

FARO TECHNOLOGIES INC
Form 10-Q
July 25, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2018

OR

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

For the transition period from _____ to _____

Commission File Number: 0-23081

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

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

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

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

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

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

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

Smaller reporting
company

Emerging growth company

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

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

There were 16,978,758 shares of the registrant's common stock outstanding as of July 23, 2018.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

FARO TECHNOLOGIES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)	June 30, 2018 (unaudited)	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 133,554	\$ 140,960
Short-term investments	10,998	10,997
Accounts receivable, net	71,641	72,105
Inventories, net	60,349	53,786
Prepaid expenses and other current assets	21,086	16,311
Total current assets	297,628	294,159
Property and equipment:		
Machinery and equipment	70,332	66,514
Furniture and fixtures	6,650	6,945
Leasehold improvements	20,039	19,872
Property and equipment at cost	97,021	93,331
Less: accumulated depreciation and amortization	(66,321)	(61,452)
Property and equipment, net	30,700	31,879
Goodwill	53,584	52,750
Intangible assets, net	23,842	22,540
Service and sales demonstration inventory, net	38,346	39,614
Deferred income tax assets, net	15,691	15,606
Other long-term assets	4,678	2,030
Total assets	\$ 464,469	\$ 458,578
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 11,764	\$ 11,569
Accrued liabilities	24,950	27,362
Income taxes payable	1,672	4,676
Current portion of unearned service revenues	30,179	29,674
Customer deposits	2,944	2,604
Total current liabilities	71,509	75,885
Unearned service revenues - less current portion	13,291	11,815
Deferred income tax liabilities	590	695
Income taxes payable - less current portion	14,578	15,952
Other long-term liabilities	1,798	2,165
Total liabilities	101,766	106,512
Commitments and contingencies - See Note 16		
Shareholders' equity:		
Common stock - par value \$.001, 50,000,000 shares authorized; 18,440,073 and 18,277,142 issued, respectively; 16,978,758 and 16,796,884 outstanding, respectively	18	18
Additional paid-in capital	233,755	223,055
Retained earnings	172,649	168,624
Accumulated other comprehensive loss	(11,985)	(7,822)
Common stock in treasury, at cost; 1,461,315 and 1,480,258 shares, respectively	(31,734)	(31,809)

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Total shareholders' equity	362,703	352,066
Total liabilities and shareholders' equity	\$ 464,469	\$ 458,578

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

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

(in thousands, except share and per share data)	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Sales				
Product	\$75,720	\$ 62,533	\$146,301	\$124,913
Service	22,524	20,149	44,777	39,331
Total sales	98,244	82,682	191,078	164,244
Cost of Sales				
Product	27,878	24,455	54,762	51,513
Service	12,675	11,467	24,839	22,222
Total cost of sales (exclusive of depreciation and amortization, shown separately below)	40,553	35,922	79,601	73,735
Gross Profit	57,691	46,760	111,477	90,509
Operating Expenses				
Selling and marketing	30,084	26,022	58,355	48,894
General and administrative	11,320	11,877	22,393	22,576
Depreciation and amortization	4,377	3,989	8,720	7,707
Research and development	9,983	9,045	19,389	17,511
Total operating expenses	55,764	50,933	108,857	96,688
Income (loss) from operations	1,927	(4,173)	) 2,620	(6,179)
Other expense (income)				
Interest income, net	(87)	) (89)	) (160)	) (171)
Other expense, net	509	459	693	467
Income (loss) before income tax expense (benefit)	1,505	(4,543)	) 2,087	(6,475)
Income tax expense (benefit)	300	(918)	) 427	(1,389)
Net income (loss)	\$1,205	\$ (3,625)	) \$1,660	\$ (5,086)
Net income (loss) per share - Basic	\$0.07	\$ (0.22)	) \$0.10	\$ (0.30)
Net income (loss) per share - Diluted	\$0.07	\$ (0.22)	) \$0.10	\$ (0.30)
Weighted average shares - Basic	16,966,928	16,700,718	16,902,390	16,692,500
Weighted average shares - Diluted	17,264,642	16,700,718	17,210,054	16,692,500

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

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

(in thousands)	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Net income (loss)	\$1,205	\$(3,625)	\$1,660	\$(5,086)
Currency translation adjustments, net of income tax	(9,377)	7,140	(4,163)	11,299
Comprehensive (loss) income	\$(8,172)	\$3,515	\$(2,503)	\$6,213

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

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

(in thousands)	Six Months Ended	
	June 30, 2018	June 30, 2017
Cash flows from:		
Operating activities:		
Net income (loss)	\$1,660	\$(5,086)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	8,720	7,707
Stock-based compensation	3,400	3,195
Provision for bad debts	211	230
Loss on disposal of assets	165	122
Provision for excess and obsolete inventory	504	736
Deferred income tax (benefit) expense	(190)	168
Change in operating assets and liabilities:		
Decrease (increase) in:		
Accounts receivable	252	4,771
Inventories	(6,664)	(10,107)
Prepaid expenses and other current assets	(3,526)	(6,489)
(Decrease) increase in:		
Accounts payable and accrued liabilities	(2,901)	1,610
Income taxes payable	(4,378)	(590)
Customer deposits	382	(163)
Unearned service revenues	2,372	(472)
Net cash provided by (used in) operating activities	7	(4,368)
Investing activities:		
Proceeds from sale of investments	—	21,000
Purchases of property and equipment	(5,164)	(3,669)
Payments for intangible assets	(1,186)	(645)
Acquisition of businesses	(3,965)	(5,496)
Equity investments and advances to affiliates	(1,786)	—
Net cash (used in) provided by investing activities	(12,101)	11,190
Financing activities:		
Payments on capital leases	(46)	(4)
Proceeds from issuance of stock related to stock option exercises	7,133	284
Net cash provided by financing activities	7,087	280
Effect of exchange rate changes on cash and cash equivalents	(2,399)	4,323
(Decrease) increase in cash and cash equivalents	(7,406)	11,425
Cash and cash equivalents, beginning of period	140,960	106,169
Cash and cash equivalents, end of period	\$133,554	\$117,594
The accompanying notes are an integral part of these condensed consolidated financial statements.		

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

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

NOTE 1 – DESCRIPTION OF BUSINESS

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

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We report our segment information in accordance with the provisions of Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 280, Segment Reporting (“FASB ASC Topic 280”). We evaluate business performance based upon several metrics, using segment profit as the primary financial measure. In the first quarter of 2018, we combined our historical Factory Metrology and 3D Machine Vision verticals under a single reporting segment, 3D Factory, which replaced our Factory Metrology reporting segment, due to the linkage between the two historical verticals related to the type or class of customers served, the nature of the products and services provided, and the nature of the production processes. The 3D Machine Vision vertical was historically reported within the former Other reporting segment. There has been no change in our total consolidated financial condition or results of operations previously reported as a result of the change in our reportable segments. The amounts related to our reporting segment information for the three and six months ended June 30, 2017 have been restated throughout this Quarterly Report on Form 10-Q to reflect the change in reporting segments. Each of our reporting segments continue to employ consistent accounting policies. As a result of this assessment, we now report our activities in the following three reportable segments:

The 3D Factory reporting segment includes our Factory Metrology and 3D Machine Vision verticals and provides both standardized and customized solutions for 3D measurement and inspection in an industrial or manufacturing environment. Applications include alignment, part inspection, dimensional analysis, first article inspection, incoming and in-process inspection, machine calibration, non-contact inspection, robot calibration, tool building and set-up, and assembly guidance.

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

The Emerging Verticals reporting segment (formerly known as "Other") includes our Product Design and Public Safety Forensics verticals. Our Product Design vertical provides advanced 3D solutions to assist in the engineering or design of a movable object, enabling a full digital workflow for applications that include reverse engineering and virtual simulation. Our Public Safety Forensics vertical provides solutions to public safety officials and professionals to capture environmental or situational scenes in 2D and 3D for crime, crash and fire scene investigations and environmental safety evaluations.

All operating segments that do not meet the criteria to be reportable segments are aggregated in the Emerging Verticals reporting segment and have been combined based on the aggregation criteria and quantitative thresholds in accordance with the provisions of FASB ASC Topic 280. See Note 15 – Segment Reporting for further information.

NOTE 2 – PRINCIPLES OF CONSOLIDATION

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

NOTE 3 – BASIS OF PRESENTATION

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

condensed consolidated results of operations for the three or six months ended June 30, 2018 are not necessarily indicative of results that may be expected for the year ending December 31, 2018 or any future interim period.

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The information included in this Quarterly Report on Form 10-Q, including the interim condensed consolidated financial statements and the accompanying notes, should be read in conjunction with the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017. The accompanying December 31, 2017 condensed consolidated balance sheet has been derived from those audited consolidated financial statements.

As described in Note 1 – Description of Business, in the first quarter of 2018, we changed our reporting segment structure. Amounts related to our reporting segment information for the three and six months ended June 30, 2017 have been restated throughout this Quarterly Report on Form 10-Q to reflect the change in reporting segments.

NOTE 4 – IMPACT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

Impact of Recently Adopted Accounting Standards -

In January 2017, the FASB issued Accounting Standards Update (“ASU”) No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business (“ASU 2017-01”) in order to clarify the definition of a business and provide additional guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. ASC Topic 805 recognizes three elements of a business: inputs, processes, and outputs. While an integrated set of assets and activities (collectively referred to as a “set”) that is a business usually has outputs, outputs are not required to be present. Additionally, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs. ASU 2017-01 provides a screen to determine when a set is not a business. The screen requires that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. If the screen is not met, the new guidance (1) requires that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output and (2) removes the evaluation of whether a market participant could replace missing elements. The new guidance provides a framework to assist entities in evaluating whether both an input and a substantive process are present. This framework includes two sets of criteria to consider that depend on whether a set has outputs. Although outputs are not required for a set to be a business, outputs generally are a key element of a business. ASU 2017-01 provides more stringent criteria for sets without outputs and more narrowly defines the term output. ASU 2017-01 became effective for us on January 1, 2018 and was applied prospectively. Our adoption of the new guidance did not have a material impact on our consolidated financial statements.

In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory (“ASU 2016-16”), which removes the prohibition in ASC Topic 740 against the immediate recognition of the current and deferred income tax effects of intra-entity transfers of assets other than inventory. This ASU requires the tax effects of intercompany transactions, other than sales of inventory, to be recognized when the transfer occurs, instead of deferred until the transferred asset is sold to a third party or otherwise recovered through use of the asset. The new guidance must be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. ASU 2016-16 became effective for us on January 1, 2018 and was applied on a modified retrospective basis. Our adoption of the new guidance did not have a material impact on our consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (“ASU 2016-15”), which clarifies how companies present and classify certain cash receipts and cash payments in the statement of cash flows. ASU 2016-15 became effective for us on January 1, 2018 and was applied on a modified retrospective basis. Our adoption of the new guidance did not have a material impact on our consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers: (Topic 606) (“ASU 2014-09”), amending its accounting guidance related to revenue recognition. Under this ASU and subsequently issued amendments, revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Additional

disclosures are required to provide the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. The following represents the impact of our adoption by significant revenue stream:

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Measurement equipment and related software: Under the prior accounting guidance, sales of measurement, imaging and realization equipment and related software sales were generally recognized upon shipment, as we considered the earnings process complete as of the shipping date. The related software sold with our measurement, imaging and realization equipment functions together with such equipment to deliver the tangible product's essential functionality. Customers frequently purchase extended warranties when purchasing measurement equipment and related software. Under the new guidance, we allocate the contract price to performance obligations based on our best estimate of the standalone selling price, utilizing data from the sale of our applicable products and services to customers separately in similar circumstances, with the exception of software licenses. We use the residual method for allocating the contract price to performance obligations relating to software licenses. Our adoption of the new guidance did not result in material changes to our accounting for revenue related to our measurement, imaging and realization equipment and related software.

Extended warranties: Under the prior accounting guidance, extended warranty sales were recognized on a straight-line basis over the term of the warranty. Extended warranty sales include contract periods that extend between one month and three years. The unearned service revenues reported in current and noncurrent liabilities on our condensed consolidated balance sheets appropriately reflect the remaining performance obligations related to these contracts. Our adoption of the new guidance did not result in material changes to our accounting for revenue related to extended warranties.

Software: Under the prior accounting guidance, software only sales were recognized when no further significant production, modification or customization of the software was required and when the following criteria were met: persuasive evidence of a sales agreement existed, delivery had occurred, and the sales price was fixed or determinable and deemed collectible. These software arrangements generally include short-term maintenance that is considered post-contract support. Maintenance renewals, when sold, were recognized on a straight-line basis over the term of the maintenance agreement. Our adoption of the new guidance did not result in material changes to our accounting for revenue related to software only sales and maintenance renewals.

The unearned service revenue liabilities reported on our condensed consolidated balance sheets reflect the contract liabilities to satisfy the remaining performance obligations for extended warranties and software maintenance. The current portion of unearned service revenues on our condensed consolidated balance sheets is what we expect to recognize to revenue within twelve months after the applicable balance sheet date relating to extended warranty and software maintenance contract liabilities. The unearned service revenues - less current portion on our condensed consolidated balance sheets is what we expect to recognize to revenue extending beyond twelve months after the applicable balance sheet date relating to extended warranty and software maintenance contract liabilities. Customer deposits on our condensed consolidated balance sheets represent customer prepayments on contracts for performance obligations that we must satisfy in the future to recognize the related contract revenue. During the three months ended June 30, 2018, we recognized \$7.2 million of service revenue that was deferred on our consolidated balance sheet as of December 31, 2017. During the six months ended June 30, 2018, we recognized \$16.2 million of service revenue that was deferred on our consolidated balance sheet as of December 31, 2017.

Under the prior accounting guidance, we recognized sales commission expense as incurred. Under the new guidance, we must capitalize commission expense and amortize such costs ratably over the term of the contract. In accordance with the modified retrospective method of adoption, we recorded a net increase to opening retained earnings as of January 1, 2018 of \$2.4 million and recognized an associated \$2.4 million deferred cost asset due to the cumulative impact of adopting the new guidance. As of June 30, 2018, the deferred cost asset related to deferred commissions was approximately \$2.5 million. For classification purposes, \$1.8 million and \$0.7 million are comprised within the Prepaid expenses and other current assets and Other long-term assets, respectively, on our condensed consolidated balance sheet. The impact of adopting the new guidance was not material to the consolidated operating results for the six months ended June 30, 2018.

We have elected to account for shipping and handling as activities to fulfill the promise to transfer the good. As such, shipping and handling fees billed to customers in a sales transaction are recorded in Sales and shipping and handling costs incurred are recorded in Cost of Sales. Additionally, we have elected to exclude from Sales any value add, sales and other taxes that we collect concurrent with revenue-producing activities. These accounting policy elections are consistent with the manner in which we have historically recorded shipping and handling fees and taxes.

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The nature of certain of our contracts gives rise to variable consideration, which may be constrained, primarily related to an allowance for sales returns. In accordance with the adoption of the new guidance, we are required to estimate the contract asset related to sales returns and record a corresponding adjustment to Cost of Sales. Historically, our allowance for sales returns has not been material and was approximately \$0.1 million as of June 30, 2018. As such, our adoption of the new guidance did not result in material changes to our accounting for variable consideration related to sales returns, and the corresponding contract asset related to such returns. See Note 5, "Revenues," for further information.

Impact of Recently Issued Accounting Standards -

In January 2017, the FASB issued ASU No. 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment ("ASU 2017-04"), which is intended to simplify the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Under the current guidance, performance of Step 2 requires us to calculate the implied fair value of goodwill by following procedures that would be required to determine the fair value of assets acquired and liabilities assumed in a business combination. Under the new guidance, we will perform our goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge will be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value up to the amount of the goodwill allocated to the reporting unit. The new guidance also eliminates the requirements for any reporting unit with a zero or negative carrying amount to perform Step 2 of the goodwill impairment test if it fails the qualitative assessment. As a result, all reporting units will be subject to the same impairment assessment. We will still have the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. ASU 2017-04 becomes effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019, with early adoption permitted for annual or any interim goodwill impairment tests after January 1, 2017. The amendments in this ASU will be applied on a prospective basis. Disclosure of the nature and reason for the change in accounting principle is required upon transition. This disclosure is required in the first annual period and in the interim period within the first annual period when we initially adopt the amendments in this ASU. We plan to adopt this guidance for our fiscal year ending December 31, 2020. We do not expect that the adoption of this guidance will have a material impact on our consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) ("ASU 2016-02"), which is intended to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. ASU 2016-02 must be applied on a modified retrospective basis and is effective for fiscal years beginning after December 15, 2018, and interim periods within those years, with early adoption permitted. We plan to adopt ASU 2016-02 in the first quarter of 2019. Although we are in the process of evaluating the impact of adoption of this ASU on our consolidated financial statements, we currently believe the most significant changes will be related to the recognition of new right-of-use assets and lease liabilities on our balance sheet for operating leases.

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NOTE 5 – REVENUES

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

	For the Three Months Ended June 30, 2018		2017	
Product sales				
Product transferred to customers at a point in time	\$75,720	\$62,533		
Product transferred to customers over time	—	—		
	\$75,720	\$62,533		
	For the Six Months Ended June 30, 2018			
	2017			
Product sales				
Product transferred to customers at a point in time	\$146,301	\$124,913		
Product transferred to customers over time	—	—		
	\$146,301	\$124,913		
	For the Three Months Ended June 30, 2018			
	2017			
Service sales				
Service transferred to customers at a point in time	\$9,907	\$8,530		
Service transferred to customers over time	12,617	11,619		
	\$22,524	\$20,149		
	For the Six Months Ended June 30, 2018			
	2017			
Service sales				
Service transferred to customers at a point in time	\$19,359	\$17,172		
Service transferred to customers over time	25,418	22,159		
	\$44,777	\$39,331		

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

	For the Three Months Ended June 30, 2018 2017	
Net sales to external customers		
United States	\$40,278	\$32,143
EMEA ⁽¹⁾	29,601	24,320
APAC ⁽¹⁾	24,944	22,882
Other Americas ⁽¹⁾	3,421	3,337
	\$98,244	\$82,682

	For the Six Months Ended June 30, 2018 2017	
Net sales to external customers		
United States	\$77,580	\$63,913
EMEA ⁽¹⁾	59,281	49,280
APAC ⁽¹⁾	47,533	44,142
Other Americas ⁽¹⁾	6,684	6,909
	\$191,078	\$164,244

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

NOTE 6 – STOCK-BASED COMPENSATION

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

We have two compensation plans that provide for the granting of stock options and other share-based awards to key employees and non-employee members of the Board of Directors (the “Board”). The 2009 Equity Incentive Plan (the “2009 Plan”) and the 2014 Equity Incentive Plan (the “2014 Plan”) provide for granting options, restricted stock, restricted stock units or stock appreciation rights to employees and non-employee directors. In May 2018, our shareholders approved an amendment to the 2014 Plan, which increased the number of shares available for issuance under the 2014 Plan by 1,000,000 shares. A maximum of 2,974,543 shares are available for issuance under the 2014 Plan, as amended, plus the number of shares (not to exceed 891,960) underlying awards outstanding under the 2004 Equity Incentive Plan (the “2004 Plan”) and the 2009 Plan as of May 29, 2014 that thereafter terminate or expire unexercised or are canceled, forfeited or lapse for any reason. No awards were outstanding under the 2004 Plan as of June 30, 2018, and no further grants will be made under the 2004 Plan or the 2009 Plan.

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

annual meeting date, subject to the non-employee director's continued membership on the Board. We record compensation cost associated with our restricted stock grants on a straight-line basis over the vesting term.

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

Our annual grants in March 2018 and March 2017 consisted of stock options and restricted stock units that are subject to only time-based vesting. The number of stock options and/or restricted stock units granted was based on the employee's individual objectives, performance against operational metrics assigned to the employee and overall contribution to FARO. The stock options vest in three equal annual installments beginning one year after the grant date. The restricted stock unit awards vest in full on the three-year anniversary of the grant date. The fair value of these stock-based awards is determined by using (a) the Black-Scholes option valuation model in the case of stock options or (b) the current market price of our common stock on the grant date in the case of restricted stock units. In 2015, we granted performance-based stock options and restricted stock units to certain executives. These awards vested in three annual installments beginning one year after the grant date if the applicable performance measures or strategic objectives were achieved. The related stock-based compensation expense was recognized over the requisite service period, taking into account the probability that we would satisfy the performance measures or strategic objectives. In addition to certain strategic objectives, the performance-based stock options and restricted stock units granted in 2015 were earned and vested based upon (1) our achievement of specified revenue and earnings per share targets, and (2) our total shareholder return ("TSR") relative to the TSR attained by companies within our defined peer group.

Due to the TSR presence in certain performance-based grants, the fair value of these awards was determined using the Monte Carlo Simulation valuation model. We expensed these market condition awards over the three-year vesting period regardless of the value the award recipients ultimately received. In March 2018, our Compensation Committee determined that 7,743 performance-based stock options and 266 restricted stock units were earned for the 2017 performance period and 17,160 stock options and 640 restricted stock units were unearned, as the required metrics were not achieved. As of June 30, 2018, all performance-based stock options and restricted stock units granted in 2015 were either vested or were forfeited because they were not earned.

The Black-Scholes option valuation model incorporates assumptions as to stock price volatility, the expected life of options or awards, a risk-free interest rate and dividend yield. The weighted-average grant-date fair value of the stock options that were granted during the six months ended June 30, 2018 and June 30, 2017 and valued using the Black-Scholes option valuation model was \$23.43 and \$14.51 per option, respectively. For stock options granted during the six months ended June 30, 2018 and June 30, 2017 valued using the Black-Scholes option valuation model, we used the following assumptions:

	Six Months Ended		
	June 30,	June 30,	
	2018	2017	
Risk-free interest rate	2.65	% 1.88% - 2.02%	
Expected dividend yield	—	% —	%
Expected term of option	4 years	5 years	
Expected volatility	45.0	% 45.2	%
Weighted-average expected volatility	45.0	% 45.2	%

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

A summary of stock option activity and weighted-average exercise prices during the six months ended June 30, 2018 follows:

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	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value as of June 30, 2018
Outstanding at January 1, 2018	1,156,763	\$ 45.93		
Granted	174,439	61.30		
Forfeited or expired	(60,448)	50.21		
Exercised	(162,594)	43.41		