product sales. Gross margin from product revenue decreased by 1.7 percentage points to 59.2% for the three months ended March 31, 2020 from 60.9% for the prior year period primarily due to the aforementioned shifts in mix. Gross margin from service revenue increased by 2.7 percentage points to 45.3% for the three months ended March 31, 2020 from 42.6% for the prior year period, primarily due to the aforementioned increase in service revenue with relatively consistent fixed costs.

Selling, general and administrative expenses. Selling, general and administrative expenses decreased by \$4.7 million, or 11.4%, to \$36.3 million for the three months ended March 31, 2020 from \$41.0 million for the three months ended March 31, 2019. This decrease was driven primarily by decreased salaries and wages and other cost savings initiatives to reduce non-personnel costs that resulted from the Restructuring Plan. Additionally, a decrease in selling commission expense was driven by lower product sales. Selling, general and administrative expenses as a percentage of sales increased to 45.7% for the three months ended March 31, 2020, compared with 43.8% of sales for the three months ended March 31, 2019. Our worldwide period-ending selling, general and administrative headcount decreased by 169, or 16.4%, to 861 at March 31, 2020, from 1,030 at March 31, 2019.

Research and development expenses. Research and development expenses decreased by \$1.2 million, or 10.5%, to \$10.4 million for the three months ended March 31, 2020 from \$11.6 million for the three months ended March 31, 2019. This decrease was mainly driven by a decrease in purchased technology intangible amortization expense as a result of the impairment of certain intangible assets in connection with the Restructuring Plan. Research and development expenses as a percentage of sales increased to 13.1% for the three months ended March 31, 2020 from 12.4% for the three months ended March 31, 2019.

Restructuring costs. In February 2020, we initiated the Restructuring Plan to improve business effectiveness, streamline operations and achieve a stated target cost level for the Company as a whole. Restructuring costs included in operating expenses for the three months ended March 31, 2020 were \$13.7 million primarily consisting of severance and related benefits charges.

Interest expense (income), net. We recorded interest expense, net of less than \$0.1 million for the three months ended March 31, 2020 and interest income, net of \$0.1 million the three months ended March 31, 2019.

Other expense, net. For the three months ended March 31, 2020, other expense increased by \$0.3 million to \$0.5 million from \$0.2 million for the three months ended March 31, 2019. These amounts were primarily driven by the effect of foreign exchange rates on the value of intercompany account balances of our subsidiaries denominated in other currencies.

Income tax (benefit) expense. For the three months ended March 31, 2020, we recorded an income tax benefit of \$2.2 million compared with income tax expense of \$0.2 million for the three months ended March 31, 2019. Our effective tax rate was (13.1%) for the three months ended March 31, 2020 compared with (50.5%) in the prior year period. The change in our income tax (benefit) expense was primarily due to a pretax loss during the first quarter of 2020 compared to pretax income in the same period of 2019. The change in our effective tax rate was primarily due to the impact of valuation allowances on our deferred tax assets that were established in many of our foreign jurisdictions during the fourth quarter of 2019.

Our quarterly estimate of our annual effective tax rate and our quarterly provision for income tax (benefit) expense are subject to significant variation due to numerous factors, including variability in accurately predicting our pretax and taxable income or loss and the mix of jurisdictions to which they relate, as well as the amount of pretax income or loss recognized during the quarter.

Net loss (income). Our net loss was \$14.8 million for the three months ended March 31, 2020 compared with net income of \$0.2 million for the prior year period, reflecting the impact of the factors described above.

Liquidity and Capital Resources

Cash and cash equivalents increased by \$23.6 million to \$157.2 million at March 31, 2020 from \$133.6 million at December 31, 2019. The increase was primarily driven by net cash provided by operating and investing activities. Cash provided by operating activities was \$16.3 million during the three months ended March 31, 2020, compared to \$5.8 million of cash provided by operations during the three months ended March 31, 2019. The increase was mainly due to changes in working capital accounts, primarily a decrease in accounts receivable, an increase in accrued liabilities driven by severance and related benefit charges as a result of our restructuring plan and a decrease in our inventories.

Cash provided by investing activities during the three months ended March 31, 2020 was \$7.8 million compared to cash used in investing activities of \$2.1 million during the three months ended March 31, 2019. The change was primarily due to the maturity of U.S. Treasury Bills amounting to \$9.0 million during the three months ended March 31, 2020 without such activity during the three months ended March 31, 2019.

Cash provided by financing activities was \$1.1 million during the three months ended March 31, 2020 compared to cash used in financing activities of \$1.2 million for the three months ended March 31, 2019. The change was primarily due to \$2.8 million in cash received from the exercise of employee stock options during the three months ended March 31, 2020 compared to \$0.3 million during the three months ended March 31, 2019.

Of our cash and cash equivalents, \$91.9 million was held by foreign subsidiaries as of March 31, 2020. On December 22, 2017, the United States enacted the U.S. Tax Cuts and Jobs Act, resulting in significant modifications to existing tax law, which included a transition tax on the mandatory deemed repatriation of foreign earnings. Despite the changes in U.S. tax law, our current intent is to indefinitely reinvest these funds in our foreign operations, as the cash is needed to fund ongoing operations.

On November 24, 2008, our Board of Directors approved a \$30.0 million share repurchase program. Acquisitions for the share repurchase program may be made from time to time at prevailing prices, as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The share repurchase program may be discontinued at any time. There is no expiration date or other restriction governing the period over which we can repurchase shares under the program. In October 2015, our Board of Directors authorized an increase to the existing share repurchase program from \$30.0 million to \$50.0 million. We made no stock repurchases during the three month period ended March 31, 2020 under this program. As of March 31, 2020, we had authorization to repurchase \$18.3 million remaining under the repurchase program.

We believe that our working capital and anticipated cash flow from operations will be sufficient to fund our long-term liquidity operating requirements for at least the next 12 months.

We have no off-balance sheet arrangements.

Contractual Obligations and Commercial Commitments

We enter into purchase commitments for products and services in the ordinary course of business. These purchases generally cover production requirements for 60 to 120 days as well as materials necessary to service customer units through the product lifecycle and for warranty commitments. As of March 31, 2020, we had \$54.0 million in purchase commitments that are expected to be delivered within the next 12 months. Other than as described in the preceding sentences, there have been no material changes to the contractual obligations and commercial commitments table included in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2019.

Critical Accounting Policies

The preparation of our condensed consolidated financial statements requires our management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses, as well as disclosure of contingent assets and liabilities. We base our estimates on historical experience, along with various other factors believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Some of these judgments can be subjective and complex and, consequently, actual results may differ from these estimates under different assumptions or conditions. A discussion of our critical accounting policies is included in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended December 31, 2019, as filed with the Securities and Exchange Commission on February 19, 2020. As of March 31, 2020, our critical accounting policies have not changed from those described in our Annual Report on Form 10-K for the year ended December 31, 2019.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Foreign Exchange Exposure

We conduct a significant portion of our business outside the United States. As of and for the three months ended March 31, 2020, 58% of our revenue was invoiced, and a significant portion of our operating expenses were paid, in foreign currencies, and 38% of our assets were denominated in foreign currencies. Fluctuations in exchange rates between the U.S. dollar and such foreign currencies may have a material effect on our results of operations and financial condition and could specifically result in foreign exchange gains and losses. The impact of future exchange rate fluctuations on the results of our operations cannot be accurately predicted due to our constantly changing exposure to various currencies, and the fact that all foreign currencies do not react in the same manner in relation to the U.S. dollar. Our most significant exposures are to the Euro, Swiss Franc, Japanese Yen, Chinese Yuan and Brazilian Real. To the extent that the percentage of our non-U.S. dollar revenues derived from international sales increases in the future, our exposure to risks associated with fluctuations in foreign exchange rates may increase. We are aware of the availability of off-balance sheet financial instruments to hedge exposure to foreign currency exchange rates, including cross-currency swaps, forward contracts and foreign currency options. However, we have not used such instruments in the past, and none were utilized in 2019 or the three months ended March 31, 2020.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of March 31, 2020. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of March 31, 2020 to provide reasonable assurance that information required to be disclosed in this Quarterly Report on Form 10-Q was recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms and was accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

During the quarter ended March 31, 2020, there was no change in our internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

In addition to the other information set forth in this Quarterly Report on Form 10-Q, you should carefully consider the factors discussed under “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2019, as filed with the SEC, and in this Item 1A before deciding to invest in, or retain, shares of our common stock. These risks could materially and adversely affect our business, financial condition, and results of operations. The risks described in our Annual Report on Form 10-K for the year ended December 31, 2019 are not the only risks we face. Our operations could also be affected by additional factors that are not presently known by us or by factors that we currently consider to be immaterial to our business. Except as set forth below, as of March 31, 2020, there have been no material changes in our risk factors from those set forth in our Annual Report on Form 10-K for the year ended December 31, 2019:

The risk factor entitled “*Our operations are vulnerable to the effects of epidemics, such as the coronavirus, which could materially disrupt our business.*” has been updated to read as follows:

On March 11, 2020, the World Health Organization declared the outbreak of a novel coronavirus (“COVID-19”) as a global pandemic, which continues to spread throughout the United States and around the world. Our operations are significantly vulnerable to the effects of pandemics, such as COVID-19, which have, and could continue to materially impact our business.

We are significantly vulnerable to the economic effects of pandemics and other public health crises, including the ongoing COVID-19 outbreak that has surfaced in every country of our global operating footprint. The impact of COVID-19, including disruptions to our business, changes in consumer behaviors, restrictions on individual and business activities, changes in consumer behavior, and financial liquidity concerns, has created significant volatility in the macro-economic environment and led to reduced economic activity. There have been material actions taken by global government authorities to contain and slow the spread of COVID-19, including travel bans, quarantines, and stay-at-home orders to restrict activities for individuals and businesses.

In response to mandates ordered by global government authorities, our non-manufacturing and technical service personnel have been ordered to work from home beginning in March 2020. Our global manufacturing operations, including facilities located in Exton, Pennsylvania, Lake Mary, Florida, Germany, Switzerland and Singapore have been designated as essential business and therefore continue to operate. In the best interest of our employees and regions in which our teams operate, we have implemented significant preventative measures to ensure the health and safety of our employees, including temperature screenings prior to entering our plants, enforcement of safe distancing between employees within our plants, encouragement that employees wash hands often, and stay-at-home measures if symptoms of COVID-19 arise during work hours or prior to entering our plants.

The full impact of the COVID-19 pandemic on our financial condition and results of operations will depend on future events and developments, such as the duration and magnitude of the outbreak, impact on our suppliers and customers, the demand for our products and services, and whether the pandemic leads to recessionary conditions in any of our key markets. Additionally, our supply and distribution chains may be disrupted or their operations discontinued permanently. As such, the ultimate impact on our financial condition and results of operations cannot be determined at this time. In 2020, we expect our business, financial condition and results of operations to be adversely affected.

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

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

On November 24, 2008, our Board of Directors approved a \$30.0 million share repurchase program. Acquisitions for the share repurchase program may be made from time to time at prevailing prices, as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The share repurchase program may be discontinued at any time. There is no expiration date or other restriction governing the period over which we can repurchase shares under the program. In October 2015, our Board of Directors authorized an increase to the existing share repurchase program from \$30.0 million to \$50.0 million. We made no stock repurchases during the three month period ended March 31, 2020 under this program. As of March 31, 2020, we had authorization to repurchase \$18.3 million remaining under the repurchase program.

Item 6. Exhibits

INDEX TO EXHIBITS

3.1	Amended and Restated Articles of Incorporation, as amended (Filed as Exhibit 3.1 to our Registration Statement on Form S-1/A filed September 10, 1997, and incorporated herein by reference)
3.2	Amended and Restated Bylaws (Filed as Exhibit 3.1 to our Current Report on Form 8-K, filed March 27, 2020 and incorporated herein by reference)
4.1	Specimen Stock Certificate (Filed as Exhibit 4.1 to our Registration Statement on Form S-1/A filed September 10, 1997, and incorporated herein by reference)
10.1	Transition and Separation Agreement by and between FARO Technologies, Inc. and Jody S. Gale, dated February 25, 2020.
10.2	Transition and Separation Agreement by and between FARO Technologies, Inc. and Robert E. Seidel, dated July 31, 2019 (Filed as Exhibit 10.1 to our Current Report on Form 8-K, filed August 2, 2019 and incorporated herein by reference)
10.3	Confidential Separation Agreement and General Release by and between FARO Technologies, Inc. and Kathleen J. Hall, dated August 26, 2019 (Filed as Exhibit 10.1 to our Current Report on Form 8-K, filed August 27, 2019 and incorporated herein by reference)
31-A	Certification of the President and Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31-B	Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32-A*	Certification of the President and Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32-B*	Certification of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.SCH	Inline XBRL Taxonomy Extension Schema Document
101.CAL	Inline XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	Inline XBRL Taxonomy Extension Label Linkbase Document
101.PRE	Inline XBRL Taxonomy Presentation Linkbase Document
101.DEF	Inline XBRL Taxonomy Extension Definition Linkbase Document
104	Cover Page Interactive Data File (formatted as inline XBRL with applicable taxonomy extension information contained in Exhibits 101.*)

* - Furnished herewith

SIGNATURE

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

FARO Technologies, Inc.

(Registrant)

Date: April 28, 2020

By: /s/ Allen Muhich

Name: Allen Muhich

Title: Chief Financial Officer

(Duly Authorized Officer and Principal Financial Officer)

FARO Technologies, Inc.**Certification Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Michael Burger, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of FARO Technologies, Inc.;
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: April 28, 2020

/s/ Michael Burger

Name: Michael Burger
Title: President and Chief Executive Officer
(Principal Executive Officer)

FARO Technologies, Inc.

Certification Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Allen Muhich, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of FARO Technologies, Inc.;
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: April 28, 2020

/s/ Allen Muhich

Name: Allen Muhich
Title: Chief Financial Officer
(Principal Financial Officer)

FARO Technologies, Inc.

Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Solely for the purposes of complying with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, I, the undersigned President and Chief Executive Officer of FARO Technologies, Inc. (the Company), hereby certify that the Quarterly Report on Form 10-Q for the quarter ended March 31, 2020 (the Report) fully complies with the requirements of Section 13(a) or 15(d) 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.

Date: April 28, 2020

/s/ Michael Burger

Name: Michael Burger

Title: President and Chief Executive Officer

(Principal Executive Officer)

FARO Technologies, Inc.

Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Solely for the purposes of complying with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, I, the undersigned Chief Financial Officer of FARO Technologies, Inc. (the Company), hereby certify that the Quarterly Report on Form 10-Q for the quarter ended March 31, 2020 (the Report) fully complies with the requirements of Section 13(a) or 15(d) 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.

Date: April 28, 2020

/s/ Allen Muhich

Name: Allen Muhich
Title: Chief Financial Officer
(Principal Financial Officer)