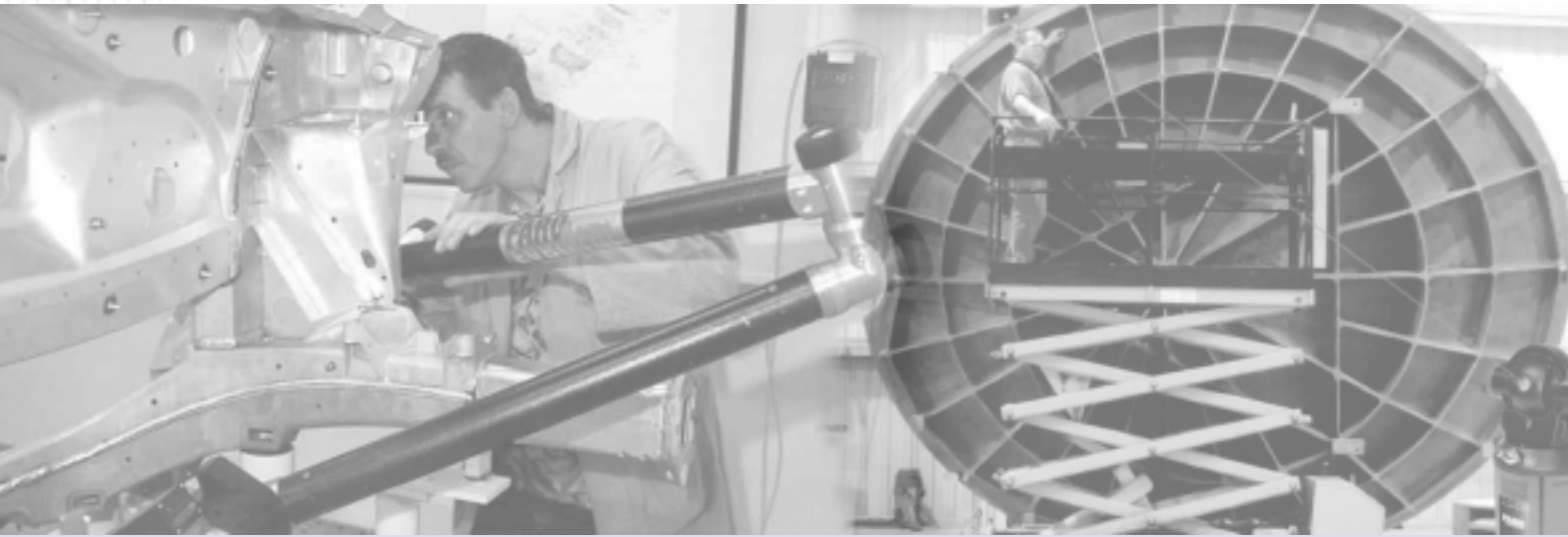


FARO®

2001 Annual Report



Financial Highlights

<i>(in millions of dollars except gross margin and earnings per share)</i>	2001	2000	1999
Sales	\$ 35.1	\$ 40.5	\$ 33.1
Gross Profit	\$ 20.8	\$ 25.7	\$ 18.9
Gross Margin%	59.3%	63.5%	57.1%
EBITDA	\$ (0.8)	\$ 2.5	\$ (4.8)
Earnings per share			
basic	\$ (0.26)	\$ 0.00	\$ (0.67)
diluted	\$ (0.26)	\$ 0.00	\$ (0.67)

(at December 31, 2001; in millions of dollars except current ratio)

Current Assets	\$ 29.4	\$ 32.3	\$ 30.3
Current Ratio	4.1	3.8	5.6
Debt	\$ 0.1	\$ 0.1	\$ 0.0
Cash provided by (used in) operating activities	\$ (0.8)	\$ 4.7	\$ 1.4
Cash and total investments	\$ 14.1	\$ 19.0	\$ 16.7



Sales
(in millions)



Gross Margin
(%)



EPS



Current Ratio



Dear Shareholder,

A year ago in this letter I expressed optimism about a significant economic recovery in the USA by the third quarter of 2001. Few in the manufacturing arena expected the actual continued slump in the economy, let alone the tragic events of September 11, which paralyzed some segments of the economy in a period of extreme uncertainty. Largely as a result of a 31% decrease in sales in the United States, FARO had its first decline in revenues (13% overall) in its history. The drop in sales in the United States was offset somewhat by an approximately level year in Europe and a 24% increase in sales in the rest of the world.

After a significant use of cash in the first quarter of the year, we quickly implemented an expense reduction program in the second quarter with a goal to return to profitability despite the continuing economic slump. As a result we reversed a use of cash in operations of \$2.2 million in the first half of 2001 to the generation of cash from operations of \$1.4 million in the second half of the year. This initiative also resulted in our first profitable quarter of 2001 in the fourth quarter of the year.

Beyond a reaction to the sluggish economy, our streamlining of expenses actually represents a shift in priorities for FARO, from a three-year period (1998-2000) marked by expansion of our product line, our geographic sales base and our customer base by sector, to a period of cost containment aimed at attaining our target financial model in 2003, with a goal of double digit bottom line as a percentage of sales.

FARO Technologies Inc. is a pioneer and leader in the Computer-Aided Manufacturing Measurement (CAM2) market. The Company believes that there are three principal forces driving the need for its products and services: 1) the widespread use by manufacturers of Computer-Aided Design (CAD) in product development that shortens product cycles, 2) the adoption by manufacturers of quality standards such as Six Sigma and ISO-9000 (and its offshoot QS-9000) that stress the measurement of every step in a manufacturing process to reduce or eliminate defects, and 3) the inability of traditional measurement devices to address many manufacturing problems, especially related to large components of products such as automobiles, aircraft and heavy-duty construction equipment.

The acquisition of SpatialMetrix Corporation ("SMX") in January 2002 provides FARO with an ability to measure up to 100 feet and completes the hardware product range contemplated for the CAM2 market as defined in 1997 when FARO went public. Economic recovery will have to accompany the achievement of our financial model goal, and in the meantime we will continue to carefully manage expenses to actual revenues.

2001 was our first full year of sales of the Faro Control Station measurement system. This product allows customers to create inspection programs (Softcheck Tools™ inspection programs) on the Faro Control Station by themselves, or to contract with FARO to create these programs. The latter does not require the customer to have inspectors with sophisticated computer skills, and provides FARO with a potential source of ongoing revenues from each product installation. In 2002 we will be trying alternative models for the promotion and delivery of these unique, industrial software products in order to increase their sales.

One measure of the potential market size for the Faro Control Station and Faro Laser Tracker products comes from a related, established technology known as Coordinate Measuring Machines (CMMs). These products do not directly compete with FARO's products, but perform similar high-accuracy, quality-control functions for many of the same customers as FARO. Traditional CMMs have

been sold in their present configuration for more than twenty years and the number of these in use today is at least 200,000 units, with an average sale price of approximately \$75,000 (range \$15,000 to over \$1.0 million)¹. For example, in 1997, 17,900 units were sold, which amounted to total revenues of \$1.3 billion.

Most of FARO's customers own one or more CMMs, suggesting that the number of CMMs might approximate the total market potential for FARO's products. Over the past seven to ten years FARO and its principal competitors have estimated total unit shipments of articulated arm type CMMs (such as our Control Station) of only 10,000-12,000, and approximately 1,500 laser trackers. Like the CMM in its first 10 years, the Faro Control Station and Faro Laser Tracker have not yet become a standard. On this basis, we see strong growth potential for FARO's products.

FARO will strive to maintain its leadership in supplying the CAM2 market during its upcoming growth period while maintaining control over cash flow, and ultimately delivering sustained earnings growth.



Simon Raab
Chairman, President, and Chief Executive Officer

The forward-looking statements in this letter, such as statements about our plans, objectives, projections, expectations, assumptions, strategies, or future events, are not guarantees of future performance and are subject to a number of risks, uncertainties, and other factors that could cause actual results to differ materially from those expressed or implied by these forward-looking statements. These factors include those discussed above and in the accompanying Annual Report on Form 10-K.

¹ Total Coordinate Measuring Machine Tools Market: Unit Shipment and Revenue Forecasts (World) 1994-2004. From World Special Machine Tools Market Copyright 1998, Frost & Sullivan

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

(Mark One)

- Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the fiscal year ended December 31, 2001 or
- Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the transition period from _____ to _____

Commission File Number 0-23081

FARO TECHNOLOGIES, INC.

(Exact name of Registrant as specified in its charter)

Florida

59-3157093

(State or other jurisdiction
of incorporation or organization)

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

125 Technology Park, Lake Mary, FL

32746

(Address of Principal Executive Offices)

(Zip Code)

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

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

Title of Each Class
None

**Name of Each Exchange
On Which Registered**
None

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

Common Stock, par value \$.001

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

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

As of March 20, 2002, there were outstanding 11,420,384 shares of Common Stock. The aggregate market value of the voting stock held by non-affiliates of the Registrant based on the last sale price reported on the NASDAQ National Market as of March 20, 2002 was \$31,291,852.

DOCUMENTS INCORPORATED BY REFERENCE

Documents

Form 10-K Reference

Portions of the Proxy Statement, dated March 29, 2002

Part III, Items 10-13

PART I
CAUTIONARY STATEMENTS FOR FORWARD-LOOKING INFORMATION

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

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

ITEM 1. BUSINESS.

Industry Background

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

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

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

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

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

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

some parts or assemblies cannot be measured at all using traditional devices, because of problems of access.

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

FARO's Business

The Company designs, develops, markets and supports portable, software-driven, 3-D measurement systems that are used in a broad range of manufacturing and industrial applications. The Company's principal products are the Control Station and the Control Station Pro (formerly FAROArm) articulated measuring devices and their companion Soft Check Tool and CAM2 software, respectively, which provide for CAD-based inspection and factory-level statistical process control. Together, these products integrate the measurement and quality inspection function with CAD software to improve productivity, enhance product quality and decrease rework and scrap in the manufacturing process. The Company uses the acronym "CAM2" for this process, which stands for Computer-aided manufacturing measurement. The Company's products bring precision measurement, quality inspection and specification conformance capabilities, integrated with leading CAD software, to the factory floor. The Company is a pioneer in the development and marketing of 3-D measurement technology in manufacturing and industrial applications and currently holds or has pending 29 patents in the United States, 19 of which also are held or pending in other jurisdictions. The Company's products have been purchased by approximately 2,900 customers worldwide, ranging from small machine shops to such large manufacturing and industrial companies as Audi, Bell Helicopter, Boeing, British Aerospace, Caterpillar, DaimlerChrysler, General Electric, General Motors, Honda, Johnson Controls, Komatsu Dresser, Lockheed Martin, Siemens and Volkswagen among many others. See additional information about FARO's business as set forth under the caption "Recent Developments" below.

Recent Developments

On January 16, 2002, the Company acquired SpatialMetrix Corporation ("SMX"), a leading manufacturer and supplier of laser trackers and targets, metrology software, and contract inspection services. In connection therewith, the Company issued 500,000 shares of the Company's common stock to former SMX shareholders and satisfied certain debt obligations of SMX. Additionally, in connection with the SMX acquisition, the Company issued an additional 350,000 shares of FARO common stock and paid \$2.0 million in cash to fully satisfy SMX's obligations to its two lenders. The Company also assumed and/or satisfied other obligations of SMX, including approximately \$2.9 million in financing provided by the Company to SMX between April 1, 2001 and the completion of the acquisition. The acquisition will be recorded utilizing the purchase method of accounting.

SMX is based in Kennett Square, Pennsylvania and has approximately 60 employees. The Company believes that this acquisition provides FARO an excellent opportunity to expand its product line with a complementary technology for its existing worldwide customer base. The SMX new generation laser tracker is a high-accuracy, portable 3-dimensional measurement technology with a range of over 100 feet, which when combined with the Company's Control Station product line and their companion Soft Check Tool and CAM2 software, results in a portable, computer-based product

line capable of handling a much wider range of manufacturing measurement applications.

The Company estimates that SMX has 35% of the installed laser tracker market. The Company exercised its contractual right to acquire SMX only after the successful design by SMX of a new generation laser tracker, which the Company expects to sell at competitive prices compared to the previous generation SMX tracker, and competitor's current products. SMX's previous generation laser tracker, which was introduced in 1996, was sold until September 2001. SMX halted production and sale of its earlier generation laser tracker in September 2001 as part of a settlement of a patent infringement lawsuit. The operations of SMX are expected to contribute favorably to the Company's revenue growth and results of operations once the new generation tracker begins to ship. The Company expects to start shipping new generation tracker products some time in the first half of 2002. Until then, the operations of SMX are expected to result in revenues of at least \$1.0 million per quarter resulting from the sale of parts, comprehensive support, and technology consulting services. Operating expenses are estimated to be approximately \$1.9 million per quarter.

FARO Products

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

Articulated Arm: Each articulated arm is comprised of three major joints, each of which may consist of one, two or three axes of motion. The articulated arm is available in a variety of sizes, configurations and precision levels that are suitable for a broad range of applications. To take a measurement, the operator simply touches the object to be measured with a probe at the end of the arm and presses a button. Data can be captured as either individual points or a series of points. Digital rotational transducers located at each of the joints of the arm measure the angles at those joints. This rotational measurement data is transmitted to an on-board controller that converts the arm angles to precise locations in 3-D space using "xyz" position coordinates and "ijk" orientation coordinates.

Touch Screen Computer: One of the main goals of the Control Station system is to provide computer-based inspection without requiring the operator to program the inspection software or even have to touch a keyboard. As such the company developed software (see the following section) which runs entirely by the operator touching simple icons on the touch screen, not unlike how a restaurant waiter enters an order. The computers are not manufactured by the Company, but are purchased from various suppliers.

SoftCheck Tool Software: A SoftCheck Tool is custom software program designed to lead an operator through the measurement process with minimal training. The extensive use of photos of the customer's part assist in achieving this goal. These programs are created by the Company from specifications provided by the customer. When the customer changes its part production it then contracts with the Company to create updated or new SoftCheck Tool programs. The Company believes that providing this "prefabricated" inspection software will increase acceptance of the Control Station by new and existing customers as it significantly reduces the need for the customer to have sophisticated programmers and inspectors on the factory floor.

The Control Station Pro. The Control Station Pro is a combination of an articulated arm, standard computer (with keyboard), and one of the Company's following CAM2 Software programs: CAM2 Design, CAM2 Measure, CAM2 Automotive. In contrast to the basic Control Station, Control

Station Pro customers may write their own inspection programs using the Company's CAM2 software. This product requires more sophisticated operators, and is often used to measure multiple parts in the same day, while the basic Control Station is often dedicated to the same part.

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

CAM2 CAD Analyzer® allows users to convert very large, complex CAD files from engineering workstations into simpler graphical images which make them available on a personal computer level for numerous applications throughout the factory from assembly and inspection planning, to the creation of user or service manuals.

CAM2 Measure® allows users to compare measurements of manufactured components or assemblies with the corresponding CAD data for the components or assemblies. CAM2 Measure® is offered with the FAROArm® and is also offered as an unbundled product.

CAM2 Automotive® also allows users to compare measurements of manufactured components with the corresponding CAD file. Unlike CAM2 Measure®, CAM2 Automotive® is especially suited to the measurement of very large components with large CAD files, typical of those in the automotive industry. CAM2 Automotive® is offered with the FAROArm® and is also offered as an unbundled product.

CAM2 SPC Process® allows for the collection, organization, and presentation of measurement data factory-wide. Not limited to measurements from the FAROArm®, CAM2 SPC Process® accepts data from CMMs and other computer-based measurement devices from many different measurement applications along the production line.

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

Customers

The Company's products have been purchased by approximately 2,900 customers worldwide, ranging from small machine shops to large manufacturing and industrial companies. The Company's ten largest customers by revenue represented an aggregate of 7.6% of the Company's total revenues in 2001. No customer represented more than 1.1% of the Company's sales in 2001. The following table illustrates, by vertical market, the Company's diverse customer base:

AEROSPACE	AUTOMOTIVE	ELECTRIC UTILITIES AND MANUFACTURERS
Lear Corporation	Audi	General Electric
Boeing	DaimlerChrysler	Westinghouse
Lockheed Martin	General Motors	Southern California Edison
Northrop Grumman	Ford	Tennessee Valley Authority
GE Aerospace	Honda	ABB Power Generation
Orbital Sciences	Hyundai Motors	Hydro Quebec
Harris Corporation	Toyota	TurboCare
Dee Howard	Nissan	Potomac Electric Power
Hughes Brothers	Porsche	Turbine Technology International
Nordam Repair Div.	Volkswagen	Siemens Power Corporation
Ball Aerospace	BMW	

HEAVY EQUIPMENT

John Deere
Case Corporation
Caterpillar
Komatsu Dresser
Clark Industries
Ingersol Rand
AGCO
Hay and Forage

HEAVY EQUIPMENT

Melroe Company
Volvo Construction Equipment
Renault Agriculture

CONSUMER PRODUCTS

Harley Davidson
Polaris
Bombardier
Xerox
Hewlett Packard
Fountain Power Boats
Taylor Made Products
Mercury Marine

CONSUMER PRODUCTS

Amana
Braun Corporation
Eastman Kodak

MISCELLANEOUS

Bill Elliot Racing
American Sheet Metal
Monyo Oil Field Products
Atlas Foundry
Molded Fiberglass
Creative Foam Products
Able Design Plastics
APW Enclosures

MISCELLANEOUS

Applied Composites
Kolenda Tool and Die
Charmalloy Castings

Sales and Marketing

The Company directs its sales and marketing efforts from its headquarters in Lake Mary, Florida. At December 31, 2001, the Company employed 85 sales and marketing professionals who operate from the Company's headquarters, and include eight North American regional sales representatives located in Charlotte, Chicago, Columbus (Ohio), Dallas, Detroit, Los Angeles, Seattle and Toronto, three German regional sales offices in Stuttgart, Munich, and Gladbeck, and sales offices located in Coventry, United Kingdom, suburban Paris, France, in Barcelona, Spain, Rivoli, Italy and in Nagoya, Japan. The Company also utilizes 12 North American and 27 international distributors primarily in territories where the Company does not have regional sales offices. See Footnote 15 to the Notes to Consolidated Financial Statements, incorporated herein by reference to Item 8 hereof, for financial information about the Company's foreign and domestic operations and export sales required by this Item.

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

The Company employs a variety of marketing techniques, including direct mail, trade shows, and advertising in trade journals, and proactively seeks publicity opportunities for customer testimonials. Management believes that word-of-mouth advertising from the Company's existing customers provides an important marketing advantage. The Company also uses computerized sales and marketing software system with telemarketing, lead tracking and analysis, as well as customer support capabilities. Finally, the Company utilizes its state-of-the-art web site to promote its product offerings. Each of the Company's sales offices is linked electronically to the Company's headquarters.

In March 1999, the Company entered into an OEM agreement with Brown & Sharpe Manufacturing Company ("Brown & Sharpe"), a unit of Hexagon, A. B. of Stockholm, Sweden that is a world leader in the manufacture of traditional CMMs and other metrology products. Brown & Sharpe markets the FAROArm® worldwide under the name GAGE 2000 A. The agreement, which grants Brown & Sharpe non-exclusive distribution right worldwide, expires in March 2002, and is renewable for successive one-year terms. The Company anticipates that this agreement will be renewed.

Research and Development

The Company believes that its future success depends on its ability to achieve technological leadership, which will require ongoing enhancements of its products and the development of new

applications and products that provide 3-D measurement solutions. Accordingly, the Company intends to continue to make substantial investments in the development of new technologies, the commercialization of new products that build on the Company's existing technological base and the enhancement and development of additional applications for its products.

The Company's research and development efforts are directed primarily at enhancing the functional adaptability of its current products and developing new and innovative products that respond to specific requirements of the emerging market for 3-D measurement systems. The Company's research and development efforts have been devoted primarily to mechanical hardware, electronics and software. The Company's engineering development efforts will continue to focus on the FAROArm® and the family of CAM2 products. Significant efforts are also being directed toward the development of new Control Station measurement technologies and additional features for existing products. See "Technology".

At December 31, 2001, the Company employed 31 scientists and technicians in its research and development efforts. Research and development expenses were approximately \$3.4 million in 2001 as compared to \$3.6 million in 2000 and \$3.8 million in 1999. Research and development activities, especially with respect to new products and technologies, are subject to significant risks, and there can be no assurance that any of the Company's research and development activities will be completed successfully or on schedule, or, if so completed, will be commercially accepted.

Technology

The primary measurement function of the articulated arm in the Control Station and Control Station Pro is to provide orientation and position information with respect to the probe at the end of the arm. This information is processed by software and can be compared to the desired dimensions contained in the CAD data of a production part or assembly to determine whether the measured data conforms to such dimensional specifications.

To accomplish this measurement function, the articulated arm is designed with six or seven joints. The arm consists of aluminum links and rotating joints that are combined in different lengths and configurations, resulting in human armlike characteristics. Each joint is instrumented with a rotational transducer, a device used to measure rotation, which is based on optical digital technology. The position and orientation of the probe in three dimensions is determined by applying trigonometric calculations at each joint. The position of the end of a link of the arm can be determined by using the angle measured and the known length of the link. Through a complex summation of these calculations at each joint, the position and orientation of the probe is determined.

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

Mechanical Hardware. The articulated arm is designed to function in diverse environments and under rigorous physical conditions. The arm monitors its temperature to adjust for environments ranging from -10 degrees to +50 degrees Celsius. The arm is constructed of pre-stressed precision bearings to resist shock loads. Low production costs are attained by the proprietary combination of reasonably priced electromechanical components accompanied by the optimization and on-board storage of calibration data. Many of the Company's innovations relate to the environmental adaptability of its products. Significant features include integrated counter-balancing, configuration convertibility and temperature compensation.

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

Software. CAM2 is a Windows-based, 32-bit application family written for the most recent PC-based technology. CAM2 has been entirely designed and programmed by the Company utilizing field input and industry wide beta site installations. CAM2 CADanalyser® is a family member for viewing, analyzing and browsing CAD files. CAM2 Measure® is complete 3D measurement application written entirely on the ACIS CAD development platform. Family member CAM2 Automotive® is also a complete 3D measurement software designed for very large CAD files and for specific Automotive applications and is written using a FARO's proprietary graphics display engine. Family member CAM2 SPC Process® is designed for plant wide dimensional data acquisition and presentation in classical SPC (Statistical Process Control) formats for plant-wide quality control. CAM2 Open Measure is a version of CAM2 Measure which can be adapted to any CAD platform. This permits CAD users to have a complete 3D measurement application operating on their native CAD platform.

All the CAM2 family members are written in the C++ development language using Microsoft Foundation Class (MFC) standards. The software fully implements UNICODE standards for worldwide translation allowing the Company to create foreign language versions to enter international markets more effectively. The software is developed with the cooperation of diverse user beta sites and a well-developed system for tracking and implementing market demands. The Company's software products are available in seven (7) languages worldwide.

Intellectual Property

The Company holds or has pending 29 patents in the United States, 19 of which are also held or pending in other jurisdictions. The Company also has 12 registered trademarks in the United States, 26 foreign registered trademarks, 6 trademark applications pending in the United States and 4 foreign trademark applications pending. The Company also has 45 URL domain names worldwide registered.

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

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

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

Manufacturing and Assembly

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

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

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

Competition

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

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

than the Company. As the market for laser trackers and our portable coordinate measurement machines expands, additional competition may emerge and the Company's existing and future competitors may commit more resources to the markets in which the Company participates.

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

Backlog

At December 31, 2001, the Company had orders representing approximately \$706,000 in product sales outstanding. The majority of such orders were shipped by March 20, 2002. Additionally, the Company had orders representing approximately \$1.0 million in warranty, training and service sales outstanding at December 31, 2001.

Employees

At December 31, 2001, the Company had 235 full-time employees, consisting of 85 sales and marketing professionals, 29 production staff, 31 research and development staff, 44 administrative staff, and 46 customer service/application engineering specialists. The Company is not a party to any collective bargaining agreements. The Company believes its employee relations are good. Management believes that its future growth and success will depend in part on its ability to retain and continue to attract highly skilled personnel. The Company anticipates that it will obtain the additional personnel required to satisfy its staffing requirements over the foreseeable future.

Management of the Registrant

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

<u>Name</u>	<u>Age</u>	<u>Principal Position</u>
Simon Raab, Ph.D.	49	Chairman of the Board, Chief Executive Officer, and President
Gregory A. Fraser, Ph.D.	47	Executive Vice President, Secretary, and Treasurer
Wendelin K.J. Scharbach	46	Managing Director of FARO Europe
Joanne M. Karimi	43	Vice President of Human Resources
Edward M. Pelshaw	43	Vice President of Manufacturing
Allen Sajedi	42	Vice President and Chief Technical Officer

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

Gregory A. Fraser, Ph.D., a co-founder of the Company, has served as Executive Vice President, Secretary, and Treasurer since August 1999. Prior to that Mr. Fraser served as Chief Financial Officer and Executive Vice President since May 1997 and as Secretary, Treasurer and a director of the Company since its inception in 1982. Mr. Fraser holds a Ph.D. in Mechanical

Engineering from McGill University, Montreal, Canada, a Masters of Theoretical and Applied Mechanics from Northwestern University and a Bachelor of Science and Bachelor of Mechanical Engineering from Northwestern University.

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

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

Edward M. Pelshaw has served as Vice President of Manufacturing of the Company since January 2000. Prior to that Mr. Pelshaw served as Director of Manufacturing of the Company since 1997, and as Purchasing Manager since 1996. Prior to that, Mr. Pelshaw served as Senior Supply and Logistic Officer with the U.S. Army. Mr. Pelshaw holds an MBA from the Webster University and a Bachelor of Science degree from Hawaii Pacific University.

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

ITEM 2. PROPERTIES.

The Company's headquarters and principal operations are located in a leased building in Lake Mary, Florida containing approximately 35,000 square feet. The Company's European headquarters are located in a leased building in Stuttgart, Germany containing approximately 14,000 square feet. The Company also has a combined sales and research and development facility that is located in a leased building in Aveiro, Portugal containing approximately 2,800 square feet. The Company believes that its current facilities will be adequate for its foreseeable needs and that it will be able to locate suitable space for additional regional offices as those needs develop.

In addition, the Company has seven sales offices in Europe, a sales office in each Canada and Japan. The Company leases all of the sales offices. The information required by the remainder of this Item is incorporated herein by reference to Exhibit 99.1 attached hereto.

ITEM 3. LEGAL PROCEEDINGS.

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

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

No matters were submitted to a vote of security holders during the last quarter of calendar 2001.

PART II

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

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

	2001		2000	
	High	Low	High	Low
First Quarter	4 ³ / ₈	2 ³ / ₁₆	5 ⁷ / ₈	2 ³ / ₈
Second Quarter	2 ⁷ / ₈	1 ¹³ / ₃₂	3 ²⁹ / ₃₂	2 ³ / ₈
Third Quarter	2 ⁶³ / ₆₄	1 ¹⁹ / ₃₂	5 ¹ / ₂	3
Fourth Quarter	2 ³¹ / ₆₄	1 ¹⁹ / ₆₄	4 ¹⁵ / ₁₆	2 ²⁵ / ₃₂

The Company has not paid any cash dividends on its Common Stock to date. The payment of dividends, if any in the future is within the discretion of the Board of Directors and will depend on the Company's earnings, its capital requirements and financial condition, and may be restricted by future credit arrangements entered into by the Company. The Company expects to retain future earnings for use in operating and expanding its business and does not anticipate paying any cash dividends in the reasonably foreseeable future. As of March 20, 2002, the last sale price of the Company's Common Stock was \$2.74, and there were approximately 81 holders of record of Common Stock. The Company believes that there are approximately 1,394 beneficial owners of its Common Stock.

On August 26, 1998 the Board of Directors authorized the officers of the Company, without further approval of the Board, to purchase in the open market up to a maximum of one million shares of the Company's Common Stock. In the fiscal year 1998, the Company purchased 40,000 shares of its Common Stock in the open market under such stock repurchase plan. During the three years in the period ended December 31, 2001 the Company did not purchase any shares of its Common Stock in the open market.

ITEM 6. SELECTED FINANCIAL DATA.

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

	Years Ended December 31					
	Pro Forma(1)	Historical				
	2001	2001	2000	1999	1998	1997
Statement of Operations Data:						
Sales	\$46,400,491	\$35,113,596	\$40,452,913	\$33,105,740	\$27,514,699	\$23,516,385
Gross profit	23,617,844	20,809,513	25,704,285	18,944,802	16,223,386	13,905,547
Income (loss) from operations ...	(10,261,433)	(4,369,710)	(697,100)	(9,705,477)(2)	(5,684,607)(3)	4,932,276
Income (loss) before income taxes	(8,416,101)	(2,506,226)	464,198	(8,516,286)	(4,480,562)	5,321,260
Net income (loss)	(8,757,839)	(2,847,964)	39,517	(7,394,822)	(4,931,094)	3,206,630
Net income (loss) per common share:						
Basic	\$ (0.74)	\$ (0.26)	\$ —	\$ (0.67)	\$ (0.46)	\$ 0.41
Diluted	\$ (0.74)	\$ (0.26)	—	(0.67)	(0.46)	0.39
Weighted average common shares Outstanding:						
Basic	11,882,449	11,032,449	11,021,606	11,015,140	10,632,708	7,831,715
Diluted	11,882,449	11,032,449	11,094,144	11,015,140	10,632,708	8,189,048

	At December 31,					
	Pro Forma(1)	Historical				
	2001	2001	2000	1999	1998	1997
Consolidated Balance Sheet Data:						
Working capital	18,143,563	\$22,303,204	\$23,672,736	\$24,869,844	\$30,997,769	\$37,277,545
Total assets	44,441,451	39,654,124	44,699,274	42,103,912	49,120,147	41,192,333
Total debt	55,506	55,506	49,260	26,236	337,710	—
Total shareholders' equity	32,488,788	32,336,461	35,955,453	36,599,346	45,375,391	38,939,411

- (1) The pro forma statement of operations and balance sheet data reflects a change to operations of \$1.7 million to record amortization of intangible assets acquired (including \$1.2 million for amortization of goodwill) and an adjustment to reduce interest expense (and accrued liabilities) of \$866,000 related to SMX bank debt paid-off upon completion of the acquisition.
- (2) Includes a charge to write down development and core technology in the amount of \$3.1 million.
- (3) Includes a charge for in-process research and development in connection with the German acquisition in the amount of \$3.2 million.

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

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

Overview

The Company designs, develops, markets and supports portable, software-driven, 3D measurement systems that are used in a broad range of manufacturing and industrial applications. The Company's principal products are the Control Station and the Control Station Pro (formerly FAROArm®) articulated measuring devices and their companion Soft Check Tool and CAM2 software, respectively, which provide for CAD-based inspection and factory-level statistical process control. Together, these products integrate the measurement and quality inspection function with CAD software to improve productivity, enhance product quality and decrease rework and scrap in the

manufacturing process. The Company's products bring precision measurement, quality inspection and specification conformance capabilities, integrated with leading CAD software, to the factory floor. The Company is a pioneer in the development and marketing of 3-D measurement technology in manufacturing and industrial applications and currently holds or has pending 29 patents in the United States, 19 of which also are held or pending in other jurisdictions. The Company's products have been purchased by approximately 2,900 customers worldwide, ranging from small machine shops to such large manufacturing and industrial companies as Audi, Bell Helicopter, Boeing, British Aerospace, Caterpillar, DaimlerChrysler, General Electric, General Motors, Honda, Johnson Controls, Komatsu Dresser, Lockheed Martin, Siemens and Volkswagen among many others.

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

In 1992, in an effort to capitalize on a demand for 3-D portable measurement tools for the factory floor, the Company made a strategic decision to target its core measurement technology to the manufacturing and industrial markets. In order to focus on manufacturing and industrial applications of its technology, the Company phased out the direct sale of its medical products and entered into licensing agreements with two major neurosurgical companies for its medical technology. Since 1992, the Company has entered into additional licensing agreements for the use of its technology for medical applications. In 1995, the Company made a strategic decision to target international markets. The Company established sales offices in France and Germany in 1996, Great Britain in 1997, Japan and Spain in 2000 and Italy in 2001. International sales represented 60.8%, 50.6% and 46.6% of sales in 2001, 2000 and 1999, respectively.

The Company derives revenues primarily from the sale of its 3-D measurement equipment, and its related multi-faceted Soft Check Tool and CAM2 software. Revenue related to these products is recognized upon shipment. Going forward, the Company also expects to generate revenue from the sale of its laser tracker product.

Revenue growth has historically resulted from increased unit sales due to an expanded sales effort that included the addition of sales personnel at existing offices, the opening of new sales offices and expanded promotional efforts which include a multilingual web site and Company demo CD. In 2000 the Company introduced The Control Station with SoftCheck Tools, new accessory items such as The FARO Rail, the FARO Powerhouse and new versions of all the members of the CAM2 software family. In January 2001, the Company acquired SpatialMetrix Corporation ("SMX"), a leading manufacturer and supplier of laser trackers and targets, metrology software, and contract inspection services. The SMX new generation laser tracker is a high-accuracy, portable 3-dimensional measurement technology. The Company expects to begin shipments of this laser tracker in the second quarter of 2002.

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

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

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

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

During 2001, the Company's sales growth has been adversely affected by the economic slowdown currently affecting the United States and Europe to a lesser extent. We expect that the current economic slowdown will continue to adversely affect U. S. sales and the Company's growth rate in other geographic markets during the first half of 2002. Accordingly, the Company adopted a cost reduction plan during the third quarter of 2001. This plan includes reducing discretionary spending, canceling certain non-strategic product development and marketing projects, and a reduction of approximately 15% of the company's U.S. workforce, or about 30 people, primarily in administration, research and development, and manufacturing.

Results of Operations

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

	Year Ended December 31,		
	<u>2001</u>	<u>2000</u>	<u>1999</u>
Statement of Operations Data:			
Sales	100.0 %	100.0 %	100.0 %
Cost of Sales	<u>40.7 %</u>	<u>36.5 %</u>	<u>42.7 %</u>
Gross profit	59.3 %	63.5 %	57.3 %
Operating expenses:			
Selling	38.3 %	34.7 %	36.7 %
General and administrative	16.5 %	14.2 %	15.0 %
Depreciation and amortization	7.3 %	7.2 %	13.5 %
Research and development	9.6 %	8.8 %	11.6 %
Employee stock options	—	.3 %	0.5 %
Impairment loss on acquired intangible assets	—	—	9.3 %
Total operating expenses	<u>71.7 %</u>	<u>65.3 %</u>	<u>86.6 %</u>
Loss from operations	(12.4)%	(1.7)%	(29.3)%
Interest income	2.6 %	2.1 %	2.2 %
Other income, net	2.7 %	.7 %	1.4 %
Interest expense	—	—	—
Net income (loss) before income taxes	(7.1)%	1.1 %	(25.7)%
Income tax expense (benefit)	1.0 %	1.0 %	(3.4)%
Net income (loss)	<u>(8.1)%</u>	<u>0.1 %</u>	<u>(22.3)%</u>

2001 Compared to 2000

Sales. Sales decreased \$5.3 million, or 13.2%, from \$40.5 million in 2000 to \$35.1 million in 2001. The decrease resulted from lower sales in the U.S. (\$6.2 million, or 31.2%, from \$20.0 million

to \$13.8 million) and Germany (\$1.6 million, or 18.9%, from \$8.6 million to \$6.9 million), partially offset by increased sales in the remainder of the world (an increase of \$2.5 million, or 21.2%, from \$11.9 million to \$14.4 million). The decrease in the U.S. primarily resulted from lower product unit sales resulting mainly from the slowing U.S. economy throughout 2001. The decrease in Germany reflects the adverse translation effect (approximately \$700,000) of the stronger U.S. dollar in 2001.

Gross profit. Gross profit decreased by \$4.9 million, or 19.0%, from \$25.7 million in 2000 to \$20.8 million in 2001. Gross margin decreased to 59.3% in 2001 from 63.5% in 2000. The decrease in gross margin resulted primarily from downward pressure on unit prices in the U.S. and Europe and the translation effect of the stronger U.S. dollar on international sales.

Selling expenses. Selling expenses decreased \$598,000, or 4.3%, from \$14.0 million in 2000 to \$13.4 million in 2001. This decrease was primarily a result of lower selling expenses in the United States (\$1.3 million) resulting from cost reduction efforts in the second half of 2001 and lower sales commissions on lower U.S. sales in 2001 and the translation effect of the stronger U.S. dollar in 2001 on the European selling expenses (approximately \$275,000), offset in part by higher selling expenses in Europe (\$670,000) and in Japan (\$282,000), principally as a result of higher compensation and marketing expenses, offset in part by.

General and administrative expenses. General and administrative expenses increased by \$50,000, or 1.0%, from \$5,763,000 in 2000 to \$5,813,000 in 2001. The increase was due to new operations in Japan (\$188,000), offset in part by lower expenses in the U.S. (\$53,000) and Europe (\$15,000) and the effect of the stronger U.S. dollar in 2001 (approximately \$70,000).

Depreciation and amortization expenses. Depreciation and amortization expenses decreased by \$372,000, or 12.7%, from \$2.9 million in 2000 to \$2.6 million in 2001 primarily as a result of assets becoming fully amortized in 2001.

Research and development expenses. Research and development expenses decreased by \$178,000, or 5.0%, from \$3.5 million in 2000 to \$3.4 million in 2001. The decrease was due to decline across many expense categories in Europe (\$286,000) and the translation effect of the stronger U.S. dollar in 2001 (\$50,000) on the European R&D expenses, offset in part by increase across many expense categories in the United States (\$157,000).

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

Other income, net. Other income, net increased by \$663,000, from \$302,000 in 2000 to \$965,000 in 2001. The increase resulted principally from higher royalty income in 2001 and lower foreign exchange losses in Europe in 2001.

Income tax expense. Income tax expense decreased by \$83,000, from \$425,000 in 2000 to \$342,000 in 2001. The net tax expense resulted from an increase in the valuation allowance for the Company's US deferred income tax assets offset by benefits realized by the utilization of German net operating loss carryforwards which were previously reserved. At December 31, 2001 the Company

has deferred income tax assets of approximately \$7.7 million (including \$1.4 million related to the U.S. operations and \$6.3 million related to foreign operations) which are offset by a valuation allowance of approximately \$7.6 million. These deferred income tax assets are primarily attributable to net operating loss carryforwards and intangible assets for which future income tax benefits may be realized.

Net income (loss). The Company's net income (loss) decreased by \$2,888,000, from net income of \$40,000 in 2000 to a loss of \$2,848,000 in 2001 to due to the factors mentioned above.

2000 Compared to 1999

Sales. Sales increased \$7.3 million, or 22.2%, from \$33.1 million in 1999 to \$40.5 million in 2000. The increase resulted from increases in the U.S. (\$2.3 million, or 13.1%, from \$17.7 million to \$20.0 million), Europe (\$3.5 million, or 32.8%, from \$10.6 million to \$14.1 million) and the remainder of the world (an increase of \$1.6 million, or 32.3%, from \$4.8 million to \$6.4 million). The increase primarily resulted from higher product unit sales in all geographic regions, partially offset by the effect of the stronger U.S. Dollar in 2000 (approximately \$1.8 million).

Gross profit. Gross profit increased by \$6.8 million, or 35.7%, from \$18.9 million in 1999 to \$25.7 million in 2000. Gross margin increased to 63.5% in 2000 from 57.3% in 1999. The increase in gross margin was primarily a result of cost reductions for computer hardware and software products in 2000, partially offset by the effect of the stronger U.S. dollar.

Selling expenses. Selling expenses increased \$1.9 million, or 15.6%, from \$12.1 million in 1999 to \$14.0 million in 2000. This increase was primarily a result of higher selling expenses in the United States (\$1.1 million) and in Europe (\$1.2 million), principally as a result of higher compensation and marketing expenses, offset in part by the effect of the stronger U.S. dollar in 2000 (approximately \$550,000).

General and administrative expenses. General and administrative expenses increased by \$800,000, or 15.9%, from \$5.0 million in 1999 to \$5.8 million in 2000. The increase was due to increases across many categories in the U.S. (\$720,000) and in Europe (\$80,000), offset in part by the effect of the stronger U.S. dollar in 2000 (approximately \$150,000).

Depreciation and amortization expenses. Depreciation and amortization expenses decreased by \$1.5 million, or 34.4%, from \$4.5 million in 1999 to \$2.9 million in 2000. The decrease primarily resulted from the \$3,073,000 impairment loss on acquired intangible assets at the end of 1999, which reduced the amount of acquired intangible assets to be amortized, offset in part by depreciation on assets acquired in 2000.

Research and development expenses. Research and development expenses decreased by \$300,000, or 7.3%, from \$3.8 million in 1999 to \$3.5 million in 2000. The decrease was due to decreases across many expense categories in the United States (\$234,000), and to by the effect of the stronger U.S. dollar in 2000 (\$130,000) on European expenses, offset in part by increase, in local currency, across many categories in Europe (\$85,000).

Employee stock option expenses. Employee stock option expenses decreased by \$46,000, or 26.9%, from \$169,000 in 1999 to \$123,000 in 2000. This decrease was a result of a reduction in the amortized deferred compensation expense related to stock options issued in 1995 and 1997. For all options issued in 2000 and 1999, no compensation expense was recorded, as the exercise price of the options was equal to the market price on the day of the grant.

Impairment loss on acquired intangible assets. An unusual impairment loss of \$3.1 million was recorded in 1999 to reflect an impairment of the intangible assets resulting from the German acquisition on May 15, 1998. The impairment resulted from the Company's revised forecast of the cash flows expected from the developed and core technology acquired with the German acquisition.

Interest income. Interest income increased by \$144,000, from \$716,000 in 1999 to \$860,000 in 2000. The increase was primarily attributable to higher average yields of interest-earning cash, cash equivalents, and investments held and higher average principal amounts invested in 2000 (see Liquidity and Capital Resources below).

Other income. Other income decreased by \$173,000, from \$475,000 in 1999 to \$302,000 in 2000. The decrease resulted principally from foreign exchange losses in 2000.

Income tax expense (benefit). Income tax expense (benefit) increased by \$1.5 million, from a benefit of \$1.1 million in 1999 to expense of \$425,000 in 2000. The tax expense resulted from the Company's U.S. operation's taxable earnings in 2000. The Company has deferred income tax assets related to its German operations which are fully offset against a valuation allowance. At December 31, 2000, the Company's foreign subsidiaries had deferred income tax assets relating to net operating loss carryforwards, which do not expire, and intangible assets of \$3,360,729 and \$3,131,325, respectively.

Net income (loss). The Company's net income (loss) increased by \$7.4 million, from a loss of \$7.4 million in 1999 to net income of \$40,000 in 2000 due to the factors mentioned above.

Recent Developments

On January 16, 2002, the Company acquired SpatialMetrix Corporation ("SMX") in exchange for 500,000 shares of FARO common stock and the satisfaction by the Company of certain obligations of SMX. In connection therewith, the Company issued an additional 350,000 shares of FARO common stock and paid \$2.0 million in cash to fully satisfy SMX's obligations to its two lenders. The Company also assumed and/or satisfied other obligations of SMX, including approximately \$2.9 million in financing provided by the Company to SMX between April 1, 2001 and the completion of the acquisition. The acquisition will be recorded utilizing the purchase method of accounting in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets." The Company estimates that SMX has 35% of the installed laser tracker market. The Company exercised its contractual right to acquire SMX only after the successful design by SMX of a new generation laser tracker, which the Company expects to sell at competitive prices compared to the previous generation SMX tracker, and competitor's current products. SMX's previous generation laser tracker, which was introduced in 1996, was sold until September 2001. SMX halted production and sale of its earlier generation laser tracker in September 2001 as part of a settlement of a patent infringement lawsuit. The operations of SMX are expected to contribute favorably to the Company's revenue growth and results of operations once the new generation tracker begins to ship. The Company expects to start shipping new generation tracker some time in the first half of 2002. Until then, the operations of SMX are expected to result in revenues of at least \$1.0 million per quarter resulting from the sale of parts, comprehensive support, and technology consulting services and in additional operating expenses in the amount of approximately \$1.9 million per quarter.

Liquidity and Capital Resources

Since 1997, the Company has financed its operations primarily from cash provided by operating activities and from the proceeds of its 1997 initial public offering of Common Stock (approximately

\$31.7 million). Total marketable securities (cash and cash equivalents, short-term investments and investments) at December 31, 2001 were \$14.1 million, compared to \$19.0 million at December 31, 2000.

For the year ended December 31, 2001, net cash used in operating activities was \$842,000 compared to net cash provided by operating activities of \$4.7 million in 2000. Net cash used in operating activities increased primarily due to the operational loss in 2001. Net cash (excluding short-term investments and investments) provided by investing activities for the year ended December 31, 2001 was \$267,000, compared to cash used in investing activities of \$3.1 million in 2000. The increase in net cash provided by investing activities in 2001 was primarily due to net decreases in short-term investments and investments in 2001 of \$4.1 million, offset primarily by loans to SMX \$2.9 million (see Note 16 of Notes to Consolidated Financial Statements contained in Item 8 herein) and purchases of property and equipment of \$788,000. Net cash provided in financing activities for the year ended December 31, 2001 was \$9,000, compared to \$11,000 in 2000. The Company invests excess cash balances in short-term investment grade securities, such as money market investments, obligations of the U.S. government and its agencies, and obligations of state and local government agencies. Currency exchange rate changes resulted in a \$224,000 reduction in the Company's reported cash at December 31, 2001.

On January 16, 2002, in connection with its acquisition of SMX, the Company issued 500,000 shares of FARO common stock and satisfied certain obligations of SMX. Additionally, the Company issued an additional 350,000 shares of FARO common stock and paid \$2.0 million in cash to fully satisfy SMX's obligations to its two lenders. The Company also assumed and/or settled other obligations of SMX. The operations of SMX are expected to contribute favorably to the Company's liquidity after the new generation tracker has been introduced. The Company expects to start shipping the new generation tracker some time in the first half of 2002. Until then, the operations of SMX are expected to result in revenues of at least \$1.0 million per quarter resulting from the sale of parts, comprehensive support, and technology consulting services and in additional operating expenses in the amount of approximately \$1.9 million per quarter. See Recent Developments above.

The Company's principal commitments at December 31, 2001 consisted of leases on its headquarters and regional and sales offices (see *Contractual Obligations and Commercial Commitments* below). There were no material commitments for capital expenditures at that date. The Company believes that its cash, investments and cash flows from operations will be sufficient to satisfy its working capital and capital expenditure needs at least through 2002.

Contractual Obligations and Commercial Commitments

The Company was a party to a term loan that expires in 2003, capital leases for automotive and other equipment with an initial term of 36 to 60 months and non-cancelable operating leases, including leases with related parties (see Note 8 of Notes to Consolidated Financial Statements) that expire on or before 2006.

Commitments under these agreements are as follows at December 31, 2001:

<u>Year</u>	<u>Payments due under:</u>			<u>Total</u>
	<u>Term Loan</u>	<u>Capital Leases</u>	<u>Operating Leases</u>	
2002	\$ 3,025	\$22,095	\$1,110,636	\$1,135,756
2003	9,862	27,005	929,274	966,141
2004	—	15,045	607,222	622,267
2005	—	2,601	381,176	383,777
2006 and thereafter	—	993	95,756	96,749
Total	<u>\$12,887</u>	<u>\$67,739</u>	<u>\$3,124,064</u>	<u>\$3,204,690</u>

SMX's principal commitments consist of a lease on its headquarters. The lease expires in August 2003. Minimum lease payments required under the lease are \$129,372 and \$86,248 in 2002 and 2003, respectively.

Critical Accounting Policies

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

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

The reserve for obsolete and slow-moving inventory was \$297,500 and \$417,900 at December 31, 2001 and 2000, respectively. The reserve for obsolete and slow-moving inventory is used to state the Company's inventories at the lower of average cost or net realizable value. Since the amount of inventoriable cost that the Company will truly recoup through sales cannot be known with exact certainty, the Company relies on past sales experience and future sales forecasts. Inventory is considered as obsolete if the Company has withdrawn it from the market or if the Company has had no sales of the product for the past 12 months nor sales forecasted for the next 12 months, therefore a reserve in an amount equal to 100% of the average cost of such inventory is recorded. The Company classifies as slow-moving inventory with quantities of on hand greater than the amounts we have sold in the past 12 months or have forecasted to sell in the next 12 months, and reserve such amount as is adequate to reduce the carrying value to net realizable value. During 2001, 2000 and 1999, the provision for obsolete and slow-moving inventory was \$856,600, \$300,955 and \$1,027,200, respectively.

Transactions with Related and Other Parties

The Company leases its headquarters from Xenon Research, Inc. ("Xenon"), all of the issued and outstanding capital stock of which is owned by Simon Raab, the Company's President and Chief Executive Officer, and Diana Raab, his spouse. The term of the lease expires on February 28, 2006, and the Company has two five-year renewal options. Base rent under the lease was \$391,000 for 2001. Base rent during renewal periods will reflect changes in the U.S. Bureau of Labor statistics consumer Price Index for all Urban Consumers.

In June 2000, the Company and each of the former CATS shareholders entered into an Amended and Restated Loan Agreement pursuant to which the Company granted loans to the former CATS shareholders in the aggregate amount of \$1.1 million (“the Loans”). The Loans are for a term of three years, at an interest rate of approximately 4.7%, and grant the borrowers an option to extend the term for an additional three years. As collateral for the Loans, the former CATS shareholders pledged to the Company 177,074 shares of the Company’s Common Stock. The Loans are a non-recourse obligation of the former CATS shareholders.

The Company engaged Cole & Partners, a mergers and acquisition and corporate finance advisory service firm, to serve as the Company’s financial advisor in connection with the Company’s acquisition in January, 2002 of SpatialMetrix, Inc. (“SMX”). Stephen R. Cole, one of the Company’s directors and member of the Audit Committee, is the founding Partner and President of Cole & Partners. The Company paid to Cole & Partners total fees of approximately \$440,000 by early 2002 for its services in the SMX acquisition.

Foreign Exchange Exposure

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

Inflation

The Company believes that inflation has not had a material impact on its results of operations in recent years and does not expect inflation to have a material impact on its operations in 2002.

Conversion to the Euro Currency

On January 1, 1999, certain member countries of the European Union established fixed conversion rates between their existing currencies and the European Union’s common currency (the Euro). The transition period for the introduction of the Euro ends June 30, 2002. In connection therewith, in January 2002 certain member countries of the European Union adopted the Euro as their national currency. Issues facing the Company as a result of the introduction of the Euro include converting information technology systems, reassessing currency risk, amending lease agreements and other contracts, and processing tax and accounting records. The Company is addressing these issues and does not expect the adoption of the Euro to have a material effect on the Company’s financial condition or results of operations.

Impact of Recently Issued Accounting Standards

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

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

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" (SFAS No. 142). SFAS No. 142 requires that goodwill no longer be amortized to earnings, but instead be reviewed for impairment. The Company adopted this new Statement effective January 1, 2002. Upon adoption of SFAS No. 142, operating expenses will be reduced by approximately \$480,000 on an annual basis for amortization and may increase for assets determined to be impaired, if any, during a respective year.

In January 2001, the Company adopted FASB Statement No. 133 (SFAS No. 133), *Accounting for Derivative Instruments and Hedging Activities*, as amended. SFAS 133 requires companies to recognize all their derivative instruments as either assets or liabilities at fair value in the statement of position. In August 2001, the Company entered into a foreign exchange rate swap allowing the Company the right to purchase up to \$1.3 million at a base rate of 1.1049 Euros per \$1.00. Under the agreement, the Company and the bank are to compensate one another based on the exchange rate agreement differential at specified measurement dates. This foreign exchange rate agreement does not qualify for special hedge accounting treatment, as it does not meet the specified criteria under SFAS 133. Therefore the changes in fair value are included in the determination of earnings.

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

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

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

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

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Consolidated Statements of Shareholders' Equity for the years Ended December 31, 2001, 2000 and 1999	26
Consolidated Statements of Cash Flows for the Years Ended December 31, 2001, 2000 and 1999	27
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INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying consolidated balance sheets of FARO Technologies, Inc. and subsidiaries as of December 31, 2001 and 2000, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the two years in the period ended December 31, 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of FARO Technologies, Inc. and subsidiaries at December 31, 2001 and 2000 and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

/s/ ERNST & YOUNG LLP

Orlando, Florida
March 1, 2002

INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying consolidated statements of operations, shareholders' equity and cash flows of FARO Technologies, Inc. and subsidiaries for the year ended December 31, 1999. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the results of operations and cash flows of FARO Technologies, Inc. and subsidiaries for the year ended December 31, 1999, in conformity with accounting principles generally accepted in the United States of America.

/s/ DELOITTE & TOUCHE LLP

Certified Public Accountants

Tampa, Florida
March 17, 2000

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31,	
	2001	2000
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 7,238,564	\$ 8,029,318
Short term investments	4,744,559	6,218,636
Accounts receivable (Note 4)	9,385,568	10,352,972
Income taxes refundable	545,118	—
Inventories, net (Note 5)	5,575,793	6,364,290
Prepaid expenses and other current assets	1,851,003	1,112,881
Deferred income taxes	76,418	203,816
Total current assets	29,417,023	32,281,913
PROPERTY AND EQUIPMENT—at cost:		
Machinery and equipment	4,038,582	3,580,892
Furniture and fixtures	1,313,809	1,253,248
Leasehold improvements	139,555	89,171
Total	5,491,946	4,923,311
Less accumulated depreciation and amortization	(3,945,247)	(3,121,029)
Property and equipment, net	1,546,699	1,802,282
INTANGIBLE ASSETS—net	2,632,791	4,055,337
INVESTMENTS	2,129,679	4,755,572
NOTES RECEIVABLE (Notes 2 and 16)	3,927,932	1,128,846
DEFERRED INCOME TAXES	—	675,324
TOTAL ASSETS	\$ 39,654,124	\$44,699,274
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt	\$ 25,120	\$ 17,397
Accounts payable	2,937,271	2,965,417
Accrued liabilities	3,064,463	4,120,404
Income taxes payable	—	684,409
Current portion of unearned service revenues	855,120	687,566
Customer deposits	231,845	133,984
Total current liabilities	7,113,819	8,609,177
OTHER LONG-TERM LIABILITIES	203,844	134,644
Total liabilities	7,317,663	8,743,821
COMMITMENTS AND CONTINGENCIES (Note 11)		
SHAREHOLDERS' EQUITY:		
Class A preferred stock—par value \$.001, 10,000,000 shares authorized, no shares issued and outstanding		
Common stock—par value \$.001, 50,000,000 shares authorized, 11,075,252 and 11,065,225 issued, 11,035,252 and 11,025,225 outstanding, respectively	11,075	11,066
Additional paid-in capital	47,704,087	47,570,059
Unearned compensation	(109,000)	—
Accumulated deficit	(12,116,098)	(9,268,134)
Other comprehensive loss	(3,002,978)	(2,206,913)
Common stock in treasury, at cost—40,000 shares in 2001 and 2000 ..	(150,625)	(150,625)
Total shareholders' equity	32,336,461	35,955,453
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 39,654,124	\$44,699,274

See accompanying notes to consolidated financial statements.

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended December 31		
	2001	2000	1999
SALES	\$35,113,596	\$40,452,913	\$33,105,740
COST OF SALES	14,304,083	14,748,628	14,160,938
Gross profit	20,809,513	25,704,285	18,944,802
OPERATING EXPENSES			
Selling	13,436,209	14,033,725	12,139,567
General and administrative	5,812,803	5,763,040	4,974,558
Depreciation and amortization	2,559,495	2,931,546	4,465,441
Research and development	3,370,716	3,549,670	3,828,801
Employee stock options	—	123,404	168,912
Impairment loss on acquired intangible assets	—	—	3,073,000
Total operating expenses	25,179,223	26,401,385	28,650,279
LOSS FROM OPERATIONS	(4,369,710)	(697,100)	(9,705,477)
OTHER INCOME (EXPENSES)			
Interest income	900,281	860,254	715,953
Other income, net	964,950	302,378	475,162
Interest expense	(1,747)	(1,334)	(1,924)
INCOME (LOSS) BEFORE INCOME TAXES	(2,506,226)	464,198	(8,516,286)
INCOME TAX EXPENSE (BENEFIT)	341,738	424,681	(1,121,464)
NET INCOME (LOSS)	\$ (2,847,964)	\$ 39,517	\$ (7,394,822)
NET LOSS PER SHARE—BASIC	\$ (0.26)	\$ 0.00	\$ (0.67)
NET LOSS PER SHARE—DILUTED	\$ (0.26)	\$ 0.00	\$ (0.67)

See accompanying notes to consolidated financial statements.

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

	Common Stock		Additional Paid-in Capital	Unearned Compensation	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Common Stock in Treasury	Total
	Shares	Amounts						
BALANCE,								
JANUARY 1, 1999	11,048,137	\$11,048	\$47,520,732	\$(292,316)	\$ (1,912,829)	\$ 199,381	\$(150,625)	\$45,375,391
Net loss					(7,394,822)			(7,394,822)
Currency translation						(1,574,259)		(1,574,259)
Comprehensive loss								(8,969,081)
Issuance of common stock	11,373	12	24,112					24,124
Amortization of unearned compensation				168,912				168,912
BALANCE,								
DECEMBER 31, 1999 . .	11,059,510	\$11,060	\$47,544,844	\$(123,404)	\$ (9,307,651) 39,517	\$(1,374,878)	\$(150,625)	\$36,599,346 39,517
Net Income								
Currency translation						(832,035)		(832,035)
Comprehensive loss								(792,518)
Issuance of common stock	5,715	6	25,215					25,221
Amortization of unearned compensation				123,404				123,404
BALANCE,								
DECEMBER 31, 2000 . .	11,065,225	\$11,066	\$47,570,059	\$ —	\$ (9,268,134) (2,847,964)	\$(2,206,913)	\$(150,625)	\$35,955,453 (2,847,964)
Net loss								
Currency translation						(796,065)		(796,065)
Comprehensive loss								(3,644,029)
Options granted subject to variable accounting			109,000	(109,000)				
Issuance of common stock	10,027	9	25,028					25,037
BALANCE,								
DECEMBER 31, 2001 . .	<u>11,075,252</u>	<u>\$11,075</u>	<u>\$47,704,087</u>	<u>\$(109,000)</u>	<u>\$(12,116,098)</u>	<u>\$(3,002,978)</u>	<u>\$(150,625)</u>	<u>\$32,336,461</u>

See accompanying notes to consolidated financial statements.

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

	Years Ended December 31		
	2001	2000	1999
CASH FLOWS FROM:			
OPERATING ACTIVITIES:			
Net income (loss)	\$(2,847,964)	\$ 39,517	\$ (7,394,822)
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:			
Depreciation and amortization	2,559,495	2,931,546	4,465,441
Bad debt expense	310,981	30,271	169,144
Provision for inventory losses	856,551	300,955	1,027,186
Impairment loss on acquired intangible assets	—	—	3,073,000
Provision for deferred income taxes	802,722	(127,139)	(708,678)
Loss on disposals of fixed assets	—	—	5,400
Employee stock options	—	123,404	168,912
Change in operating assets and liabilities:			
Decrease (increase) in:			
Accounts receivable	197,437	(946,693)	(1,096,418)
Income taxes refundable	(545,118)	234,470	481,578
Inventories	(178,323)	(549,516)	(794,260)
Notes receivable	—	—	47,752
Prepaid expenses and other assets	(796,145)	(586,176)	(422,079)
Increase (decrease) in:			
Accounts payable and accrued liabilities	(894,764)	2,095,884	2,380,514
Income taxes payable	(684,409)	684,409	398
Unearned service revenues	268,794	436,132	(5,757)
Customer deposits	108,249	55,817	(28,458)
Net cash (used in) provided by operating activities	<u>(842,494)</u>	<u>4,722,881</u>	<u>1,368,853</u>
INVESTING ACTIVITIES:			
Proceeds from investments	6,250,000	6,690,000	21,782,431
Purchases of investments	(2,150,029)	(7,422,252)	(15,012,556)
Notes receivable	(2,799,086)	(1,001,593)	—
Purchases of property and equipment	(788,168)	(1,197,532)	(1,120,552)
Payments for intangible assets	(245,694)	(120,264)	(316,527)
Net cash provided by (used in) investing activities	<u>267,023</u>	<u>(3,051,641)</u>	<u>5,332,796</u>
FINANCING ACTIVITIES:			
Payments of long-term debt, Capital lease obligations and notes payable	(16,497)	(14,070)	(306,403)
Proceeds from issuance of common stock, net	25,037	25,221	24,124
Net cash provided by (used in) financing activities	<u>8,540</u>	<u>11,151</u>	<u>(282,279)</u>
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(223,823)	(161,035)	(1,095,064)
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(790,754)	1,521,356	5,324,306
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	8,029,318	6,507,962	1,183,656
CASH AND CASH EQUIVALENTS, END OF PERIOD	<u>\$ 7,238,564</u>	<u>\$ 8,029,318</u>	<u>\$ 6,507,962</u>

See accompanying notes to consolidated financial statements.

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2001, 2000 AND 1999

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Principles of Consolidation—The consolidated financial statements include the accounts of FARO Technologies, Inc. and all majority-owned subsidiaries (collectively, the “Company”). All significant intercompany transactions and balances have been eliminated. The financial statements of the foreign subsidiaries are translated into U.S. dollars using exchange rates in effect at period-end for assets and liabilities and average exchange rates during each reporting period for results of operations. Adjustments resulting from translation of financial statements are reflected as a separate component of comprehensive (loss) income.

Revenue Recognition, Product Warranty and Extended Maintenance Contracts—Revenue related to the Company’s 3-D measurement equipment and related software is recognized upon shipment as the Company considers the earnings process substantially complete as of the shipping date. Revenue from sales of software only is recognized when no further significant production, modification or customization of the software is required and where the following criteria are met: persuasive evidence of a sales agreement exists, delivery has occurred, and the sales price is fixed or determinable and deemed collectible. Revenues resulting from sales of comprehensive support, training and technology consulting services are recognized as such services are performed. Extended maintenance plan revenues are recognized in proportion to maintenance costs projected to be incurred. The Company warrants its products against defects in design, materials and workmanship for one year. A provision for estimated future costs relating to warranty expenses is recorded when products are shipped. Costs relating to extended maintenance plans are recognized as incurred.

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

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

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

Investments consisted of the following:

	December 31	
	2001	2000
Government agency securities	\$2,032,679	\$ 898,840
Certificates of deposit	97,000	240,309
Corporate notes	—	3,616,423
	\$2,129,679	\$4,755,572

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Management determines the appropriate classification of its short term investments and investments in debt securities at the time of the purchase and reevaluates such determinations at each balance sheet date. All investments in debt securities are classified as held to maturity as the company has the positive intent and ability to hold the securities to maturity. Held to maturity securities are stated at amortized cost. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and interest are included in other income in the consolidated statements of operations. The Company's investments in debt securities are diversified among high credit quality securities in accordance with the Company's investment policy. The gross unrealized gain on all held to maturity debt securities was approximately \$123,000 and \$65,000 at December 31, 2001 and 2000, respectively.

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

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

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

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

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

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

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

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

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

technical performance requirements. Capitalization of product design costs ceases and amortization of such costs begins when the product is available for general release to customers.

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

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

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

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

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

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

In 1999, the Company entered into an OEM agreement with Brown & Sharpe Manufacturing Company ("Brown & Sharpe"), a unit of Hexagon, A. B. of Stockholm, Sweden that is a world leader in the manufacture of traditional coordinate measurement machines (CMMs) and other metrology products. Brown & Sharpe will market the FAROArm® worldwide under the name GAGE 2000 A. The agreement, which grants Brown & Sharpe non-exclusive distribution right worldwide, expires in March 2002, and is renewable for successive one-year terms. The Company anticipates that this agreement will be renewed.

No customer represented more than 6% of the Company's total sales for the years ended December 31, 2001, 2000 and 1999.

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

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

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

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

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

Impact of Recently Issued Accounting Standards—In July 2001, the FASB issued Statement of Financial Accounting Standards No. 142, “Goodwill and Other Intangible Assets” (SFAS No. 142). SFAS No. 142 establishes accounting and reporting standards for acquired goodwill and other intangible assets, and supersedes APB Opinion No.17, “Intangible Assets”. SFAS No. 142 requires that goodwill no longer be amortized to earnings, but instead be reviewed for impairment. The Company adopted this new Statement effective January 1, 2002. Upon adoption of SFAS No. 142, operating expenses will be reduced by approximately \$480,000 on an annual basis for amortization and may increase for assets determined to be impaired, if any, during a respective year.

In January 2001, the Company adopted Statement of Financial Accounting Standards Statement No. 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities*, as amended. SFAS 133 requires companies to recognize all their derivative instruments as either assets or liabilities at fair value in the statement of financial position. The accounting for changes in the fair

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

value (i.e. gains and losses) of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship and further, on the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, a company must designate the hedging instrument based on the exposure being hedged. For derivative instruments that are designated and qualify as cash flow hedges, the effective portion of the gain or loss is reported as a component of other comprehensive income. Accounting for such instruments is referred to as "special hedge accounting." However, SFAS 133 eliminates special hedge accounting if the derivative instrument does not meet certain criteria.

In August 2001, the Company entered into a foreign exchange rate swap allowing the Company the right to purchase up to \$1.3 million at a base rate of 1.1049 Euros per \$1.00. Under the agreement, the Company and the bank are to compensate one another based on the exchange rate agreement differential at specified measurement dates. This foreign exchange rate agreement expires in September 2002 and does not qualify for special hedge accounting mentioned above, as it did not meet the specified criteria under SFAS 133. Therefore the changes in fair value are recorded in income.

During the year ended December 31, 2001, the Company recognized a gain of \$37,000 related to the change in fair value of the foreign exchange rate agreement in the Statement of Operations. The asset of \$37,000 is recorded in other assets on the balance sheet.

2. ACQUISITION OF CATS

In 1998, the Company acquired CATS GmbH for total consideration of \$16 million (including direct costs of the acquisition), consisting of \$5 million in cash, 916,668 shares of the Company's Common Stock and the assumption of certain outstanding liabilities of CATS. The acquisition was recorded under the purchase method of accounting.

The acquisition agreement provided that the Company would provide a loan to each of the two former shareholders of CATS, who remain key employees of the Company, to fund their tax liability in connection with the Company's acquisition of CATS. In connection therewith, in June 2000 the Company and each of the former CATS shareholders entered into an Amended and Restated Loan Agreement and the Company granted loans to the former CATS shareholders in the aggregate amount of \$1.1 million ("the Loans"). The Loans are for a term of three years, at an interest rate of approximately 4.7%, and grant the borrowers an option to extend the term for an additional three years. As collateral for the Loans, the former CATS shareholders pledged to the Company 177,074 shares of the Company's Common Stock. The Loans are a non-recourse obligation of the former CATS shareholders.

The valuation of CATS was based on management's estimates of after tax net cash flows for certain intangible assets. The actual after tax net cash flows may vary from management's original estimates. In the fourth quarter of 1999, the Company recorded a write-down of developed and core technology of approximately \$3.1 million in the consolidated statement of operations. This write-down was in accordance with SFAS No. 121, "Accounting for Impairment of Long-Lived Assets" ("SFAS No. 121"). Developed and core technology was determined to have been impaired because the anticipated future cash flows resulting from the software products acquired from CATS GmbH

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

indicate that the recoverability of a portion of the developed and core technology is not reasonably assured. The estimated fair value of the developed and core technology was determined by calculating the present value of the estimated future cash flows.

3. SUPPLEMENTAL CASH FLOW INFORMATION

Selected cash payments and non cash activities were as follows:

	<u>Years ended December 31</u>		
	<u>2001</u>	<u>2000</u>	<u>1999</u>
Cash paid for interest	\$ 1,747	\$ 1,334	\$ 3,237
Cash paid for income taxes	673,787	54,000	24,392
Non cash investing and financing activities:			
Fixed assets acquired under capital lease obligations . .	33,041	55,795	—

4. ALLOWANCE FOR DOUBTFUL ACCOUNTS

The allowance for doubtful accounts is as follows:

	<u>Years ended December 31</u>		
	<u>2001</u>	<u>2000</u>	<u>1999</u>
Balance, beginning of year	\$ 353,514	\$334,612	\$139,690
Provision	310,981	30,271	169,144
(Amounts written off) recoveries	(324,780)	(11,369)	25,778
Balance, end of year	<u>\$ 339,715</u>	<u>\$353,514</u>	<u>\$334,612</u>

5. INVENTORIES

Inventories, net consist of the following:

	<u>December 31</u>	
	<u>2001</u>	<u>2000</u>
Raw materials	\$ 496,298	\$ 486,002
Work-in-process	1,875,912	1,610,210
Finished goods	341,348	991,169
Sales demonstration	2,862,235	3,276,909
	<u>\$5,575,793</u>	<u>\$6,364,290</u>

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

	<u>Years ended December 31</u>		
	<u>2001</u>	<u>2000</u>	<u>1999</u>
Balance, beginning of year	\$ 417,930	\$1,080,815	\$ 54,728
Charges to Cost of Sales	856,551	300,955	1,027,186
Amounts written off	(976,973)	(963,840)	(1,099)
Balance, end of year	<u>\$ 297,508</u>	<u>\$ 417,930</u>	<u>\$1,080,815</u>

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

6. INTANGIBLE ASSETS

Intangible assets consist of the following:

	December 31	
	2001	2000
Goodwill	\$ 2,325,225	\$ 2,456,913
Existing product technology	4,589,775	4,849,715
Work force in place	445,445	470,673
Customer relationships	477,842	504,904
Product design costs	341,948	861,367
Patents	1,225,815	1,235,300
Other	131,033	277,253
Total	9,537,083	10,656,125
Accumulated amortization	(6,904,292)	(6,600,788)
Intangible assets—net	\$ 2,632,791	\$ 4,055,337

Amortization expense was \$1,557,819, \$2,062,293 and \$3,625,045 in 2001, 2000 and 1999, respectively.

7. ACCRUED LIABILITIES

Accrued liabilities consist of the following:

	December 31	
	2001	2000
Accrued compensation and benefits	\$1,060,378	\$2,185,314
Accrued royalties and warranties	138,200	183,385
Other accrued liabilities	1,865,885	1,751,705
	\$3,064,463	\$4,120,404

8. NOTES PAYABLE AND DEBT

The Company has an available line of credit of \$1,500,000. Drawings under the line of credit bear interest at a rate equivalent to a 30-day commercial paper plus 2.75%. There were no amounts outstanding under the line of credit at December 31, 2001 and 2000.

Long-term debt consists of the following:

	December 31	
	2001	2000
4-year, 5.9% automobile loan	\$ 12,887	\$ 16,635
Obligations under capital leases	67,739	50,022
Total	80,626	66,657
Less current portion	(25,120)	(17,397)
	\$ 55,506	\$ 49,260

Long-term debt of \$55,506 and \$49,260 is included in other long-term liabilities in the accompanying consolidated balance sheet as of December 31, 2001 and 2000, respectively. Long-

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

term debt at December 31, 2001 is due as follows: 2002—\$25,120; 2003—\$36,867; 2004—\$15,045; 2005—\$2,601 and thereafter—\$993.

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

9. RELATED PARTY TRANSACTIONS

Related Party Lease—The Company leases its plant and office building from Xenon Research, Inc. (“Xenon”), a 29.7% shareholder. Pursuant to the terms of the lease agreement, which expires in 2006, the Company has a five-year renewal option. The base rent during renewal periods will reflect changes in the U.S. Bureau of Labor Statistics, Consumer Price Index for all Urban Consumers. Rent expense under this lease was approximately \$391,000 in 2001, \$355,000 in 2000, and \$358,000 in 1999.

Related Party Loans—On June 20, 2000 the Company and each of the former CATS shareholders entered into an Amended and Restated Loan Agreement pursuant to which the Company granted loans to the former CATS shareholders in the aggregate amount of \$1.1 million (“the Loans”). The Loans outstanding are for a term of three years, at an interest rate of approximately 4.7%, and grant the borrowers an option to extend the term for an additional three years. See Note 2 of Notes to Consolidated Financial Statements above.

Related Party Consulting Services—The Company engaged Cole & Partners, a mergers and acquisition and corporate finance advisory service firm, to serve as the Company's financial advisor in connection with the Company's acquisition in January, 2002 of SpatialMetrix, Inc. (“SMX”). Stephen R. Cole, one of the Company's directors and member of the Audit Committee, is the founding Partner and President of Cole & Partners. The Company paid to Cole & Partners total fees of approximately \$440,000 by early 2002 for its services in the SMX acquisition.

10. INCOME TAXES

(Loss) income before taxes consisted of the following:

	Years ended December 31		
	2001	2000	1999
Domestic	\$(2,229,358)	\$ 1,814,032	\$(2,508,948)
Foreign	(276,868)	(1,349,834)	(6,007,338)
(Loss) income before income taxes	\$(2,506,226)	\$ 464,198	\$(8,516,286)

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

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

	Years ended December 31		
	2001	2000	1999
Current:			
Federal	\$(460,984)	\$ 503,000	\$ (357,453)
State	—	48,820	(55,333)
	<u>(460,984)</u>	<u>551,820</u>	<u>(412,786)</u>
Deferred:			
Federal	731,704	(115,891)	(585,932)
State	71,018	(11,248)	10,174
Foreign	—	—	(132,920)
	<u>802,722</u>	<u>(127,139)</u>	<u>(708,678)</u>
	<u>\$ 341,738</u>	<u>\$ 424,681</u>	<u>\$(1,121,464)</u>

Income tax expense (benefit) for the years ended December 31, 2001, 2000, and 1999 differ from the amount computed by applying the federal statutory corporate rate to (loss) income before income taxes. The differences are reconciled as follows:

	Years ended December 31		
	2001	2000	1999
Tax (benefit) expense at statutory rate	\$ (775,605)	\$ 157,827	\$(2,895,537)
State income taxes, net of federal benefit	(73,568)	55,155	(109,543)
Nontaxable interest income	—	—	(141,180)
Foreign tax rate difference	194,430	28,551	(986,167)
Research and development credit	(159,160)	(134,638)	(171,059)
Nondeductible items	33,356	36,684	42,530
Change in deferred tax asset valuation allowance	1,092,132	430,392	3,028,662
Other	30,153	(149,290)	110,830
Total income tax expense (benefit)	<u>\$ 341,738</u>	<u>\$ 424,681</u>	<u>\$(1,121,464)</u>

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

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

	December 31,	
	2001	2000
Net deferred income tax asset—Current		
Product design costs	\$ (41,880)	\$ (113,519)
Tax credits	382,315	36,839
Other	240,408	280,496
Valuation allowance	(504,425)	—
Net deferred income tax asset—Current	\$ 76,418	\$ 203,816
Net deferred income tax asset—Non-current		
Depreciation	\$ 411,803	\$ 291,145
Employee stock options	183,348	183,986
Unearned service revenue	169,362	200,193
Intangible assets	3,227,871	3,131,325
Carryforwards	3,087,378	3,360,729
Valuation allowance	(7,079,762)	(6,492,054)
Net deferred income tax asset—Non current	\$ —	\$ 675,324

At December 31, 2001, the Company's domestic entities had deferred income tax assets in the amount of \$1,345,356. For financial reporting purposes a valuation allowance of \$1,268,938 was set up during the year to appropriately reflect the portion of the deferred tax asset that is more likely than not to be realized.

At December 31, 2001, the Company's foreign subsidiaries had deferred income tax assets relating to net operating loss carry-forwards, which do not expire, and intangible assets of \$3,087,378 and \$3,227,871, respectively. For financial reporting purposes, a valuation allowance of \$6,315,249 has been recognized to offset the deferred tax assets relating to the net operating losses and intangible assets.

11. COMMITMENTS AND CONTINGENCIES

Leases—The following is a schedule of future minimum lease payments required under non-cancelable operating leases, including leases with related parties (see Note 8), in effect at December 31, 2001:

Year Ending December 31	Amount
2002	\$1,110,636
2003	929,274
2004	607,222
2005	381,176
2006 and thereafter	95,756
Total future minimum lease payments	\$3,124,064

Rent expense for 2001, 2000, and 1999 was approximately \$1,101,000, \$1,120,000, and \$973,000, respectively.

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

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

12. STOCK OPTION PLANS

The Company has three stock option plans that provide for the granting of stock options to key employees and non-employee members of the Board of Directors. The 1993 Stock Option Plan ("1993 Plan") and the 1997 Employee Stock Option Plan ("1997 Plan") provide for granting incentive stock options and nonqualified stock options to officers and key employees of the Company. The 1997 Non-employee Director Plan provides for granting nonqualified stock options and formula options to non-employee directors. Additionally, in connection with its initial public offering in 1997, the Company issued warrants to purchase 100,000 shares of its Common Stock at \$13.20 per share. Such warrants expire in 2002.

The Company is authorized to grant options for up to 1,000,000 shares of Common Stock under the 1993 Plan, of which 295,997 and 123,372 options have been granted at exercise prices of \$3.36 and \$3.60, respectively. These options vest over primarily 3 and 4-year periods. The Company is authorized to grant options for up to 1,400,000 shares of Common Stock under the 1997 Plan, of which 916,219 options have been granted at exercise prices between \$1.50 and \$12.00 (for those meant to qualify for treatment as incentive stock options). These options vest over a three-year period. The Company is authorized to grant up to 250,000 shares of Common Stock under the 1997 Non-employee Director Plan. Each non-employee director is granted 3,000 options upon election to the Board of Directors and then annually upon attending the annual meeting of shareholders (formula options). Formula options granted to directors are generally granted upon the same terms and conditions as options granted to officers and employees. These options vest over a three-year period. Additionally in 1997, certain non-employee directors were granted options to purchase 160,000 of Common Stock in consideration for their prior service on the Board of Directors. These options vested upon grant at an exercise price of \$12.

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

In the fourth quarter of 2001, the Company cancelled approximately 548,000 "out of the money" options, including approximately 440,000 options issued under the 1997 Plan and approximately 108,000 options issued under the 1997 Non-employee Director Plan. As a result, 91,000 options granted in 2001, under the 1997 Plan, were subjected to variable accounting treatment. Under FIN No. 44, stock options issued within six months of a cancellation must be accounted for as variable under certain circumstances. Variable accounting requires companies to re-measure compensation costs for the variable options until the options are exercised, cancelled, or forfeited without replacement. Compensation is dependent on fluctuations in the quoted stock prices for the

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Company's common stock. Such compensation costs will be recognized over a three-year vesting schedule until the options are fully vested, exercised, cancelled, or forfeited, after which time the compensation will be recognized immediately at each reporting period.

Compensation costs charged to operations associated with the Company's stock option plans was \$123,404 and \$168,912, in 2000, and 1999, respectively. There was no charge to operations in 2001 in connection with these plans. Compensation cost was based on the difference between the value of the stock, at date of grant, and its exercise price multiplied by the number of shares vested in each year.

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

	Years Ended December 31,					
	2001		2000		1999	
	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price	Options	Weighted-Average Exercise Price
Outstanding at beginning of year	1,291,315	\$ 8.61	1,140,686	\$ 9.79	1,194,165	\$ 9.73
Granted	334,000	1.77	260,050	2.70	66,000	4.76
Cancelled	(548,074)	12.45	—		—	
Forfeited	(123,197)	7.60	(108,249)	6.63	(108,106)	7.76
Exercised	(4,546)	0.36	(1,172)	3.60	(11,373)	2.60
Outstanding at end of year	<u>949,498</u>	4.19	<u>1,291,315</u>	8.61	<u>1,140,686</u>	9.79
Outstanding exercisable at year-end	474,464	\$ 6.32	881,640	\$10.23	659,275	\$10.49
Weighted-average fair value of options granted during the year	\$1.00		\$1.63		\$3.75	

A summary of stock options outstanding and exercisable as of December 31, 2001 follows:

<u>Exercise Price</u>	<u>Options Outstanding</u>	<u>Weighted-Average Remaining Contractual Life (Years)</u>	<u>Options Exercisable</u>
\$ 0.36	23,312	3.97	23,312
\$ 1.50	265,700	9.84	0
\$ 2.56-2.94	256,100	8.43	65,934
\$ 3.13-3.75	226,715	6.63	213,881
\$ 4.13-5.12	18,000	7.39	11,666
\$10.34-12.00	59,671	6.01	59,671
\$13.20	100,000	0.71	100,000
	<u>949,498</u>		<u>474,464</u>

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

Remaining non-exercisable options as of December 31, 2001 become exercisable as follows:

<u>Years Ending December 31</u>	<u>Amount</u>
2002	185,101
2003	179,433
2004	110,500
	<u>475,034</u>

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

	<u>Years Ended December 31,</u>		
	<u>2001</u>	<u>2000</u>	<u>1999</u>
Net (loss) income			
As reported	\$(2,847,964)	\$ 39,517	\$(7,394,822)
Pro forma	(3,173,944)	(943,306)	(8,531,554)
(Loss) income per share—Basic			
As reported	\$ (0.26)	\$ —	\$ (0.67)
Pro forma	(0.29)	(0.09)	(0.77)
(Loss) income per share—Diluted			
As reported	\$ (0.26)	\$ —	\$ (0.67)
Pro forma	(0.29)	(0.09)	(0.77)

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

	<u>Years Ended December 31,</u>		
	<u>2001</u>	<u>2000</u>	<u>1999</u>
Risk-free interest rate	3.60% to 6.72%	4.44% to 6.72%	5.50%
Expected dividend yield	0%	0%	0%
Expected option life	1-10 years	3-10 years	3-10 years
Stock price volatility	62.50%	65.30%	105.21%

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

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

13. EARNINGS PER SHARE

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

	Years Ended December 31,					
	2001		2000		1999	
	Shares	Per-Share Amount	Shares	Per-Share Amount	Shares	Per-Share Amount
Basic EPS	11,032,449	\$(0.26)	11,021,606	\$0.00	11,015,140	\$(0.67)
Effect of Dilutive Securities:						
Stock Options			72,538			
Diluted EPS	11,032,449	\$(0.26)	11,094,144	\$0.00	11,015,140	\$(0.67)

14. EMPLOYEE RETIREMENT BENEFITS PLAN

The Company maintains a 401(k) defined contribution retirement plan for its U.S. employees, which provides benefits for all employees meeting certain age and service requirements. The Company may make a discretionary contribution each Plan year, as determined by its Board of Directors. Discretionary contributions or employer matches can be made to the participant’s account but cannot exceed 6% of compensation. Costs charged to operations in connection with the Plan during 2001 and 2000 aggregated \$83,400 and \$35,000, respectively. The Company made no contributions to the Plan prior to 2000.

15. SEGMENT GEOGRAPHIC DATA

The Company develops, manufactures, markets and supports Computer Aided Design (CAD)-based quality assurance products and CAD-based inspection and statistical process control software. This one line of business represents more than 99% of consolidated sales. The Company operates through sales teams established by geographic area. Each team is equipped to deliver the entire line of Company products to customers within its geographic area. The Company has aggregated the sales teams into a single operating segment as a result of the similarities in the nature of products sold, the type of customers and the methods used to distribute the Company’s products.

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

	December 31,					
	2001		2000		1999	
	Sales	Long-lived Assets	Sales	Long-lived Assets	Sales	Long-lived Assets
United States	\$13,755,991	\$2,058,163	\$19,997,884	\$2,326,790	\$17,687,875	\$2,522,654
Germany	6,936,796	1,944,642	8,557,809	3,385,662	6,321,760	5,083,420
France	3,128,551	6,842	2,927,787	9,136	1,716,031	41,145
United Kingdom	2,973,442		2,603,297		2,568,020	
Other Foreign	8,318,816	169,843	6,366,136	136,031	4,812,054	
	\$35,113,596	\$4,179,490	\$40,452,913	\$5,857,619	\$33,105,740	\$7,647,219

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

16. SUBSEQUENT EVENT

On January 16, 2002, the Company acquired SpatialMetrix Corporation (“SMX”) in exchange for 500,000 shares of FARO common stock and the satisfaction by the Company of certain obligations of SMX. In connection therewith, the Company issued an additional 350,000 shares of FARO common stock and paid \$2.0 million in cash to fully satisfy SMX’s obligations to its two lenders. The Company also assumed and/or satisfied other obligations of SMX. The transaction will be recorded utilizing the purchase method of accounting in accordance with SFAS No. 142, “Goodwill and Other Intangible Assets.” SMX Corp. is a leading manufacturer and supplier of laser trackers and targets, metrology software, and contract inspection services.

In April 2001, the Company provided \$1.5 million in financing to SMX by entering into a Participation Agreement with SMX’s bank pursuant to which the Company funded and simultaneously acquired a \$1.5 million interest in SMX’s then outstanding \$3.8 million bank line of credit. In October 2001, the Company and SMX entered into an additional agreement pursuant to which the Company would provide to SMX up to an additional \$1.5 million in financing. The Company and SMX’s bank amended the Participation Agreement so that such additional financing to SMX also would be made through participation in SMX’s bank line of credit. Consequently, SMX’s bank line of credit could increase to a maximum of \$5.3 million, of which FARO would own up to \$3.0 million. Prior to closing, the Company had provided \$2.9 million of aggregate financing to SMX pursuant to the Participation Agreement.

17. QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

<u>Quarter Ended</u>	<u>March 31, 2001</u>	<u>June 30, 2001</u>	<u>September 30, 2001</u>	<u>December 31, 2001</u>
Sales	\$ 8,405,530	\$ 8,265,131	\$8,416,886	\$10,026,049
Gross profit	4,966,003	4,801,330	5,300,500	5,741,680
Net income (loss)	(1,127,255)	(1,583,284)	(699,035)	561,610
Net income (loss) per share:				
Basic	(0.10)	(0.14)	(0.06)	0.05
Diluted	(0.10)	(0.14)	(0.06)	0.05

<u>Quarter Ended</u>	<u>March 31, 2000</u>	<u>June 30, 2000</u>	<u>September 30, 2000</u>	<u>December 31, 2000</u>
Sales	\$9,849,767	\$10,923,279	\$8,810,972	\$10,868,895
Gross profit	5,909,407	6,926,735	5,614,077	7,254,066
Net income (loss)	(417,570)	591,398	(360,387)	226,076
Net income (loss) per share:				
Basic	(0.04)	0.05	(0.03)	0.02
Diluted	(0.04)	0.05	(0.03)	0.02

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

The information contained in the Company’s current report on Form 8-K dated August 21, 2000 is incorporated herein by reference.

PART III

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

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

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

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

ITEM 11. EXECUTIVE COMPENSATION.

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

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

Security ownership of certain beneficial owners and management to be set forth under the caption "Principal Shareholders" in the Proxy Statement is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

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

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K.

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

(1) Financial Statements. Included in Part II, Item 8 is an index to the Consolidated Financial Statements of FARO Technologies, Inc. and Report of Ernst & Young LLP, Independent Certified Public Accountants, filed as part of this Form 10-K. Additionally, included as Exhibit 99.2 are the unaudited financial statements of SpatialMetrix Corporation ("SMX") for each of the two years in the period ended December 31, 2001 and unaudited pro forma financial information pertaining to the acquisition of SMX.

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

(3) Exhibits.

<u>Exhibit No.</u>	<u>Description</u>
2.1	Agreement and Plan of Merger dated September 14, 2001, as amended, between the Registrant and Spatialmetrix Corporation <i>(Filed as Exhibit 2.1 to Registrant's Current Report on Form 8-K dated January 16, 2002 and incorporated herein by reference)</i>
3.1	Articles of Incorporation, as amended <i>(Filed as Exhibit 3.1 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)</i>
3.2	Bylaws, as amended <i>(Filed as Exhibit 3.2 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)</i>
4.1	Specimen Stock Certificate <i>(Filed as Exhibit 4.1 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)</i>
10.1	1993 Stock Option Plan, as amended <i>(Filed as Exhibit 10.1 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)</i>
10.2	1997 Employee Stock Option Plan <i>(Filed as Exhibit 10.2 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)</i>
10.3	1997 Non-Employee Director Stock Option Plan <i>(Filed as Exhibit 10.3 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)</i>
10.4	1997 Non-Employee Directors' Fee Plan <i>(Filed as Exhibit 10.4 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)</i>
10.5	Business Lease, dated March 1, 1991, between the Registrant (as successor-by-merger to FARO Medical Technologies (U.S.), Inc.) and Xenon Research, Inc. <i>(Filed as Exhibit 10.7 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)</i>
10.6	Nonexclusive Unique Application Reseller Agreement, dated September 9, 1996, between the Registrant and Autodesk, Inc. <i>(Filed as Exhibit 10.9 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)</i>
10.7	Form of Patent and Confidentiality Agreement between the Registrant and each of its employees <i>(Filed as Exhibit 10.10 to Registrant's Registration Statement on Form S-1, No. 333-32983, and incorporated herein by reference)</i>
10.8	Nonexclusive Unique Application Reseller Agreement, dated as of March 1, 1998, between the Registrant and Autodesk, Inc. <i>(Filed as Exhibit 10.11 to Registrant's Form 10-K for calendar year 1997, No. 0-23081, and incorporated herein by reference)</i>
10.9	First Amendment to Business Lease, dated as of January 20, 1998, between the Registrant (as successor by merger to FARO Medical Technologies (US), Inc.) and Xenon Research, Inc., <i>(Filed as Exhibit 10.12 to Registrant's Form 10-K for calendar year 1997, No. 0-23081 and incorporated herein by reference)</i>
10.10	FARO OEM Purchase Agreement, dated March 12, 1999 between the Company and Brown & Sharpe Manufacturing Company. <i>(Filed as Exhibit 10.13 to Registrant's Form 10-K for calendar year 1998, No. 0-23081 and incorporated herein by reference)</i>

<u>Exhibit No.</u>	<u>Description</u>
10.11	OEM Contract (1) year extension, signed March 1, 2001 between the Registrant and Brown & Sharpe Manufacturing Company. <i>(Filed as Exhibit 10.15 to Registrant's Form 10-K for calendar year 2000, No. 000-23081 and incorporated herein by reference)</i>
10.12	WCMA Line of Credit No. 740-07K27 dated May 10, 2001 between the Registrant and Merrill Lynch Business Financial Services, Inc. <i>(Filed herewith)</i>
21.1	List of Subsidiaries <i>(Filed herewith)</i>
23.1	Consent of Ernst & Young LLP <i>(Filed herewith)</i>
23.2	Consent of Deloitte & Touche LLP <i>(Filed herewith)</i>
24.1	Power of Attorney <i>(Included on Page 46 of this Report)</i>
99.1	Properties <i>(Filed herewith)</i>
99.2	Unaudited Financial Statements of SpatialMetrix Corporation for the two years in the period ended December, 31, 2001 and unaudited pro forma financial information pertaining to the acquisition of SMX <i>(Filed herewith)</i>

(b) Reports on Form 8-K

None.

Corporate Information

Directors

Simon Raab
Chairman of the Board, President
and Chief Executive Officer;
Co-founder; Director since 1982

Gregory A. Fraser
Executive Vice President,
Secretary and Treasurer;
Co-founder; Director since 1982

Hubert d'Amours⁽¹⁾
President, Montroyal Capital, Inc.
and Capimont, Inc., Montreal,
Canada (venture capital
investment companies);
Director since 1990

Andre Julien⁽¹⁾
Independent Consultant and former
President, LAB Pharmacological
Research International, Montreal,
Canada; Director since 1986

Norman H. Schipper, Q.C.
Of Counsel to Goodmans LLP,
Barristers & Solicitors, Toronto,
Canada; Director since 1982

Stephen R. Cole⁽¹⁾
Senior Partner, Cole and Partners
Limited
Toronto, Canada;
Director since 2000

⁽¹⁾Member, Audit Committee

Executive Officers

Simon Raab
Chairman of the Board, President
and Chief Executive Officer

Gregory A. Fraser
Executive Vice President,
Secretary and Treasurer

Senior Management

Siegfried K. Buss
Co-managing Director, Faro Europe

Joanne M. Karimi
Vice President, Human Resources

Edward M. Pelshaw
Vice President, Manufacturing

Allen Sajedi
Vice President, Engineering

Wendelin K.J. Scharbach
Co-managing Director, Faro Europe

Transfer Agent & Registrar

U.S. Bank
Milwaukee, Wisconsin

Auditors

Ernst & Young LLP
Orlando, Florida

Legal Counsel

Foley & Lardner

10-K Report

FARO Technologies, Inc.'s annual
report on Form 10-K will be provided
to holders of the Company's securi-
ties
at no charge when available.
Contact: Investor Relations at
800-736-0234.

Annual Stockholders' Meeting

Date: April 25, 2002
Time: 10 A.M.
Location: 125 Technology Park Drive
Lake Mary, Florida 32746





Corporate Headquarters

125 Technology Park Drive
Lake Mary, FL 32746
Tel. 407-333-9911
Fax. 407-333-4181
www.faro.com

Europe Headquarters

Ingersheimerstr .12
D-70499 Stuttgart-Weimlimdorf
Germany
Tel. 49-1711-22-22435
Fax. 49-1711-22-22444

Japan Headquarters

1015 Yamanota, Nagakute-cho,
Aichi, 480-1113
Japan
Tel: 81-561-64-3773
Fax: 81-561-64-3883