HESKA CORP
Form 10-Q
May 10, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2016
OR

o 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: 0-22427
HESKA CORPORATION
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 77-0192527 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification Number) |
| 3760 Rocky Mountain Avenue<br>Loveland, Colorado | 80538 |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code:
(970) 493-7272

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 x No o
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 x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

| | |
|---|---|
| Large accelerated filer o | Accelerated filer x |
| Non-accelerated filer o (Do not check if a small reporting company) | Smaller Reporting Company ¨ |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x
6,682,137 shares of the Registrant's Public Common Stock, $.01 par value, were outstanding at May 9, 2016.

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HESKA CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands, except shares and per share amounts)

| | December 31, 2015 | (unaudited) March 31, 2016 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $6,890 | $6,180 |
| Accounts receivable, net of allowance for doubtful accounts of $189 and $203, respectively | 16,136 | 13,707 |
| Due from – related parties | 308 | 244 |
| Inventories, net | 16,101 | 18,613 |
| Other current assets | 1,827 | 1,440 |
| Total current assets | 41,262 | 40,184 |
| Property and equipment, net | 17,020 | 17,761 |
| Note receivable – related party | 1,516 | 1,528 |
| Goodwill and other intangibles | 20,966 | 20,992 |
| Deferred tax asset | 25,883 | 25,302 |
| Other long-term assets | 3,072 | 4,325 |
| Total assets | $109,719 | $110,092 |
| | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $7,624 | $5,941 |
| Accrued liabilities | 5,416 | 6,661 |
| Current portion of deferred revenue | 5,461 | 3,896 |
| Line of credit | 143 | 798 |
| Other short-term borrowings, including current portion of long-term note payable | 159 | 159 |
| Total current liabilities | 18,803 | 17,455 |
| Long-term note payable, net of current portion | 69 | 32 |
| Deferred revenue, net of current portion, and other | 11,572 | 11,323 |
| Total liabilities | 30,444 | 28,810 |
| Commitments and contingencies (Note 11) | | |
| Non-Controlling Interest | 15,747 | 15,777 |
| Stockholders' equity: | | |
| Preferred stock, $.01 par value, 2,500,000 shares authorized, none issued or outstanding | — | — |
| Common stock, $.01 par value, 7,500,000 shares authorized, none issued or outstanding | — | — |
| Public common stock, $.01 par value, 7,500,000 shares authorized, 6,625,287 and 6,636,389 shares issued and outstanding, respectively | 66 | 66 |
| Additional paid-in capital | 227,267 | 227,798 |
| Accumulated other comprehensive income | 187 | 186 |
| Accumulated deficit | (163,992 ) | (162,545 ) |
| Total stockholders' equity | 63,528 | 65,505 |

| | | |
|---|---|---|
| Total liabilities and stockholders' equity | $109,719 | $110,092 |

See accompanying notes to consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

| | Three Months Ended March 31, | |
|---|---|---|
| | 2015 | 2016 |
| Revenue: | | |
| Core companion animal health | $19,572 | $23,434 |
| Other vaccines, pharmaceuticals and products | 3,322 | 3,712 |
| Total revenue, net | 22,894 | 27,146 |
| Cost of revenue | 12,810 | 15,704 |
| Gross profit | 10,084 | 11,442 |
| Operating expenses: | | |
| Selling and marketing | 5,460 | 5,619 |
| Research and development | 419 | 575 |
| General and administrative | 3,184 | 3,278 |
| Total operating expenses | 9,063 | 9,472 |
| Operating income | 1,021 | 1,970 |
| Interest and other expense (income), net | 137 | (133) |
| Income before income taxes | 884 | 2,103 |
| Income tax expense: | | |
| Current income tax expense | 44 | 74 |
| Deferred income tax expense | 257 | 582 |
| Total income tax expense | 301 | 656 |
| Net income | 583 | 1,447 |
| Net income (loss) attributable to non-controlling interest | (15) | 261 |
| Net income attributable to Heska Corporation | $598 | $1,186 |
| Basic earnings per share attributable to Heska Corporation | $0.10 | $0.18 |
| Diluted earnings per share attributable to Heska Corporation | $0.09 | $0.17 |
| Weighted average outstanding shares used to compute basic earnings per share attributable to Heska Corporation | 6,181 | 6,496 |
| Weighted average outstanding shares used to compute diluted earnings per share attributable to Heska Corporation | 6,869 | 7,164 |

See accompanying notes to consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(in thousands)
(unaudited)

| | Three Months Ended March 31, | |
|---|---|---|
| | 2015 | 2016 |
| Net income | $583 | $1,447 |
| Other comprehensive income (expense): | | |
| Sale of equity investment | — | (90) |
| Foreign currency translation | 76 | 89 |
| Comprehensive income | 659 | 1,446 |
| Comprehensive income (loss) attributable to non-controlling interest | (15) | 261 |
| Comprehensive income attributable to Heska Corporation | $674 | $1,185 |

See accompanying notes to consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

| | Three Months Ended March 31, | |
|---|---|---|
| | 2015 | 2016 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $583 | $1,447 |
| Adjustments to reconcile net income to cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 1,006 | 1,096 |
| Deferred tax expense | 257 | 582 |
| Stock based compensation | 398 | 527 |
| Unrealized (gain) loss on foreign currency translation | 16 | (1) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 405 | 2,429 |
| Inventories | (4,058) | (3,538) |
| Other current assets | (194) | 323 |
| Accounts payable | 237 | (1,683) |
| Accrued liabilities and other | 785 | 1,229 |
| Other non-current assets | (393) | (1,250) |
| Deferred revenue and other | (432) | (1,798) |
| Net cash used in operating activities | (1,390) | (637) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from sale of equity investment | — | 115 |
| Purchases of property and equipment | (605) | (905) |
| Proceeds from disposition of property and equipment | — | 95 |
| Net cash used in investing activities | (605) | (695) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from issuance of common stock, net of distributions | 235 | 33 |
| Proceeds from line of credit borrowings, net | 1,633 | 655 |
| Repayments of other debt | (34) | (128) |
| Net cash provided by financing activities | 1,834 | 560 |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH | 34 | 62 |
| DECREASE IN CASH AND CASH EQUIVALENTS | (127) | (710) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 5,855 | 6,890 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | $5,728 | $6,180 |

See accompanying notes to consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

Heska Corporation and its wholly-owned and majority-owned subsidiaries ("Heska", the "Company", "we" or "our") sell advanced veterinary diagnostic and other specialty veterinary products. Our offerings include blood testing instruments and supplies, digital imaging products, software and services, and single use products and services such as in-clinic heartworm diagnostic tests, heartworm preventive products, allergy immunotherapy products and allergy testing. Our core focus is on the canine and feline companion animal health markets.

In the opinion of management, the accompanying unaudited Condensed Consolidated Financial Statements contain all adjustments, consisting of normal, recurring adjustments, necessary to present fairly the financial position of the Company at March 31, 2016, and the results of our operations and cash flows for the three months ended March 31, 2016 and 2015.

The Condensed Consolidated Financial Statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") have been condensed or omitted pursuant to such rules and regulations. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements and Notes thereto contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015 and other financial information filed with the SEC.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the 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. Significant estimates are required when establishing the allowance for doubtful accounts and the provision for excess or obsolete inventory, in determining the period over which our obligations are fulfilled under agreements to license product rights and/or technology rights, evaluating long-lived and intangible assets for impairment, determining the allocation of purchase price under purchase accounting, estimating the expense associated with the granting of stock options, determining the value of our non-controlling interest and in determining the need for, and the amount of, a valuation allowance on deferred tax assets.

Critical Accounting Policies

Our accounting policies are described in our audited Consolidated Financial Statements and Notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2015.

Recent Accounting Pronouncements

In March 2016, the FASB issued guidance codified in Accounting Standards Codification (“ASC”) Topic 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. The standard simplifies several aspects related to the accounting for share-based payment transactions, including the accounting for income taxes, statutory tax withholding requirements and classification on the statement of cash flows. The standard will be effective for the fiscal year beginning January 1, 2017 and subsequent interim periods. We are currently evaluating the impact the provisions of the Topic will have on our consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

In February 2016, the FASB issued ASU 2016-02, Leases, which supersedes ASC 840, Leases, and creates a new topic, ASC 842, Leases. This update requires lessees to recognize a lease liability and a lease asset for all leases, including operating leases, with a term greater than 12 months on its balance sheet. The update also expands the required quantitative and qualitative disclosures surrounding leases. This update is effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years, with earlier application permitted. This update will be applied using a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. We are currently evaluating the effect of this update on our consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes. The amendments in this update simplify the presentation of deferred income taxes and require that deferred tax liabilities and assets be classified as non-current in a classified statement of financial position. This update applies to all entities that present a classified statement of financial position. These amendments may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. If the guidance is applied prospectively, disclosure is made in the first interim and first annual period of change, the nature of and reason for the change in accounting principle and a statement that prior periods were not retrospectively adjusted. If the guidance is applied retrospectively, disclosure is made in the first interim and first annual period of change, the nature of and reason for the change in accounting principle and quantitative information about the effects of the accounting change on prior periods. The amendments are effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Earlier application is permitted for all entities as of the beginning of an interim or annual reporting period. We have decided to early-adopt ASU 2015-17, which resulted in a retrospective adjustment of amounts disclosed in our consolidated balance sheet as of March 31, 2015.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). Upon the effective date, the ASU replaces almost all existing revenue recognition guidance, including industry specific guidance, in generally accepted accounting principles. In August 2015, the FASB issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date. The amendments in this update deferred the effective date for implementation of ASU 2014-09 by one year and are now effective for annual reporting periods beginning after December 15, 2017. Early application is permitted only as of annual reporting periods beginning after December 15, 2016 including interim reporting periods within that period. We are currently assessing the impact that the adoption of this standard will have on our consolidated financial statements and related disclosures upon implementation.

2. ACQUISITION AND RELATED PARTY ITEMS

On February 24, 2013, the Company acquired a 54.6% interest in Cuattro Veterinary USA, LLC which was subsequently renamed Heska Imaging US, LLC ("Heska Imaging"). The remaining minority position (45.4)% in Heska Imaging is subject to purchase by Heska under performance-based puts and calls following calendar year 2016 and 2017. Should Heska undergo a change in control, as defined, prior to the end of 2017, Heska Imaging minority unit holders will be entitled to sell their Heska Imaging units to Heska.

Heska Imaging markets, sells and supports digital radiography and ultrasound products along with embedded software and support, data hosting and other services.

Shawna M. Wilson, Clint Roth, DVM, Steven M. Asakowicz, Rodney A. Lippincott, Kevin S. Wilson and Cuattro, LLC own approximately 29.75%, 8.39%, 4.09%, 3.07%, 0.05% and 0.05% of Heska Imaging, respectively. Kevin S. Wilson is the Chief Executive Officer and President of the Company and the spouse of

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HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

Shawna M. Wilson. Steven M. Asakowicz serves as Executive Vice President, Companion Animal Health Sales for the Company. Rodney A. Lippincott serves as Executive Vice President, Companion Animal Health Sales for the Company. Mr. Wilson, Mrs. Wilson and trusts for their children and family own a 100% interest in Cuattro, LLC. Cuattro, LLC owns a 100% interest in Cuattro Software, LLC. Mr. Wilson, Mrs. Wilson and trusts for their children and family own a majority interest in Cuattro Veterinary, LLC and Cuattro Medical, LLC.

Since January 1, 2016, Cuattro, LLC has charged Heska Imaging $3.1 million, primarily related to digital imaging products, for which there is an underlying supply contract with minimum purchase obligations, software and services as well as other operating expenses; Heska Corporation charged Heska Imaging $1.3 million, primarily related to sales expenses; Heska Corporation charged Cuattro, LLC $82 thousand, primarily related to facility usage and other services.

At March 31, 2016, Heska Imaging had a $1.5 million note receivable, including accrued interest, from Cuattro Veterinary, LLC, which is due on June 15, 2016 and listed as "Note receivable - related party" on the Company's consolidated balance sheets. We currently do not anticipate collecting this note in 2016 due to our pending acquisition of Cuattro Veterinary, LLC. Heska Corporation had net accounts receivable from Cuattro, LLC of $32 thousand which is included in "Due from – related parties" on the Company's consolidated balance sheets; Heska Imaging had net prepaid receivables from Cuattro, LLC of $212 thousand which is included in "Due from – related parties" on the Company's consolidated balance sheets; Heska Corporation had accounts receivable from Heska Imaging of $5.4 million, including accrued interest, which eliminated in consolidation of the Company's financial statements; all monies owed accrue interest at the same interest rate Heska Corporation pays under its credit and security agreement with Wells Fargo Bank, National Association ("Wells Fargo") once past due with the exception of the note receivable, which accrues at this rate to its maturity date.

The aggregate position in Heska Imaging of the unit holders who hold the 45.4% of Heska Imaging that Heska Corporation does not own (the "Put Value") is being accreted to its estimated redemption value in accordance with Heska Imaging's Operating Agreement (the "Operating Agreement"). Since the Operating Agreement contains certain put rights that are out of the control of the Company, authoritative guidance requires the non-controlling interest, which includes the estimated value of such put rights, to be displayed outside of the equity section of the consolidated balance sheets. The adjustment to increase or decrease the Put Value to its expected redemption value and to estimate any distributions required under the Operating Agreement to the unit holders who hold the 45.4% of Heska Imaging that Heska Corporation does not own (the "Imaging Minority") each reporting period is recorded to stockholders' equity in accordance with U.S. GAAP.

The following is a reconciliation of the non-controlling interest balance (in thousands):

| | |
|---|---|
| Beginning December 31, 2015 | $15,747 |
| Accretion of Put Value | 30 |
| Balance March 31, 2016 | $15,777 |

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

3. INCOME TAXES

Our total income tax expense and the effective tax rate for our income before income taxes are as follows (in thousands):

| | Three months ended March 31, | |
|---|---|---|
| | 2015 | 2016 |
| Income before income taxes | $884 | $2,103 |
| Total income tax expense | 301 | 656 |
| Effective tax rate | 34.0 % | 31.2 % |

We are subject to income taxes in the U.S. federal jurisdiction, and various foreign, state and local jurisdictions. Tax regulations within each jurisdiction are subject to the interpretation of the related tax laws and regulations and require significant judgment to apply. Cash paid for income taxes for each of the three months ended March 31, 2015 and 2016 was $5 thousand.

4. EARNINGS PER SHARE

Basic earnings per share ("EPS") is computed by dividing net income attributable to Heska Corporation by the weighted-average number of common shares outstanding during the period. The computation of diluted EPS is similar to the computation of basic EPS except that the numerator is increased to exclude charges that would not have been incurred, and the denominator is increased to include the number of additional common shares that would have been outstanding (using the if-converted and treasury stock methods), if securities containing potentially dilutive common shares (stock options and restricted stock units but excluding options to purchase fractional shares resulting from the Company's December 2010 1-for-10 reverse stock split) had been converted to common shares, and if such assumed conversion is dilutive.

The following is a reconciliation of the weighted-average shares outstanding used in the calculation of basic and diluted earnings per share for the three months ended March 31, 2015 and 2016 (in thousands, except per share data):

| | Three Months Ended March 31, | |
|---|---|---|
| | 2015 | 2016 |
| Net income attributable to Heska Corporation | $598 | $1,186 |
| | | |
| Basic weighted-average common shares outstanding | 6,181 | 6,496 |
| Assumed exercise of dilutive stock options and restricted stock units | 688 | 668 |
| Diluted weighted-average common shares outstanding | 6,869 | 7,164 |
| | | |
| Basic earnings per share | $0.10 | $0.18 |
| Diluted earnings per share | $0.09 | $0.17 |

The following stock options and restricted units were excluded from the computation of diluted earnings per share because they would have been anti-dilutive (in thousands):

| | Three Months Ended March 31, | |
|---|---|---|
| | 2015 | 2016 |
| Stock options | 106 | 120 |

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

5. GOODWILL AND OTHER INTANGIBLES

The following summarizes the changes in goodwill during the three months ended March 31, 2016 (in thousands):

| | March 31, 2016 |
|---|---|
| Carrying amount, beginning of period | $20,910 |
| Adjustments due to foreign currency fluctuations | 29 |
| Carrying amount, end of period | $20,939 |

Other intangibles consisted of the following as of December 31, 2015 and March 31, 2016 (in thousands):

| | December 31, 2015 | March 31, 2016 |
|---|---|---|
| Gross carrying amount | $ 788 | $788 |
| Accumulated amortization | (732 ) | (735 ) |
| Net carrying amount | $ 56 | $53 |

Amortization expense relating to other intangibles is as follows (in thousands):

| | Three Months Ended March 31, | |
|---|---|---|
| | 2015 | 2016 |
| Amortization expense | $65 | $ 3 |

Estimated amortization expense related to intangibles for each of the five years from 2016 (remaining) through 2020 and thereafter is as follows (in thousands):

| Year Ending December 31, | |
|---|---|
| 2016 (remaining) | $7 |
| 2017 | 10 |
| 2018 | 10 |
| 2019 | 10 |
| 2020 | 10 |
| Thereafter | 6 |
| | $53 |

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

6. PROPERTY AND EQUIPMENT

Detail of property and equipment is as follows (in thousands):

| | December 31, 2015 | March 31, 2016 |
|---|---|---|
| Land | $377 | $377 |
| Building | 2,868 | 2,868 |
| Machinery and equipment | 35,284 | 36,945 |
| Leasehold and building improvements | 6,673 | 6,720 |
| Construction in progress | 1,496 | 1,531 |
| | 46,698 | 48,441 |
| Less accumulated depreciation and amortization | (29,678 ) | (30,680 ) |
| Total property and equipment, net | $17,020 | $17,761 |

The Company has utilized marketing programs whereby its instruments in inventory may be placed in a customer's location on a rental basis. The cost of these instruments is transferred to machinery and equipment or other long-term assets and depreciated, typically over a five to seven year period depending on the circumstance under which the instrument is placed with the customer. Total costs transferred from inventory were approximately $1.0 million for each of the three month periods ended March 31, 2015 and 2016.

The Company has sold certain customer rental contracts and underlying assets to a third party under the agreement that once the customer has met the customer obligations under the contract, ownership of the assets underlying the contract would be returned to the Company. The Company enters a debit to cash and a corresponding credit to deferred revenue at the time of these sales. These sales, all related to the Company's 54.6%-owned subsidiary, Heska Imaging, provided $42 thousand of cash which was reported in the "deferred revenue and other" line item of the Company's consolidated statements of cash flows for the three months ended March 31, 2015. There were no such sales during the three months ended March 31, 2016. As the Company anticipates it will regain ownership of the assets underlying these sales, it reports these assets as part of property and equipment and depreciates these assets per its depreciation policies. The Company had $2.2 million and $1.9 million of net property and equipment related to these transactions as of December 31, 2015 and March 31, 2016, respectively, all related to the Company's 54.6%-owned subsidiary, Heska Imaging.

Depreciation and amortization expense for property and equipment was $1.0 million and $1.1 million for the three months ended March 31, 2015 and 2016, respectively.

The Company capitalizes third-party software costs, where appropriate, and reports such costs, net of accumulated amortization, on the "property and equipment, net" line of its consolidated balance sheets. We had $0.4 million of such capitalized costs, net of accumulated amortization, on the "property and equipment, net" line on each of our consolidated balance sheets as of December 31, 2015 and March 31, 2016, respectively. Capitalized software costs in a given year are reported on the "purchases of property and equipment" line item of the Company's consolidated statements of cash flows. We had $35 thousand of capitalized software costs reported on the "purchases of property and equipment" line item of our consolidated statements of cash flows for the quarter ended March 31, 2015. There were no capitalized software costs incurred in the three months ended March 31, 2016.

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

7. INVENTORIES

Inventories are stated at the lower of cost or net realizable value using the first-in, first-out method. Inventory we manufacture includes the cost of material, labor and overhead. If the cost of inventories exceeds estimated net realizable value, provisions are made to reduce the carrying value to estimated net realizable value.

Inventories, net consist of the following (in thousands):

| | December 31, 2015 | March 31, 2016 |
|---|---|---|
| Raw materials | $8,531 | $10,475 |
| Work in process | 2,839 | 3,472 |
| Finished goods | 6,122 | 6,092 |
| Allowance for excess or obsolete inventory | (1,391) | (1,426) |
| | $16,101 | $18,613 |

8. ACCRUED LIABILITIES

Accrued liabilities consisted of the following as of December 31, 2015 and March 31, 2016 (in thousands):

| | December 31, 2015 | March 31, 2016 |
|---|---|---|
| Accrued payroll and employee benefits | $ 860 | $ 1,013 |
| Accrued property taxes | 721 | 357 |
| Accrued purchases | 300 | 1,274 |
| Other | 3,535 | 4,017 |
| Total accrued liabilities | $ 5,416 | $ 6,661 |

Other accrued liabilities consists of items that are individually less than 5% of total current liabilities.

9. CAPITAL STOCK

Stock Option Plans

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-model with the following weighted average assumptions for options granted in the three months ended March 31, 2015 and 2016.

| | 2015 | 2016 |
|---|---|---|
| Risk-free interest rate | 1.10% | 1.45% |
| Expected lives | 3.4 years | 4.5 years |
| Expected volatility | 42% | 41% |
| Expected dividend yield | 0% | 0% |

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

A summary of our stock option plans, excluding options to purchase fractional shares resulting from our December 2010 1-for-10 reverse stock split, is as follows:

| | Year Ended December 31, 2015 | | Three Months Ended March 31, 2016 | |
|---|---|---|---|---|
| | Options | Weighted Average Exercise Price | Options | Weighted Average Exercise Price |
| Outstanding at beginning of period | 1,074,251 | $ 10.110 | 940,610 | $ 14.163 |
| Granted at Market | 146,446 | $ 36.904 | 1,000 | $ 30.520 |
| Canceled | (28,440) | $ 10.080 | (347) | $ 14.711 |
| Exercised | (251,647) | $ 10.559 | (5,290) | $ 11.675 |
| Outstanding at end of period | 940,610 | $ 14.163 | 935,973 | $ 14.195 |
| Exercisable at end of period | 621,559 | $ 10.269 | 642,909 | $ 10.272 |

The total estimated fair value of stock options granted during the three months ended March 31, 2015 and 2016 were computed to be approximately $15 thousand and $11 thousand, respectively. The amounts are amortized ratably over the vesting periods of the options. The weighted average estimated fair value of options granted during the three months ended March 31, 2015 and 2016 was computed to be approximately $6.17 and $10.93, respectively. The total intrinsic value of options exercised during the three months ended March 31, 2015 and 2016 was $1.3 million and $107 thousand, respectively. The cash proceeds from options exercised during the three months ended March 31, 2015 and 2016 was $407 thousand and $62 thousand, respectively.

The following table summarizes information about stock options outstanding and exercisable at March 31, 2016, excluding outstanding options to purchase an aggregate of 6.0 fractional shares resulting from our December 2010 1-for-10 reverse stock split with a weighted average remaining contractual life of 0.60 years, a weighted average exercise price of $16.77 and exercise prices ranging from $11.00-$22.50. We intend to issue whole shares only from option exercises. The following table includes 109,500 shares underlying options issued in December 2015 with a strike price of $39.76 and expiration date of December 28, 2025 which will only vest and become exercisable if our stockholders approve an increase in the total number of authorized shares of our Public Common Stock to at least 8.5 million shares on or before December 31, 2022.

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Exercise Prices | Number of Options Outstanding at March 31, 2016 | Weighted Average Remaining Contractual Life in Years | Weighted Average Exercise Price | Number of Options Exercisable at March 31, 2016 | Weighted Average Exercise Price |
| $ 4.40 - $ 6.90 | 225,302 | 4.52 | $ 5.600 | 223,052 | $ 5.594 |
| $ 6.91 - $ 8.26 | 188,524 | 7.62 | $ 7.384 | 108,788 | $ 7.384 |
| $ 8.27 - $15.80 | 189,795 | 6.02 | $ 9.688 | 162,762 | $ 9.748 |
| $15.81 - $18.30 | 178,965 | 5.19 | $ 18.016 | 114,674 | $ 17.952 |
| $18.31 - $39.76 | 153,387 | 9.26 | $ 36.306 | 33,633 | $ 26.980 |
| $ 4.40 - $39.76 | 935,973 | 6.35 | $ 14.195 | 642,909 | $ 10.272 |

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HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

As of March 31, 2016, there was approximately $2.0 million in total unrecognized compensation cost related to outstanding stock options. That cost is expected to be recognized over a weighted average period of 1.70 years, with approximately $560 thousand to be recognized in the nine months ending December 31, 2016 and all cost to be recognized as of March 2020, assuming all options vest according to the vesting schedules in place at March 31, 2016. As of March 31, 2016, the aggregate intrinsic value of outstanding options was approximately $14.6 million and the aggregate intrinsic value of exercisable options was approximately $11.7 million.

Employee Stock Purchase Plan (the "ESPP")

For the three months ended March 31, 2015 and 2016, we issued 827 and 5,885 shares under the ESPP, respectively. In all periods presented, we estimated the fair values of stock purchase rights granted under the ESPP using the Black-Scholes pricing model. The weighted average assumptions used for the periods presented were as follows:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2015 | 2016 |
| Risk-free interest rate | 0.23% | 0.51% |
| Expected lives | 1.3 years | 1.2 years |
| Expected volatility | 35% | 41% |
| Expected dividend yield | 0% | 0% |

For the three months ended March 31, 2015 and 2016, the weighted-average fair value of the purchase rights granted was $5.21 and $6.29 per share, respectively.

Restricted Stock Issuance

On March 17, 2015, the Company issued unvested shares to certain Executive Officers related to performance-based restricted stock grants (the "Performance Grants") and performance-based restricted stock grants related to the Company's 2015 Management Incentive Plan (the "2015 MIP Grants"). The Company issued 52,956 shares under the Performance Grants and 24,649 shares under 2015 MIP Grants. The Performance Grants have met the underlying performance condition based on the Company's 2015 financial performance and are to cliff vest on March 17, 2018, subject to other vesting provisions in the underlying restricted stock grant agreement. The 2015 MIP Grants were subject to the Company’s achievement of certain financial goals and other vesting provisions in the underlying restricted stock grant agreement. On March 2, 2016, the Company vested 14,364 shares related to the 2015 MIP Grant based on the respective performance criteria, including 4,788 shares withheld for tax, and canceled the remaining 10,285 shares.

On March 2, 2016, the Company issued 15,000 unvested shares to certain Executive Officers related to performance-based restricted stock grants as part of the Company’s 2016 Management Incentive Plan (the "2016 MIP Grants"). The 2016 MIP Grants are to vest on the date MIP Payouts are to be made under the 2016 Management Incentive Plan and are subject to the Company’s achievement of certain financial goals and other vesting provisions in the underlying restricted stock grant agreement.

On March 26, 2016, 27,500 shares originally issued to Mr. Wilson on March 26, 2014 pursuant to an employment agreement between Mr. Wilson and the Company effective as of March 26, 2014 (the "Wilson Employment Agreement") vested pursuant to the Wilson Employment Agreement.

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

Restrictions on the transfer of Company stock

The Company's Restated Certificate of Incorporation, as amended (the "Certificate of Incorporation"), places restrictions (the "Transfer Restrictions") on the transfer of the Company's stock that could adversely affect the Company's ability to utilize its domestic Federal Net Operating Loss Position. In particular, the Transfer Restrictions prevent the transfer of shares without the approval of the Company's Board of Directors if, as a consequence of such transfer, an individual, entity or groups of individuals or entities would become a 5-percent holder under Section 382 of the Internal Revenue Code of 1986, as amended, and the related Treasury regulations, and also prevents any existing 5-percent holder from increasing his or her ownership position in the Company without the approval of the Company's Board of Directors. Any transfer of shares in violation of the Transfer Restrictions (a "Transfer Violation") shall be void ab initio under the Certificate of Incorporation, and the Company's Board of Directors has procedures under the Certificate of Incorporation to remedy a Transfer Violation including requiring the shares causing such Transfer Violation to be sold and any profit resulting from such sale to be transferred to a charitable entity chosen by the Company's Board of Directors in specified circumstances.

10. ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income consisted of the following (in thousands):

| | Minimum pension liability | Foreign currency translation | Unrealized gains (losses) on available for sale investments | Total accumulated other comprehensive income |
|---|---|---|---|---|
| Balances at December 31, 2015 | $ (576) | $ 673 | $ 90 | $ 187 |
| Current period other comprehensive income (loss) | — | 89 | (90) | (1) |
| Balances at March 31, 2016 | $ (576) | $ 762 | $ — | $ 186 |

11. COMMITMENTS AND CONTINGENCIES

The Company holds certain rights to market and manufacture all products developed or created under certain research, development and licensing agreements with various entities. In connection with such agreements, the Company has agreed to pay the entities royalties on net product sales. In each of the three months ended March 31, 2015 and 2016, royalties of $0.1 million became payable under these agreements.

The Company has contracts with suppliers for unconditional annual minimum inventory purchases and milestone obligations to third parties the Company believes are likely to be triggered currently totaling approximately $0.2 million for each of the fiscal years 2016 and 2017.

From time to time, the Company may be involved in litigation relating to claims arising out of its operations. On March 12, 2015, a complaint was filed against us by Shaun Fauley in the United States District Court Northern District of Illinois alleging our transmittal of unauthorized faxes in violation of the federal Telephone Consumer Protection Act of 1991, as amended by the Junk Fax Prevention Act of 2005, as a class action seeking stated damages of the greater of actual monetary loss or five hundred dollars per violation. We intend to defend ourselves vigorously in this matter. As of March 31, 2016, the Company was not a party to any other legal proceedings that were expected, individually or in the aggregate, to have a material adverse effect on our business, financial condition or operating results.

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

The Company's current terms and conditions of sale include a limited warranty that its products and services will conform to published specifications at the time of shipment and a more extensive warranty related to certain of its products. The Company also sells a renewal warranty for certain of its products. The typical remedy for breach of warranty is to correct or replace any defective product, and if not possible or practical, the Company will accept the return of the defective product and refund the amount paid. Historically, the Company has incurred minimal warranty costs. The Company's warranty reserve at March 31, 2016 was $0.4 million.

12. INTEREST AND OTHER EXPENSE (INCOME)

Interest and other expense (income) consisted of the following (in thousands):

| | Three Months Ended March 31, | |
|---|---|---|
| | 2015 | 2016 |
| Interest income | $(58) | $(33) |
| Interest expense | 52 | 38 |
| Other, net | 143 | (138) |
| | $137 | $(133) |

Cash paid for interest for each of the three months ended March 31, 2015 and 2016 was $18 thousand.

13. CREDIT FACILITY

At March 31, 2016, we had a $15.0 million asset-based revolving line of credit with Wells Fargo which has a maturity date of December 31, 2017 as part of our credit and security agreement with Wells Fargo. At March 31, 2016, we had $0.8 million of borrowings outstanding on this line of credit. Our ability to borrow under this line of credit varies based upon available cash, eligible accounts receivable and eligible inventory. On March 31, 2016, any interest on borrowings due was to be charged at a stated rate of three month LIBOR plus 2.25% and payable monthly. There is an annual minimum interest charge of $75 thousand under the agreement. We are required to comply with various financial and non-financial covenants, and we have made various representations and warranties under our agreement with Wells Fargo. A key financial covenant is based on a fixed charge coverage ratio, as defined in our agreement with Wells Fargo. We were in compliance with all financial covenants as of March 31, 2016 and our available borrowing capacity based upon eligible accounts receivable and eligible inventory under our revolving line of credit was approximately $10.7 million.

14. SEGMENT REPORTING

The Company consists of two reportable segments, Core Companion Animal Health ("CCA") and Other Vaccines, Pharmaceuticals and Products ("OVP"). The Core Companion Animal Health segment includes diagnostic instruments and supplies, as well as single use diagnostic and other tests, pharmaceuticals and vaccines, primarily for canine and feline use. The CCA segment also includes digital radiography and ultrasound products along with embedded software and support, data hosting and other services from Heska Imaging. These products are sold directly by the Company as well as through independent third-party distributors and through other distribution relationships. CCA segment products manufactured at the Des Moines, Iowa production facility included in the OVP segment's assets are transferred at cost and are not recorded as revenue for the OVP segment. The Other Vaccines, Pharmaceuticals and Products segment includes private label vaccine and pharmaceutical production, primarily for cattle, but also for other animals including small mammals. All OVP products are sold by third parties under third-party labels.

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

One customer represented approximately 11% of our revenue and another company generated approximately 12% of our revenue for the three months ended March 31, 2015. One customer represented approximately 20% of our accounts receivable at December 31, 2015 and 13% of our accounts receivable at March 31, 2016 and another customer represented 13% of our accounts receivable at December 31, 2015 and 10% of accounts receivable at March 31, 2016. No other customers represented 10% or more of revenue for the three months ended March 31, 2015 and 2016 nor 10% or more of accounts receivable at December 31, 2015 or March 31, 2016. We have established an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends, and other information.

Summarized financial information concerning the Company's reportable segments is shown in the following table (in thousands):

| Three Months Ended March 31, 2015 | Core Companion Animal Health | Other Vaccines, Pharmaceuticals and Products | Total |
|---|---|---|---|
| Total revenue | $ 19,572 | $ 3,322 | $22,894 |
| Operating Income | 535 | 486 | 1,021 |
| Income before income taxes | 410 | 474 | 884 |
| Capital expenditures | 307 | 298 | 605 |
| Depreciation and amortization | 830 | 176 | 1,006 |

| Three Months Ended March 31, 2016 | Core Companion Animal Health | Other Vaccines, Pharmaceuticals and Products | Total |
|---|---|---|---|
| Total revenue | $ 23,434 | $ 3,712 | $27,146 |
| Operating Income | 1,758 | 212 | 1,970 |
| Income before income taxes | 1,808 | 295 | 2,103 |
| Capital expenditures | 397 | 508 | 905 |
| Depreciation and amortization | 897 | 199 | 1,096 |

Revenue is attributed to individual countries based on customer location. Total revenue by principal geographic area was as follows (in thousands):

| | Three Months Ended March 31, | |
|---|---|---|
| | 2015 | 2016 |
| United States | $22,279 | $26,480 |
| Europe | 615 | 666 |
| Total | $22,894 | $27,146 |

Asset information by reportable segment as of December 31, 2015 is as follows (in thousands):

| | Core Companion Animal Health | Other Vaccines, Pharmaceuticals and Products | Total |
|---|---|---|---|
| Total assets | $ 92,567 | $ 17,152 | $109,719 |
| Net assets | 48,175 | 15,353 | 63,528 |

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

Asset information by reportable segment as of March 31, 2016 is as follows (in thousands):

| | Core Companion Animal Health | Other Vaccines, Pharmaceuticals and Products | Total |
|---|---|---|---|
| Total assets | $ 93,330 | $ 16,762 | $110,092 |
| Net assets | 57,152 | 8,353 | 65,505 |

Total assets by principal geographic areas were as follows (in thousands):

| | December 31, 2015 | March 31, 2016 |
|---|---|---|
| United States | $106,780 | $106,980 |
| Europe | 2,939 | 3,112 |
| Total | $109,719 | $110,092 |

15. SUBSEQUENT EVENTS

On November 11, 2015, the Company entered into a Unit Purchase Agreement (the "International Agreement") with Cuattro Veterinary, LLC ("Cuattro International"), Kevin S. Wilson and all of the Cuattro International members (the "Members"). Cuattro International sells the same digital radiography solutions outside the United States that Heska Imaging sells in the United States. Under the terms of the International Agreement, the Company agreed to deliver $6.0 million in stock, subject to a minimum of 175,000 shares and a maximum of 200,000 shares, in exchange for 100% ownership of Cuattro International. In addition, the Company also agreed to issue additional shares of common stock to the Members (the "Contingent Shares") in the event that any of the liabilities or obligations of Cuattro International that have been fully reserved as uncollectible (the "Reserved Assets") from affiliates of Cuattro International, Mr. Wilson and the Members are recovered by the Company or Cuattro International. Additionally, the Company would assume approximately $2.1 million in debt as part of the International Agreement. The acquisition was expected to close on or about January 1, 2016 subject to certain closing conditions, including the affirmative vote of the Company's stockholders to increase by 1,000,000 shares each the authorized shares of both classes of the Company's Common Stock Securities, as defined in the Company's Restated Certificate of Incorporation, as amended (the "Share Increase"). On December 16, 2015, the Company entered into a First Amendment to Unit Purchase Agreement, dated effective as of December 1, 2015 (the "First International Amendment"), with Cuattro International, Kevin S. Wilson and all of the Members. The First International Amendment extended to February 29, 2016 from December 31, 2015 the earliest date upon which the parties may terminate the International Agreement for the failure of a closing condition under the International Agreement to be satisfied. The Amendment also capped Contingent Shares at 100,000.

On March 14, 2016, the Company, Cuattro International, Kevin S. Wilson and the Members terminated the International Agreement and superseded the International Agreement with an agreement and plan of merger by and among the Company, the Company’s wholly-owned subsidiary, Cuattro International Merger Subsidiary Inc., a Delaware corporation ("Merger Sub"), Cuattro International and the Members (the "New Agreement") and Heska Imaging extended the due date on the $1.5 million note receivable, including accrued interest, from Cuattro Veterinary, LLC, which is listed as "Note receivable – related party" on the Company's consolidated balance sheets, from March 15, 2016 to June 15, 2016. All parties involved intend that the transactions contemplated by the New Agreement be treated as a transaction that qualifies as a "reorganization" within the meaning of Section 368(a)(2)(E)

of the Internal Revenue Code of 1986, as amended (the "Code"), and the New Agreement is intended to be, and is adopted as, a plan of reorganization for purposes of Sections 354 and 361 of the Code and within the meaning of Treasury regulation section 1.368-2(g). The New Agreement eliminated the use of Contingent Shares in the event any of the Reserved

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

Assets are recovered by the Company or Cuattro International; in such a circumstance, the Members would be paid in cash under the New Agreement. The earliest date upon which the parties may terminate the New Agreement for failure of a closing condition to be satisfied under the New Agreement is May 31, 2016.

On April 14, 2016, the Company filed a definitive proxy statement with the SEC which included a Share Increase proposal for consideration by the Company's stockholders at the Company's 2016 Annual Meeting of Stockholders on May 13, 2016. Assuming this Share Increase proposal is approved by the Company's stockholders, the Company expects to obtain 100% ownership of Cuattro International by the end of May 2016.

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the Unaudited Condensed Consolidated Financial Statements and related Notes included in Part I Item I of this Form 10-Q.

This discussion contains forward-looking statements that involve risks and uncertainties. Such statements, which include statements concerning future revenue sources and concentration, gross profit margins, selling and marketing expenses, research and development expenses, general and administrative expenses, capital resources, additional financings or borrowings and additional losses, are subject to risks and uncertainties, including, but not limited to, those discussed below and elsewhere in this Form 10-Q, particularly in Part II, Item 1A "Risk Factors," that could cause actual results to differ materially from those projected. The forward-looking statements set forth in this Form 10-Q are as of the close of business on May 9, 2016, and we undertake no duty and do not intend to update this information, except as required by applicable securities laws.

Overview

We sell advanced veterinary diagnostic and other specialty veterinary products. Our offerings include blood testing instruments and supplies, digital imaging products, software and services, and single use products and services such as in-clinic heartworm diagnostic tests, heartworm preventive products, allergy immunotherapy products and allergy testing. Our core focus is on the canine and feline companion animal health markets.

Our business consists of two reportable segments, Core Companion Animal Health ("CCA"), which represented 81% of our revenue for the twelve months ended March 31, 2016 (which we define as "LTM") and Other Vaccines, Pharmaceuticals and Products ("OVP"), which represented 19% of LTM revenue.

The CCA segment includes, primarily for canine and feline use, blood testing instruments and supplies, digital imaging products, software and services, and single use products and services such as heartworm diagnostic tests, heartworm preventive products, allergy immunotherapy products and allergy testing.

Blood testing and other non-imaging instruments and supplies represented approximately 38% of our LTM revenue. Many products in this area involve placing an instrument in the field and generating future revenue from consumables, including items such as supplies and service, as that instrument is used. Approximately 30% of our LTM revenue resulted from the sale of such consumables to an installed base of instruments and approximately 8% of our LTM revenue was from hardware revenue. A loss of, or disruption in, the supply of consumables we are selling to an installed base of instruments could substantially harm our business. All of our blood testing and other non-imaging instruments and supplies are supplied by third

parties, who typically own the product rights and supply the product to us under marketing and/or distribution agreements. In many cases, we have collaborated with a third party to adapt a human instrument for veterinary use. Major products in this area include our chemistry instruments, our hematology instruments, our blood gas instruments, our immunodiagnostic instruments and their affiliated operating consumables. Revenue from products in these three areas, including revenues from consumables, represented approximately 34% of our LTM revenue.

Imaging hardware, software and services represented approximately 20% of LTM revenue. Digital radiography is the largest product offering in this area, which also includes ultrasound instruments. Digital radiography solutions typically consist of a combination of hardware and software placed with a customer, often combined with an ongoing service and support contract. Our experience has been that most of the revenue is generated at the time of sale in this area, in contrast to the blood testing category discussed above where ongoing consumable revenue is often a larger component of economic value as a given blood testing instrument is used.

Other CCA revenue, including single use diagnostic and other tests, pharmaceuticals and biologicals as well as research and development, licensing and royalty revenue, represented approximately 24% of our LTM revenue. Since items in this area are often single use by their nature, our typical aim is to build customer satisfaction and loyalty for each product, generate repeat annual sales from existing customers and expand our customer base in the future. Products in this area are both supplied by third parties and provided by us. Major products and services in this area include our heartworm diagnostic tests, our heartworm preventives, our allergy test kits, our allergy immunotherapy and our allergy testing. Combined revenue from heartworm-related products and allergy-related products represented 22% of our LTM revenue.

We consider the CCA segment to be our core business and devote most of our management time and other resources to improving the prospects for this segment. Maintaining a continuing, reliable and economic supply of products we currently obtain from third parties is critical to our success in this area. Virtually all of our sales and marketing expenses occur in the CCA segment. The majority of our research and development spending is dedicated to this segment as well.

All of our CCA products are ultimately sold primarily to or through veterinarians. In many cases, veterinarians will mark up their costs to the end user. The acceptance of our products by veterinarians is critical to our success. CCA products are sold directly to end users by us as well as through distribution relationships, such as our corporate agreement with Merck Animal Health, the sale of kits to conduct blood testing to third-party veterinary diagnostic laboratories and independent third-party distributors. Revenue from direct sales and distribution relationships represented approximately 65% and 35%, respectively, of CCA LTM revenue.

The OVP segment includes our 168,000 square foot USDA- and FDA-licensed production facility in Des Moines, Iowa. We view this facility as an asset which could allow us to control our cost of goods on any pharmaceuticals and vaccines that we may commercialize in the future. We have increased integration of this facility with our operations elsewhere. For example, virtually all our U.S. inventory, excluding our imaging products, is now stored at this facility and related fulfillment logistics are managed there. CCA segment products manufactured at this facility are transferred at cost and are not recorded as revenue for our OVP segment. We view OVP reported revenue as revenue primarily to cover the overhead costs of the facility and to generate incremental cash flow to fund our CCA segment.

Our OVP segment includes private label vaccine and pharmaceutical production, primarily for cattle but also for other animals such as small mammals. All OVP products are sold by third parties under third-party labels.

Historically, a significant portion of our OVP segment's revenue has been generated from the sale of certain bovine vaccines, which have been sold primarily under the Titanium® and MasterGuard® brands. We have an agreement with Eli Lilly and Company ("Eli Lilly") and its affiliates operating through Elanco for the production of these vaccines. Our OVP segment also produces vaccines and pharmaceuticals for other third parties.

Results of Operations

Our analysis presented below is organized to provide the information we believe will facilitate an understanding of our historical performance and relevant trends going forward.

The following table sets forth, for the periods indicated, certain data derived from our consolidated statements of operations (in thousands):

| | Three Months Ended March 31, | |
|---|---|---|
| | 2015 | 2016 |
| Revenue | $22,894 | $27,146 |
| Gross Profit | 10,084 | 11,442 |
| Operating expenses | 9,063 | 9,472 |
| Operating income | 1,021 | 1,970 |
| Interest and other expense (income), net | 137 | (133) |
| Income before income taxes | 884 | 2,103 |
| Provision for income taxes | 301 | 656 |
| Net income | 583 | 1,447 |
| Net income (loss) attributable to non-controlling interest | (15) | 261 |
| Net income attributable to Heska Corporation | $598 | $1,186 |

The following table sets forth, for the periods indicated, the percentage of sales represented by certain items reflected in our consolidated statements of operations:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2015 | 2016 |
| Revenue | 100.0 % | 100.0 % |
| Gross Profit | 44.0 % | 42.1 % |
| Operating expenses | 39.6 % | 34.9 % |
| Operating income | 4.5 % | 7.3 % |
| Interest and other expense (income), net | 0.6 % | (0.5)% |
| Income before income taxes | 3.9 % | 7.7 % |
| Provision for income taxes | 1.3 % | 2.4 % |
| Net income | 2.5 % | 5.3 % |
| Net income (loss) attributable to non-controlling interest | (0.1)% | 1.0 % |
| Net income attributable to Heska Corporation | 2.6 % | 4.4 % |

Revenue

Total revenue increased 19% to $27.1 million in the three months ended March 31, 2016 compared to $22.9 million in the three months ended March 31, 2015.

CCA segment revenue increased 20% to $23.4 million in the three months ended March 31, 2016 compared to $19.6 million in the three months ended March 31, 2015. Greater revenue from our imaging products, our instrument consumables and our hematology instruments were key factors in the improvement.

OVP segment revenue increased 12% to $3.7 million in the three months ended March 31, 2016 compared to $3.3 million in the three months ended March 31, 2015. Revenue from a reproductive product and a new product for one of our customers, somewhat offset by lower sales of cattle vaccines for international distribution, were key factor in the increase.

Gross Profit

Gross profit increased 13% to $11.4 million in the three months ended March 31, 2016 compared to $10.1 million in the three months ended March 31, 2015. Gross Margin, which is gross profit divided by total revenue, decreased to 42.1% in the three months ended March 31, 2016 compared to 44.0% in the three months ended March 31, 2015. Product mix in our OVP segment was the most significant factor in the decline.

Operating Expenses

Selling and marketing expenses increased 3% to $5.6 million in the three months ended March 31, 2016 compared to $5.5 million in the three months ended March 31, 2015. Increased commissions due to higher revenue from our imaging products was a key factor in the change.

Research and development expenses increased 37% to $0.6 million in the three months ended March 31, 2016, compared to $0.4 million in the three months ended March 31, 2015. Increased development project spending related to imaging products was a factor in the change.

General and administrative expenses increased 3% to $3.3 million in the three months ended March 31, 2016, compared to $3.2 million in the three months ended March 31, 2015. Increased legal expenses were a factor in the change.

Interest and Other Expense (Income), Net

Interest and other expense (income), net, was income of $133 thousand in the three months ended March 31, 2016, as compared to an expense of $137 thousand in the three months ended March 31, 2015. This line item can be broken into the following components: net interest income or expense, net foreign currency gains and losses and other income. Net interest was an expense of $5 thousand in the three months ended March 31, 2016, as compared to income of $6 thousand in the three months ended March 31, 2015. Net foreign currency gain was $46 thousand in the three months ended March 31, 2016, as compared to a net foreign currency loss of $143 thousand in the three months ended March 31, 2015. A key factor in the difference was the impact of exchange rates between the Euro and the Swiss Franc, which is the functional currency of our Swiss subsidiary. Other income was $92 thousand in the three months ended March 31, 2016 primarily related to the sale of an equity investment during the quarter and $0 in the three months ended March 31, 2015.

Income Tax Expense (Benefit)

In the three months ended March 31, 2016, we had total income tax expense of $0.7 million, including $0.6 million in domestic deferred income tax expense, a non-cash item primarily related to our domestic NOL position, and $0.1 million in current income tax expense. In the three months ended March 31, 2015, we had total income tax expense of $0.3 million, including $0.3 million in domestic deferred income

tax expense, a non-cash item primarily related to our domestic NOL position, and $44 thousand in current income tax expense. Greater income before income taxes was a key factor in our higher income tax expense in the current period as compared to the same quarter in 2015.

Net Income (Loss)

Net income was $1.4 million for the three months ended March 31, 2016, as compared to net income of $0.6 million in the prior year period. Increased revenue, somewhat offset by lower Gross Margin and higher operating expenses, were factors in the improvement.

Net Income (Loss) attributable to Heska Corporation

Net income attributable to Heska Corporation was $1.2 million for the three months ended March 31, 2016, as compared to a net income attributable to Heska Corporation of $0.6 million in the prior year period. The difference between this line item and "Net Income (Loss)" is the net income or loss attributable to our minority interest in Heska Imaging, which was net income of $261 thousand in the three months ended March 31, 2016 as compared to a loss of $15 thousand in the three months ended March 31, 2015.

Impact of Inflation

In recent years, inflation has not had a significant impact on our operations.

Liquidity, Capital Resources and Financial Condition

We believe that adequate liquidity and cash generation is important to the execution of our strategic initiatives. Our ability to fund our operations, acquisitions, capital expenditures, and product development efforts may depend on our ability to generate cash from operating activities which is subject to future operating performance, as well as general economic, financial, competitive, legislative, regulatory, and other conditions, some of which may be beyond our control. Our primary sources of liquidity are our available cash, cash generated from current operations and availability under our credit facilities noted below.

For the three months ended March 31, 2016, we had net income of $1.4 million and net cash used by operations of $0.6 million. At March 31, 2016, we had $6.2 million of cash and cash equivalents, working capital of $22.7 million and $0.8 million outstanding borrowings under our revolving line of credit, discussed below.

At March 31, 2016, we had a $15.0 million asset-based revolving line of credit with Wells Fargo which has a maturity date of December 31, 2017 as part of our credit and security agreement with Wells Fargo. At March 31, 2016, we had $0.8 million of borrowings outstanding on this line of credit. Our ability to borrow under this line of credit varies based upon available cash, eligible accounts receivable and eligible inventory. On March 31, 2016, any interest on borrowings due was to be charged at a stated rate of three month LIBOR plus 2.25% and payable monthly. We are required to comply with various financial and non-financial covenants, and we have made various representations and warranties under our agreement with Wells Fargo. A key financial covenant is based on a fixed charge coverage ratio, as defined in our agreement with Wells Fargo. Failure to comply with any of the covenants, representations or warranties could result in our being in default on the loan and could cause all outstanding amounts payable to Wells Fargo to become immediately due and payable or impact our ability to borrow under the agreement. We were in compliance with all financial covenants as of March 31, 2016 and our available borrowing capacity based upon eligible accounts receivable and eligible inventory under our revolving line of credit was approximately $10.7 million.

A summary of our cash from operating, investing and financing activities is as follows (in thousands):

| | Three Months Ended March 31, | |
|---|---|---|
| | 2015 | 2016 |
| Net cash used in operating activities | $(1,390) | $(637) |
| Net cash used in investing activities | (605) | (695) |
| Net cash provided by financing activities | 1,834 | 560 |
| Effect of currency translation on cash | 34 | 62 |
| Decrease in cash and cash equivalents | (127) | (710) |
| Cash and cash equivalents, beginning of the period | 5,855 | 6,890 |
| Cash and cash equivalents, end of the period | $5,728 | $6,180 |

Net cash used by operating activities was $0.6 million in the three months ended March 31, 2016, as compared to net cash used by operating activities of $1.4 million in the three months ended March 31, 2015, a favorable decrease of approximately $0.8 million. Key factors in the change were a $2.0 million increase in cash provided by accounts receivable and a $1.2 million increase in net income and deferred tax expense, partially offset by a $1.5 million increase in cash used for accounts payable, accrued liabilities and other short term liabilities and a $1.4 million increase in cash used in deferred revenue and other non-current liabilities.

Net cash used in investing activities was $0.7 million in the three months ended March 31, 2016 as compared to net cash used in investing activities of $0.6 million in the three months ended March 31, 2015, an unfavorable increase of approximately $0.1 million. Increased purchases of demonstration and loaner imaging products, offset by proceeds from the sale of an equity investment, were factors in the change.

Net cash flows from financing activities provided cash of $0.6 million in the three months ended March 31, 2016, as compared to $1.8 million the three months ended March 31, 2015, which represented a $1.3 million decrease in cash provided. The largest factors in the change were a $1.0 million decrease in borrowings from our revolving line of credit and a $0.2 million decrease in proceeds from the issuance of common stock, net of distributions.

At March 31, 2016, Heska Corporation had accounts receivable from Heska Imaging of $5.4 million, including accrued interest, which eliminates upon consolidation of our financial statements. These monies accrue at the same interest rate as Heska Corporation pays under its asset-based revolving line of credit with Wells Fargo once past due.

At March 31, 2016, we, including the balance sheets of our consolidated subsidiaries, had net prepaid receivables from Cuattro, LLC of $244 thousand. All monies owed accrue interest at the same interest rate Heska Corporation pays under its credit and security agreement with Wells Fargo once past due. These items are listed on our consolidated balance sheets as "Due from – related parties" as Kevin S. Wilson, our Chief Executive Officer and President, Mrs. Wilson and trusts for their children and family hold a 100% interest in Cuattro, LLC.

At March 31, 2016, we had a $1.5 million note receivable, including accrued interest, from Cuattro Veterinary, LLC. The note accrues interest at the same interest rate as the Company pays under its asset-based revolving line of credit with Wells Fargo and is currently due on June 15, 2016. We do not currently anticipate collecting this note in 2016 due to our pending acquisition of Cuattro Veterinary, LLC. Cuattro Veterinary, LLC sells the same digital radiography solutions outside the United States that Heska Imaging sells in the United States. The note is listed on our consolidated balance sheets as "Note receivable – related party" as Kevin S. Wilson, Mrs. Wilson and trusts for their children and family hold an indirect majority interest in

Cuattro Veterinary, LLC. This note was held by Heska Imaging at the time of our acquisition of a majority interest in Heska Imaging on February 24, 2013.

At March 31, 2016, we had other borrowings outstanding totaling $191 thousand, all of which were obligations of a Heska Imaging loan from De Lage Landen Financial Services, Inc. ("DLL"). The note bears an interest rate of 6% and is due in equal monthly payments, including principal and interest, of $13 thousand through June 2017. The note may be prepaid prior to maturity, but is subject to a surcharge in such a circumstance. The principal associated with this note of approximately $159 thousand is listed as "Other short term borrowings" on our consolidated balance sheets as it is due within a year.

At March 31, 2016, our consolidated balance sheets included $15.8 million in non-controlling interest. This represents the value of the aggregate position in Heska Imaging of the Imaging Minority. At the time of the Acquisition, we estimated a weighted average valuation for this position and began accreting to this value over a three year period from the date of the Acquisition using a weighted average cost of capital of 18.65%. The cost of capital assumption was provided to us by a third party with expertise in estimating such items. We evaluate the value of this position every reporting period and in 2014 decided to adjust our accretion to a weighted average accretion based on various potential outcomes and our estimate of the likelihood of such outcomes, which had the effect of lowering the accretion from what it otherwise would have been. The accretion is to be recorded as a credit where this line item has increased compared to the prior reporting period, with the corresponding debit to directly reduce additional paid-in-capital as we have an accumulated deficit. If the value of non-controlling interest were to decrease compared to the prior reporting period, we anticipate non-controlling interest would be adjusted with a debit to non-controlling interest and a corresponding credit to additional paid-in-capital.

Our financial plan for 2016 indicates that our available cash and cash equivalents, together with cash from operations and borrowings expected to be available under our revolving line of credit, will be sufficient to fund our operations through 2016 and into 2017. However, our actual results may differ from this plan, and we may be required to consider alternative strategies. We may be required to raise additional capital in the future. If necessary, we expect to raise these additional funds through the increased sale of customer leases, the sale of equity securities or the issuance of new term debt secured by the same assets as the term loans which were fully repaid in 2010. There is no guarantee that additional capital will be available from these sources on acceptable terms, if at all, and certain of these sources may require approval by existing lenders. See "Risk Factors" in Item 1A of this Form 10-Q for a discussion of some of the factors that affect our capital raising alternatives.

Under the Operating Agreement, should Heska Imaging meet certain performance criteria, the Imaging Minority has been granted put options to sell us some or all of the Imaging Minority's remaining 45.4% position in Heska Imaging following the audit of our 2016 and 2017 financial statements. If Heska Imaging generates at least $20 million in revenue in either 2016 or 2017 and the Imaging Minority exercises its put right in full, we would be required to purchase the Imaging Minority's position for consideration valued at 9 times Heska Imaging's operating income, subject to a maximum valuation of $13.6 million – as well as 25% of Heska Imaging's cash. If Heska Imaging generates at least $30 million in revenue and $3.0 million in operating income in either 2016 or 2017 and the Imaging Minority exercises its put right in full, we would be required to purchase the Imaging Minority's position for consideration valued at $17.0 million – as well as 25% of Heska Imaging's cash. Furthermore, should Heska Imaging meet certain performance criteria, and the Imaging Minority fail to exercise an applicable put to sell us all of the Imaging Minority's position in Heska Imaging following the audit of our 2016 or 2017 financial statements, we would have a call option to purchase all, but not less than all, of the Imaging Minority's position in Heska Imaging. If Heska Imaging generates at least $30 million in revenue and $3.0 million in operating income in either 2016 or 2017 and the Imaging Minority does not exercise its put rights at all, we would have the option to purchase the Imaging Minority's position for consideration valued at $19.6 million – as well as 25% of Heska Imaging's cash. We

believe it is likely that we will deliver up to 55% of the consideration for these puts and calls in shares of our Public Common Stock. While we intend to meet any related cash payment obligations with funds provided by our ongoing operations and assets, likely supplemented by debt financing and potentially with equity financing, there can be no assurance our results will unfold according to our expectations. These potential cash payment obligations are an important consideration for us in our cash management decisions.

We believe it is likely that Heska Imaging will meet the required performance criteria for its 2016 lowest strike put, but not its 2016 highest strike put, following the audit of our 2016 financial statements and that we will be able to deliver 55% of the consideration required by the put in our Public Common Stock. In this case, the Imaging Minority would be granted a put following our 2016 audit which could require us to deliver up to $13.6 million as well as 25% of Heska Imaging's cash, to purchase the 45.4% of Heska Imaging we do not own. In such a case, while we have the right to deliver up to 55% of the consideration in our Public Common Stock under certain conditions, such stock is to be valued based on 90% of market value (the "Delivery Stock Value") and is limited to approximately 650 thousand shares in any case. If the Delivery Stock Value per share is less than the market value per share of our Public Common Stock at the time of the Acquisition, we do not have the right to deliver any Public Common Stock as consideration. Assuming we deliver the full 55% of the consideration in our Public Common Stock, we could still have an obligation to pay as much as approximately $6.1 million in cash as well as 25% of Heska Imaging's cash to the Imaging Minority in this circumstance.

We would consider acquisitions if we felt they were consistent with our strategic direction. We paid $1.6 million in dividends in 2012, and while we may consider paying dividends again in the long term, we do not anticipate the payment of any further dividends for the foreseeable future. We conducted an odd lot tender offer in 2012 which could have led to the repurchase of approximately $400 thousand of our stock if all eligible holders had chosen to participate, and while we may consider stock repurchase alternatives in an opportunistic manner or in the long term, we do not anticipate any stock repurchase programs in the foreseeable future.

Effect of currency translation on cash

Net effect of foreign currency translations on cash changed $28 thousand to a $62 thousand positive impact in the three months ended March 31, 2016 as compared to a $34 thousand positive impact in the three months ended March 31, 2015. These effects are related to changes in exchange rates between the US Dollar and the Swiss Franc, which is the functional currency of our Swiss subsidiary.

Off Balance Sheet Arrangements

We have no off balance sheet arrangements or variable interest entities.

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with U.S. GAAP requires us to make judgments, assumptions and estimates that affect the amounts reported in the Condensed Consolidated Financial Statements and accompanying notes. Note 1 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2015 describes the significant accounting policies and methods used in the preparation of our Consolidated Financial Statements. Our critical accounting estimates, discussed in the Management's Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2015, include estimates for revenue recognition, allowances for doubtful accounts, accounting for income taxes, the value of our non-controlling interest and assessing excess and obsolete inventories. Such accounting policies and estimates require significant judgments and assumptions to be used in the preparation

of the Condensed Consolidated Financial Statements and actual results could differ materially from the amounts reported based on variability in factors affecting these estimates.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Market risk represents the risk of loss that may impact the financial position, results of operations or cash flows due to adverse changes in financial and commodity market prices and rates. We are exposed to market risk in the areas of changes in United States and foreign interest rates and changes in foreign currency exchange rates as measured against the United States dollar. These exposures are directly related to our normal operating and funding activities.

Interest Rate Risk

At March 31, 2016, there was approximately $0.8 million outstanding on our line of credit with Wells Fargo. We also had approximately $6.2 million of cash and cash equivalents at March 31, 2016, the majority of which was invested in liquid interest bearing accounts. We had no interest rate hedge transactions in place on March 31, 2016. We completed an interest rate risk sensitivity analysis based on the above and an assumed one-percentage point decrease in interest rates would have an approximate $54 thousand negative impact on our pre-tax earnings based on our outstanding balances as of March 31, 2016.

Foreign Currency Risk

Our investment in foreign assets consists primarily of our investment in our Swiss subsidiary. Foreign currency risk may impact our results of operations. In cases where we purchase inventory in one currency and sell corresponding products in another, our gross margin percentage is typically at risk based on foreign currency exchange rates. In addition, in cases where we may be generating operating income in foreign currencies, the magnitude of such operating income when translated into U.S. dollars will be at risk based on foreign currency exchange rates. Our agreements with suppliers and customers vary significantly in regard to the existence and extent of currency adjustment and other currency risk sharing provisions. We had no foreign currency hedge transactions in place on March 31, 2016.

We have a wholly-owned subsidiary in Switzerland which uses the Swiss Franc as its functional currency. We purchase inventory in foreign currencies, primarily Euros, and sell corresponding products in U.S. dollars. We also sell products in foreign currencies, primarily Euros and Japanese Yen, where our inventory costs are largely in U.S. dollars. Based on our results of operations for the twelve months ending March 31, 2016, currency holdings and currency-related prepaid accounts, accounts receivable and accounts payable (all of which, including currency holdings, we will refer to as "Currency Accounts") as of March 31, 2016 and the functional currency of the accounting entity where such Currency Accounts are held, the expected impact on our consolidated statements of operations, if foreign currency exchange rates were to strengthen/weaken by 25% against the Dollar, would be a resulting gain/loss in operating income of approximately $262 thousand and a currency loss/gain of $69 thousand, if all other currencies were to strengthen/weaken by 25% against the Swiss Franc, would be a resulting loss/gain in operating income of approximately $176 thousand and a currency gain/loss of $406 thousand, and if all other currencies were to strengthen/weaken by 25% against the Euro, would be a resulting loss/gain in operating income of approximately $269 thousand and a currency loss/gain of $468 thousand.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and our chief financial officer, evaluated the effectiveness of our disclosure controls and procedures, as defined by Rule 13a-15 of the Exchange Act, as of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time period specified in the SEC's rules and forms and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding disclosure.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1 Legal Proceedings.

From time to time, we may be involved in litigation related to claims arising out of our operations. On March 12, 2015, a complaint was filed against us by Shaun Fauley in the United States District Court Northern District of Illinois alleging our transmittal of unauthorized faxes in violation of the federal Telephone Consumer Protection Act of 1991, as amended by the Junk Fax Prevention Act of 2005, as a class action seeking stated damage of the greater of actually monetary loss or five hundred dollars per violation. We intend to defend the Company vigorously in this matter. As of March 31, 2016, we were not a party to any other legal proceedings that are expected, individually or in the aggregate, to have a material adverse effect on our business, financial condition or operating results. Information regarding reportable legal proceedings is contained in Note 11, Commitments and Contingencies, of the unaudited condensed consolidated financial statements in this Quarterly Report on Form 10-Q.

Item 1A. Risk Factors

Our future operating results may vary substantially from period to period due to a number of factors, many of which are beyond our control. The following discussion highlights some of these factors and the possible impact of these factors on future results of operations. The risks and uncertainties described below are not the only ones we face. Additional risks or uncertainties not presently known to us or that we deem to be currently immaterial also may impair our business operations. If any of the following factors actually occur, our business, financial condition or results of operations could be harmed. In that case, the price of our Public Common Stock could decline and investors in our Public Common Stock could experience losses on their investment.

Our February 2013 acquisition of a 54.6% majority interest in Cuattro Veterinary USA, LLC, which has been renamed Heska Imaging US, LLC, could be detrimental to the interests of our shareholders due to related puts, calls or other provisions, or for other reasons including related to conflicts of interest.

Under the Amended and Restated Operating Agreement of Heska Imaging (the "Operating Agreement"), should Heska Imaging meet certain performance criteria, the Imaging Minority has been granted a put option to sell us some or all of the Imaging Minority's position in Heska Imaging following the

audit of our financial statements for 2016 and 2017. Based on Heska Imaging's current ownership position, this put option could require us to deliver up to $17.0 million following calendar year 2016 or calendar year 2017 - as well as 25% of Heska Imaging's cash (any applicable payment in aggregate to be defined as the "Put Payment") to acquire the outstanding minority interest in Heska Imaging. While we have the right to deliver up to 55% of the consideration in our Public Common Stock under certain circumstances, such stock is to be valued based on 90% of market value (the "Delivery Stock Value") and is limited to approximately 650 thousand shares in any case. If the Delivery Stock Value per share is less than the market value per share of our Public Common Stock at the time of the Acquisition, we do not have the right to deliver any Public Common Stock as consideration. Cash required under any Put Payment could put a significant strain on our financial position or require us to raise additional capital. There is no guarantee that additional capital will be available in such a circumstance on reasonable terms, if at all. We may be unable to obtain debt financing, the public markets may be unreceptive to equity financing and we may not be able to obtain financing from other alternative sources, such as private equity. Any debt financing, if available, may include restrictive covenants and high interest rates and any equity financing would likely be dilutive to stockholders in this scenario. If additional funds are required and are not available, it would likely have a material adverse effect on our business, financial condition and our ability to continue as a going concern.

Under the Operating Agreement, should Heska Imaging meet certain performance criteria, and the Imaging Minority fail to exercise an applicable put to sell us all of the Imaging Minority's position in Heska Imaging following the audit of our financial statements for 2016 and 2017, we would have a call option to purchase all, but not less than all, of the Imaging Minority's position in Heska Imaging. Based on Heska Imaging's current ownership position, exercising this call option could require us to deliver up to $19.6 million following calendar year 2016 or calendar year 2017 - as well as 25% of Heska Imaging's cash (any applicable payment in aggregate to be defined as the "Call Payment") to acquire the outstanding minority interest in Heska Imaging. While we have the right to deliver up to 55% of the consideration in our Public Common Stock under certain circumstances, such stock is to be valued based on 90% of market value (the "Delivery Stock Value") and is limited to approximately 650 thousand shares in any case. If the Delivery Stock Value per share is less than the market value per share of our Public Common Stock at the time of the Acquisition, we do not have the right to deliver any Public Common Stock as consideration. If we believe it is desirable to exercise any one of these calls, cash required under the Call Payment could put a significant strain on our financial position or require us to raise additional capital. There is no guarantee that additional capital will be available in such a circumstance on reasonable terms, if at all. If we believe it is desirable to exercise any such call, determine we are unable to economically finance the Call Payment and do not exercise the call as a result, we could be subject to a more expensive Put Payment less than a year in the future. In this circumstance, unless there is a significant change in our financial position or market conditions, such a Put Payment could have a material adverse effect on our business, financial condition and our ability to continue as a going concern.

Under and as defined in and subject to the terms of the Operating Agreement, should we undergo a change in control, the Imaging Minority will be entitled to sell their Heska Imaging units to us for cash of up to $13.6 million based on Heska Imaging's prior year Operating Income (the "Change in Control Payment"). The Change in Control Payment may decrease the interest of third parties in acquiring the Company or a majority of the Company's shares, which could otherwise have occurred at a premium to the Company's then current market price for the benefit of some or all of our shareholders. This could make some investors less likely to buy and hold our stock.

Under the terms of the Operating Agreement, Heska Imaging is to be managed by a three-person board of managers, two of which are to be appointed by Heska Corporation and one of which is to be appointed by Kevin S. Wilson, a founder of Heska Imaging who has also been Heska Corporation's Chief Executive Officer and President since March 31, 2014. The current board of managers consists of Mr. Wilson, Jason A. Napolitano, Heska Corporation's Chief Operating Officer, Chief Financial Officer, Executive

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Vice President and Secretary and Nancy Wisnewski, Ph.D., Heska Corporation's Executive Vice President, Product Development and Customer Support. Until the earlier of (1) our acquiring 100% of the units of Heska Imaging pursuant to the puts and/or calls discussed above or (2) the sixth anniversary of the Acquisition, Heska Imaging may only take the following actions, among others, by unanimous consent of the board of managers: (i) issue securities, (ii) incur, guarantee, prepay, refinance, renew, modify or extend debt, (iii) enter into material contracts, (iv) hire or terminate an officer or amend the terms of their employment, (v) make a distribution other than a tax or liquidation distribution, (vi) enter into a material acquisition or disposition arrangement or a merger, (vii) lease or acquire an interest in real property, (viii) convert or reorganize Heska Imaging, or (ix) amend its certificate of formation or the Heska Imaging Agreement. This unanimous consent provision may hinder our ability to optimize the value of our investment in Heska Imaging in certain circumstances.

While the terms of both the Amended and Restated Master License Agreement and the Supply Agreement between Heska Imaging and Cuattro, LLC were negotiated at arm's length as part of the Acquisition, Mr. Wilson has an interest in these agreements and any time and resources devoted to monitoring and overseeing this relationship may prevent us from deploying such time and resources on other matters.

Mr. Wilson's employment agreement with us acknowledges that Mr. Wilson has business interests in Cuattro, LLC, Cuattro Software, LLC, Cuattro Medical, LLC and Cuattro Veterinary, LLC which may require a portion of his time, resources and attention in his working hours. If Mr. Wilson's time is occupied by these or other business interests, he may not contribute as much as he otherwise would have to enhancing our business, to the detriment of our shareholder value. Mr. Wilson is the spouse of Shawna M. Wilson ("Mrs. Wilson"). Mr. Wilson, Mrs. Wilson and trusts for their children and family own a majority interest in Cuattro Medical, LLC. In addition, including shares held by Mrs. Wilson and by trusts for the benefit of Mr. and Mrs. Wilson's children and family, Mr. Wilson also owns a 100% interest in Cuattro, LLC, the largest supplier to Heska Imaging. Cuattro, LLC owns a 100% interest in Cuattro Software, LLC and a majority interest in Cuattro Veterinary, LLC. On November 11, 2015, we announced an agreement under which we are to purchase 100% ownership of Cuattro Veterinary, LLC. That agreement was terminated and superseded on March 14, 2016 by an agreement and plan of merger.

Since January 2016, Cuattro, LLC charged Heska Imaging $3.1 million, primarily related to digital imaging products, for which there is an underlying supply contract with minimum purchase obligations, software and service as well as other operating expenses provided for under a license agreement and a supply agreement, respectively; Heska Corporation charged Heska Imaging $1.3 million, primarily related to sales and other administrative expenses; Heska Corporation net charged Cuattro, LLC $82 thousand primarily related to facility usage and other services.

At March 31, 2016, Heska Imaging had a $1.5 million note receivable, including accrued interest, from Cuattro Veterinary, LLC, which is currently due on June 15, 2016, but which we do not currently anticipate collecting in 2016 due to our pending acquisition of Cuattro Veterinary, LLC; Heska Corporation had accounts receivable from Heska Imaging of $5.4 million, including accrued interest; Heska Corporation had net accounts receivable from Cuattro, LLC of $32 thousand; Heska Imaging had net prepaid receivables from Cuattro, LLC of $212 thousand. All monies owed accrue interest at the same interest rate Heska Corporation pays under its credit and security agreement with Wells Fargo once past due with the exception of the note receivable, which accrues at this rate to its maturity date.

Mrs. Wilson, Clint Roth, DVM, Mr. Asakowicz, Mr. Lippincott, Mr. Wilson and Cuattro, LLC own approximately 29.75%, 8.39%, 4.09%, 3.07%, 0.05% and 0.05% of Heska Imaging, respectively, each are a member of Heska Imaging, and each have an interest in the puts and calls discussed above. If Mr. Wilson, Mr. Asakowicz or Mr. Lippincott is distracted by these holdings or interests, they may not contribute as much as they otherwise would have to enhancing our business, to the detriment of our shareholder value. While the

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Operating Agreement was negotiated at arm's length as part of the Acquisition, and requires that none of the members shall cause Heska Imaging to operate its business in any manner other than the ordinary course of business, any time and resources devoted to monitoring and overseeing this relationship may prevent us from deploying such time and resources on other matters.

In addition, like any acquisition, if Heska Imaging significantly underperforms our financial expectations, it may serve to diminish rather than enhance shareholder value. Heska Imaging generated operating income of $0.8 million in 2015 and an operating loss of approximately $2.1 million in 2014.

We may face costly legal disputes, including related to our intellectual property or technology or that of our suppliers or collaborators.

We may face legal disputes related to our business. For example, on March 12, 2015, a complaint was filed against us by Shaun Fauley in the United States District Court Northern District of Illinois alleging our transmittal of unauthorized faxes in violation of the federal Telephone Consumer Protection Act of 1991, as amended by the Junk Fax Prevention Act of 2005, as a class action seeking stated damages of the greater of actual monetary loss or five hundred dollars per violation. Even if meritless, these disputes may require significant expenditures on our part and could entail a significant distraction to members of our management team or other key employees. Insurance coverage may not cover any costs required to litigate a legal dispute or an unfavorable ruling or settlement. A legal dispute leading to an unfavorable ruling or settlement, whether or not insurance coverage may be available for any portion thereof, could have significant material adverse consequences on our business. We may have to use legal means and incur affiliated costs to secure the benefits to which we are entitled, such as to collect payment for goods shipped to third parties, which would reduce our income as compared to what it otherwise would have been.

We may become subject to patent infringement claims and litigation in the United States or other countries or interference proceedings conducted in the United States Patent and Trademark Office, or USPTO, to determine the priority of inventions. The defense and prosecution of intellectual property suits, USPTO interference proceedings and related legal and administrative proceedings are likely to be costly, time-consuming and distracting. As is typical in our industry, from time to time we and our collaborators and suppliers have received, and may in the future receive, notices from third parties claiming infringement and invitations to take licenses under third-party patents. Any legal action against us or our collaborators or suppliers may require us or our collaborators or suppliers to obtain one or more licenses in order to market or manufacture effected products or services. However, we or our collaborators or suppliers may not be able to obtain licenses for technology patented by others on commercially reasonable terms, or at all, may not be able to develop alternative approaches if unable to obtain licenses or current and future licenses may not be adequate, any of which could substantially harm our business.

We may also need to pursue litigation to enforce any patents issued to us or our collaborative partners, to protect trade secrets or know-how owned by us or our collaborative partners, or to determine the enforceability, scope and validity of the proprietary rights of others. Any litigation or interference proceedings will likely result in substantial expense to us and significant diversion of the efforts of our technical and management personnel. Any adverse determination in litigation or interference proceedings could subject us to significant liabilities to third parties. Further, as a result of litigation or other proceedings, we may be required to seek licenses from third parties which may not be available on commercially reasonable terms, if at all.

If the third parties who have substantial marketing rights for certain of our historical products, existing products or future products under development are not successful in marketing those products, then our sales and financial position may suffer.

We are party to an agreement with Merck Animal Health, which grants Merck Animal Health exclusive distribution and marketing rights for our canine heartworm preventive product, TRI-HEART Plus Chewable Tablets, ultimately sold to or through veterinarians in the United States and Canada. Historically, a significant portion of our OVP segment's revenue has been generated from the sale of certain bovine vaccines, which have been sold primarily under the Titanium® and MasterGuard® brands. We have a supply agreement with Eli Lilly and its Affiliates operating through Elanco for the production of these vaccines. Either of these marketing partners may not devote sufficient resources to marketing our products and our sales and financial position could suffer significantly as a result. Revenue from Merck & Co., Inc. ("Merck") entities, including Merck Animal Health, represented 10% of our LTM revenue. Revenue from Eli Lilly entities, including Elanco, represented 12% of our LTM revenue. If Merck Animal Health personnel fail to market, sell and support our heartworm preventive sufficiently or if Elanco personnel fail to market, sell and support the bovine vaccines we produce and sell to Elanco sufficiently, our sales could decline significantly. Furthermore, there may be nothing to prevent these partners from pursuing alternative technologies, products or supply arrangements, including as part of mergers, acquisitions or divestitures. For example, we believe a unit of Merck has obtained FDA approval for a canine heartworm preventive product with additional claims compared with our TRI-HEART Plus Chewable Tablets, which we believe is not currently being marketed actively. Should Merck decide to emphasize sales and marketing efforts of this product rather than our TRI-HEART Plus Chewable Tablets or cancel our agreement regarding canine heartworm preventive distribution and marketing, our sales could decline significantly. In another example, if Elanco were to emphasize sales and marketing efforts for bovine vaccines other than those we produce or cancel our supply agreement and produce the vaccines we supply to them by themselves, our sales could decline significantly. Third-party marketing assistance may not be available in the future on reasonable terms, if at all. If the third parties with marketing rights for our products were to merge or go out of business, the sale and promotion of our products could be diminished.

We operate in a highly competitive industry, which could render our products obsolete or substantially limit the volume of products that we sell. This would limit our ability to compete and maintain sustained profitability.

The market in which we compete is intensely competitive. Our competitors include independent animal health companies and major pharmaceutical companies that have animal health divisions. We also compete with independent, third-party distributors, including distributors who sell products under their own private labels. In the point-of-care diagnostic testing market, our major competitors include IDEXX Laboratories, Inc. ("IDEXX"), Abaxis Inc. ("ABAXIS"), and Zoetis Inc. ("Zoetis"). The products manufactured by our OVP segment for sale by third parties compete with similar products offered by a number of other companies, some of which have substantially greater financial, technical, research and other resources than us and may have more established marketing, sales, distribution and service organizations than those of our OVP segment's customers. Competitors may have facilities with similar capabilities to our OVP segment, which they may operate and sell at a lower unit price to customers than our OVP segment does, which could cause us to lose customers. Companies with a significant presence in the companion animal health market, such as Bayer AG, CEVA Santé Animale, Eli Lilly, Merck, Sanofi, Vétoquinol S.A. and Virbac S.A. may be marketing or developing products that compete with our products or would compete with them if developed. These and other competitors and potential competitors may have substantially greater financial, technical, research and other resources and larger, more established marketing, sales and service organizations than we do. Our competitors may offer broader product lines and have greater name recognition than we do. For example, if Zoetis devotes its significant commercial and financial resources to growing its market share in our OVP or allergy segments, our sales could suffer significantly. Our competitors may also develop or

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market technologies or products that are more effective or commercially attractive than our current or future products or that would render our technologies and products obsolete. Further, additional competition could come from new entrants to the animal health care market. Moreover, we may not have the financial resources, technical expertise or marketing, sales or support capabilities to compete successfully. One of our competitors, Abaxis, recently announced agreements with units of VCA Inc. ("VCA") for the long-term supply of blood chemistry testing products to VCA-owned veterinary clinics and for the co-marketing of Abaxis' blood chemistry testing products with VCA's veterinary diagnostic laboratory offering, which may serve to intensify competition and lower our margins as well as limit our prospects to sell blood chemistry testing products to VCA-owned veterinary clinics.

If we fail to compete successfully, our ability to achieve sustained profitability will be limited and sustained profitability, or profitability at all, may not be possible.

The loss of significant customers who, for example, are historically large purchasers or who are considered leaders in their field could damage our business and financial results.

No single customer accounted for more than 10% of our consolidated revenue for the three months ended March 31, 2016. Revenue from Merck entities, including Merck Animal Health, represented approximately 11% of our consolidated revenue for the three months ended March 31, 2015. Revenue from a finance company whose activities include financing our customer's purchases and purchasing lease contracts from us, represented approximately 12% of our consolidated revenue for the three months ended March 31, 2015. No other single customer accounted for more than 10% of our consolidated revenue for the three months ended March 31, 2015.

Merck entities accounted for approximately 13% of our consolidated accounts receivable and Eli Lilly entities accounted for approximately 10% of our consolidated accounts receivable at March 31, 2016. Merck entities accounted for approximately 12% of our consolidated accounts receivable and Eli Lilly entities accounted for approximately 11% of our consolidated accounts receivable at March 31, 2015. No other single customer accounted for more than 10% of our consolidated accounts receivable at March 31, 2016 or March 31, 2015.

The loss of significant customers who, for example, are historically large purchasers or who are considered leaders in their field could damage our business, including via reputational damage, and financial results.

We have historically not consistently generated positive cash flow from operations, may need additional capital and any required capital may not be available on reasonable terms or at all.

We may be required to raise additional capital in the future. If necessary, we expect to raise these additional funds by borrowing under our revolving line of credit, the increased sale of customer leases, the sale of equity securities or the issuance of new term debt secured by the same category of assets as the term loans which we fully repaid in 2010. There is no guarantee that additional capital will be available from these sources on reasonable terms, if at all, and certain of these sources may require approval by existing lenders. Funds we expect to be available under our existing revolving line of credit may not be available and other lenders could refuse to provide us with additional debt financing. Financial institutions and other potentially interested parties may not be interested in purchasing our customer leases on economic terms, or at all. The public markets may be unreceptive to equity financings and we may not be able to obtain additional private equity or debt financing. Any equity financing would likely be dilutive to stockholders and additional debt financing, if available, may include restrictive covenants and increased interest rates that would limit our currently planned operations and strategies. Furthermore, even if additional capital is available, it may not be of the magnitude required to meet our needs under these or other scenarios. If additional funds are required

and are not available, it would likely have a material adverse effect on our business, financial condition and our ability to continue as a going concern.

We rely substantially on third-party suppliers. The loss of products or delays in product availability from one or more third-party suppliers could substantially harm our business.

To be successful, we must contract for the supply of, or manufacture ourselves, current and future products of appropriate quantity, quality and cost. Such products must be available on a timely basis and be in compliance with any regulatory requirements. Similarly, we must provide ourselves, or contract for the supply of certain services. Such services must be provided in a timely and appropriate manner. Failure to do any of the above could substantially harm our business.

We rely on third-party suppliers to manufacture those products we do not manufacture ourselves and to provide services we do not provide ourselves. Proprietary products provided by these suppliers represent a majority of our revenue. We currently rely on these suppliers for our blood testing instruments and consumable supplies for these instruments, for our imaging products and related software and services, for key components of our point-of-care diagnostic tests as well as for the manufacture of other products.

The loss of access to products from one or more suppliers could have a significant, negative impact on our business. We often purchase products from our suppliers under agreements that are of limited duration or potentially can be terminated on an annual basis. In the case of our blood testing instruments and our digital radiography solutions, post-termination, we are typically entitled to non-exclusive access to consumable supplies, or ongoing non-exclusive access to products and services to meet the needs of an existing customer base, respectively, for a defined period upon expiration of exclusive rights, which could subject us to competitive pressures in the period of non-exclusive access. Although we believe we will be able to maintain a supply of our major product and service offerings in the near future, there can be no assurance that our suppliers will meet their obligations under any agreements we may have in place with them or that we will be able to compel them to do so. Risks of relying on suppliers include:

- Inability to meet minimum obligations. Current agreements, or agreements we may negotiate in the future, may commit us to certain minimum purchase or other spending obligations. It is possible we will not be able to create the market demand to meet such obligations, which could create a drain on our financial resources and liquidity. Some such agreements may require minimum purchases and/or sales to maintain product rights and we may be significantly harmed if we are unable to meet such requirements and lose product rights.
- Loss of exclusivity. In the case of our blood testing instruments, if we are entitled to non-exclusive access to consumable supplies for a defined period upon expiration of exclusive rights, we may face increased competition from a third party with similar non-exclusive access or our former supplier, which could cause us to lose customers and/or significantly decrease our margins and could significantly affect our financial results. In addition, current agreements, or agreements we may negotiate in the future, with suppliers may require us to meet minimum annual sales levels to maintain our position as the exclusive distributor of these products. We may not meet these minimum sales levels and maintain exclusivity over the distribution and sale of these products. If we are not the exclusive distributor of these products, competition may increase significantly, reducing our revenues and/or decreasing our margins.
- Changes in economics. An underlying change in the economics with a supplier, such as a large price increase or new requirement of large minimum purchase amounts, could have a significant, adverse effect on our business, particularly if we are unable to identify and implement an alternative source of supply in a timely manner.

- The loss of product rights upon expiration or termination of an existing agreement. Unless we are able to find an alternate supply of a similar product, we would not be able to continue to offer our customers the same breadth of products and our sales and operating results would likely suffer. In the case of an instrument supplier, we could also potentially suffer the loss of sales of consumable supplies, which would be significant in cases where we have built a significant installed base, further harming our sales prospects and opportunities. Even if we were able to find an alternate supply for a product to which we lost rights, we would likely face increased competition from the product whose rights we lost being marketed by a third party or the former supplier and it may take us additional time and expense to gain the necessary approvals and launch an alternative product.
- High switching costs. In our blood testing instrument products we could face significant competition and lose all or some of the consumable revenues from the installed base of those instruments if we were to switch to a competitive instrument. If we need to change to other commercial manufacturing contractors for certain of our regulated products, additional regulatory licenses or approvals generally must be obtained for these contractors prior to our use. This would require new testing and compliance inspections prior to sale, thus resulting in potential delays. Any new manufacturer would have to be educated in, or develop, substantially equivalent processes necessary for the production of our products. We likely would have to train our sales force, distribution network employees and customer support organization on the new product and spend significant funds marketing the new product to our customer base.
- The involuntary or voluntary discontinuation of a product line. Unless we are able to find an alternate supply of a similar product in this or similar circumstances with any product, we would not be able to continue to offer our customers the same breadth of products and our sales would likely suffer. Even if we are able to identify an alternate supply, it may take us additional time and expense to gain the necessary approvals and launch an alternative product, especially if the product is discontinued unexpectedly.
- Inconsistent or inadequate quality control. We may not be able to control or adequately monitor the quality of products we receive from our suppliers. Poor quality items could damage our reputation with our customers.
- Limited capacity or ability to scale capacity. If market demand for our products increases suddenly, our current suppliers might not be able to fulfill our commercial needs, which would require us to seek new manufacturing arrangements and may result in substantial delays in meeting market demand. If we consistently generate more demand for a product than a given supplier is capable of handling, it could lead to large backorders and potentially lost sales to competitive products that are readily available. This could require us to seek or fund new sources of supply, which may be difficult to find or may require terms that are less advantageous if available at all.
- Regulatory risk. Our manufacturing facility and those of some of our third-party suppliers are subject to ongoing periodic unannounced inspection by regulatory authorities, including the FDA, USDA and other federal, state and foreign agencies for compliance with strictly enforced Good Manufacturing Practices, regulations and similar foreign standards. We do not have control over our suppliers' compliance with these regulations and standards. Regulatory violations could potentially lead to interruptions in supply that could cause us to lose sales to readily available competitive products.
- Developmental delays. We may experience delays in the scale-up quantities needed for product development that could delay regulatory submissions and commercialization of our products in development, causing us to miss key opportunities.

- Limited geographic rights. We typically do not have global geographic rights to products supplied by third parties. If we were to determine a market opportunity in a geography where we did not have distribution rights and were unable to obtain such rights from the supplier, it might hamper our ability to succeed in such geography and our sales and profits would be lower than they otherwise would have been.
- Limited intellectual property rights. We typically do not have intellectual property rights, or may have to share intellectual property rights, to the products supplied by third parties and any improvements to the manufacturing processes or new manufacturing processes for these products.

Potential problems with suppliers such as those discussed above could substantially decrease sales, lead to higher costs and/or damage our reputation with our customers due to factors such as poor quality goods or delays in order fulfillment, resulting in our being unable to sell our products effectively and substantially harming our business.

We may be unable to market and sell our products successfully.

We may not develop and maintain marketing and/or sales capabilities successfully, and we may not be able to make arrangements with third parties to perform these activities on satisfactory terms. If our marketing and sales strategy is unsuccessful, our ability to sell our products will be negatively impacted and our revenues will decrease. This could result in the loss of distribution rights for products or failure to gain access to new products and could cause damage to our reputation and adversely affect our business and future prospects.

The market for companion animal healthcare products is highly fragmented. Because our CCA proprietary products are generally available only to veterinarians or by prescription and our medical instruments require technical training to operate, we ultimately sell all our CCA products primarily to or through veterinarians. The acceptance of our products by veterinarians is critical to our success. Changes in our ability to obtain or maintain such acceptance or changes in veterinary medical practice could significantly decrease our anticipated sales. As the vast majority of cash flow to veterinarians ultimately is funded by pet owners without private insurance or government support, our business may be more susceptible to severe economic downturns than other health care businesses which rely less on individual consumers.

We recently have entered into agreements with independent third party distributors, including Butler Animal Health Supply, LLC d/b/a Henry Schein Animal Health ("Henry Schein"), which we expect to market and sell our products to a greater degree than in the recent past. Our agreement with Henry Schein prohibits us from selling our chemistry blood testing products and our hematology blood testing products to an independent third party distributor other than Henry Schein. Independent third-party distributors may be effective in increasing sales of our products to veterinarians, although we would expect a corresponding lower gross margin as such distributors typically buy products from us at a discount to end user prices. It is possible new or existing independent third-party distributors could cannibalize our direct sales efforts and lower our total gross margin. For us to be effective when working with an independent third-party distributor, the distributor must agree to market and/or sell our products and we must provide proper economic incentives to the distributor as well as contend effectively for the time, energy and focus of the employees of such distributor given other products the distributor may be carrying, potentially including those of our competitors. If we fail to be effective with new or existing independent third-party distributors, our financial performance may suffer.

We depend on key personnel for our future success. If we lose our key personnel or are unable to attract and retain additional personnel, we may be unable to achieve our goals.

Our future success is substantially dependent on the efforts of our senior management and other key personnel, including our Chief Executive Officer and President, Kevin Wilson. The loss of the services of members of our senior management or other key personnel may significantly delay or prevent the achievement of our business objectives. Although we have employment agreements with many of these individuals, all are at-will employees, which means that either the employee or Heska may terminate employment at any time without prior notice. If we lose the services of, or fail to recruit, key personnel, the growth of our business could be substantially impaired. We do not maintain key person life insurance for any of our senior management or key personnel.

Obtaining and maintaining regulatory approvals in order to market our products may be costly and delay the marketing and sales of our products. Failure to meet all regulatory requirements could cause significant losses from affected inventory and the loss of market share.

Many of the products we develop, market or manufacture may subject us to extensive regulation by one or more of the USDA, the FDA, the EPA and foreign and other regulatory authorities. These regulations govern, among other things, the development, testing, manufacturing, labeling, storage, pre-market approval, advertising, promotion and sale of some of our products. Satisfaction of these requirements can take several years and time needed to satisfy them may vary substantially, based on the type, complexity and novelty of the product. The decision by a regulatory authority to regulate a currently non-regulated product or product area could significantly impact our revenue and have a corresponding adverse impact on our financial performance and position while we attempt to comply with the new regulation, if such compliance is possible at all.

The effect of government regulation may be to delay or to prevent marketing of our products for a considerable period of time and to impose costly procedures upon our activities. We may not be able to estimate the time to obtain required regulatory approvals accurately and such approvals may require significantly more time than we anticipate. We have experienced in the past, and may experience in the future, difficulties that could delay or prevent us from obtaining the regulatory approval or license necessary to introduce or market our products. Such delays in approval may cause us to forego a significant portion of a new product's sales in its first year due to seasonality and advanced booking periods associated with certain products. Regulatory approval of our products may also impose limitations on the indicated or intended uses for which our products may be marketed.

Difficulties in making established products to all regulatory specifications may lead to significant losses related to affected inventory as well as market share. Among the conditions for certain regulatory approvals is the requirement that our facilities and/or the facilities of our third-party manufacturers conform to current Good Manufacturing Practices and other requirements. If any regulatory authority determines that our manufacturing facilities or those of our third-party manufacturers do not conform to appropriate manufacturing requirements, we or the manufacturers of our products may be subject to sanctions, including, but not limited to, warning letters, manufacturing suspensions, product recalls or seizures, injunctions, refusal to permit products to be imported into or exported out of the United States, refusals of regulatory authorities to grant approval or to allow us to enter into government supply contracts, withdrawals of previously approved marketing applications, civil fines and criminal prosecutions. Furthermore, third parties may perceive procedures required to obtain regulatory approval objectionable and may attempt to disrupt or otherwise damage our business as a result. In addition, certain of our agreements may require us to pay penalties if we are unable to supply products, including for failure to maintain regulatory approvals.

Any of these events, alone or in unison, could damage our business.

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Our future revenues depend on successful product development, commercialization and/or market acceptance, any of which can be slower than we expect or may not occur.

The product development and regulatory approval process for many of our potential products is extensive and may take substantially longer than we anticipate. Research projects may fail. New products that we may be developing for the veterinary marketplace may not perform consistently within our expectations. Because we have limited resources to devote to product development and commercialization, any delay in the development of one product or reallocation of resources to product development efforts that prove unsuccessful may delay or jeopardize the development of other product candidates. If we fail to successfully develop new products and bring them to market in a timely manner, our ability to generate additional revenue will decrease.

Even if we are successful in the development of a product or obtain rights to a product from a third-party supplier, we may experience delays or shortfalls in commercialization and/or market acceptance of the product. For example, veterinarians may be slow to adopt a product, a product may not achieve the anticipated technical performance in field use or there may be delays in producing large volumes of a product. The former is particularly likely where there is no comparable product available or historical precedent for such a product. The ultimate adoption of a new product by veterinarians, the rate of such adoption and the extent veterinarians choose to integrate such a product into their practice are all important factors in the economic success of one of our new products and are factors that we do not control to a large extent. If our products do not achieve a significant level of market acceptance, demand for our products will not develop as expected and our revenues will be lower than we anticipate. For example, our VitalPath Blood Gas and Electrolyte Analyzer, supplied under an agreement, the ("Roche Agreement"), with Roche Diagnostics Corporation ("Roche"), generated significantly less revenue than we anticipated following its launch in May 2010 as placements of this product with customers did not occur as we expected.

Interpretation of existing legislation, regulations and rules, including financial accounting standards, or implementation of future legislation, regulations and rules could cause our costs to increase or could harm us in other ways.

We prepare our financial statements in conformance with United States generally accepted accounting principles, or GAAP. These accounting principles are established by and are subject to interpretation by the SEC, the Financial Accounting Standards Board ("FASB") and others who interpret and create accounting policies. A change in those policies can have a significant effect on our reported results and may affect our reporting of transactions completed before a change is made effective. Such changes may adversely affect our reported financial results, the way we conduct our business or have a negative impact on us if we fail to track such changes.

If our regulators and/or auditors adopt or interpret more stringent standards than we anticipate, we could experience unanticipated changes in our reported financial statements, including but not limited to restatements, which could adversely affect our business due to litigation and investor confidence in our financial statements. In addition, changes in the underlying circumstances to which we apply given accounting standards and principles may affect our results of operations and have a negative impact on us. For example, we review goodwill recognized on our consolidated balance sheets at least annually and if we were to conclude there was an impairment of goodwill, we would reduce the corresponding goodwill to its estimated fair value and recognize a corresponding expense in our statement of operations. This impairment and corresponding expense could be as large as the total amount of goodwill recognized on our consolidated balance sheets, which was $20.9 million at March 31, 2016. There can be no assurance that future goodwill impairments will not occur if projected financial results are not met, or otherwise.

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The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") has increased our required administrative actions and expenses as a public company since its enactment. The general and administrative costs of complying with Sarbanes-Oxley will depend on how it is interpreted over time. Of particular concern are the level of standards for internal control evaluation and reporting adopted under Section 404 of Sarbanes-Oxley. If our regulators and/or auditors adopt or interpret more stringent standards than we anticipate, we and/or our auditors may be unable to conclude that our internal controls over financial reporting are designed and operating effectively, which could adversely affect investor confidence in our financial statements and cause our stock price to decline. Even if we and our auditors are able to conclude that our internal control over financial reporting is designed and operating effectively in such a circumstance, our general and administrative costs are likely to increase. In 2015, we were required to have our independent registered public accountant conduct an audit of our internal control over financial reporting because as of June 30, 2015 our stock market value was above a certain level prescribed by regulation. This has increased, and is expected to increase, our general and administrative costs from what they otherwise would have been.

Similarly, we are required to comply with the SEC's mandate to provide interactive data using the eXtensible Business Reporting Language as an exhibit to certain SEC filings. Compliance with this mandate has required a significant time investment, which has and may in the future preclude some of our employees from spending time on more productive matters. In addition, actions by other entities, such as enhanced rules to maintain our listing on the Nasdaq Capital Market, could also increase our general and administrative costs or have other adverse effects on us, as could further legislative, regulatory or rule-making action or more stringent interpretations of existing legislation, regulations and rules.

Our stock price has historically experienced high volatility, and could do so in the future, including experiencing a material price decline resulting from a large sale in a short period of time. In addition, our Public Common Stock has certain transfer restrictions which could reduce trading liquidity from what it otherwise would have been and have other undesired effects.
Should a relatively large shareholder decide to sell a large number of shares in a short period of time, it could lead to an excess supply of our shares available for sale and correspondingly result in a significant decline in our stock price.

The securities markets have experienced significant price and volume fluctuations and the market prices of securities of many microcap and small cap companies have in the past been, and can in the future be expected to be, especially volatile. During the twelve months ended March 31, 2016, the closing stock price of our Public Common Stock has ranged from a low of $25.73 to a high of $39.76. Fluctuations in the trading price or liquidity of our Public Common Stock may adversely affect our ability to raise capital through future equity financings. Factors that may have a significant impact on the market price and marketability of our Public Common Stock include:

- stock sales by large stockholders or by insiders;
- changes in the outlook for our business;
- our quarterly operating results, including as compared to expected revenue or earnings and in comparison to historical results;
- termination, cancellation or expiration of our third-party supplier relationships;
- announcements of technological innovations or new products by our competitors or by us;
- litigation;
- regulatory developments, including delays in product introductions;
- developments or disputes concerning patents or proprietary rights;
- availability of our revolving line of credit and compliance with debt covenants;
- releases of reports by securities analysts;
- economic and other external factors; and
- general market conditions.

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In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been instituted. If a securities class action suit is filed against us, it is likely we would incur substantial legal fees and our management's attention and resources would be diverted from operating our business in order to respond to the litigation.

On May 4, 2010, our shareholders approved an amendment (the "Amendment") to our Restated Certificate of Incorporation. The Amendment places restrictions on the transfer of our stock that could adversely affect our ability to use our domestic Federal Net Operating Loss carryforward ("NOL"). In particular, the Amendment prevents the transfer of shares without the approval of our Board of Directors if, as a consequence, an individual, entity or groups of individuals or entities would become a 5-percent holder under Section 382 of the Internal Revenue Code of 1986, as amended, and the related Treasury regulations, and also prevents any existing 5-percent holder from increasing his or her ownership position in the Company without the approval of our Board of Directors. Any transfer of shares in violation of the Amendment (a "Transfer Violation") shall be void ab initio under the our Restated Certificate of Incorporation, as amended (our "Certificate of Incorporation") and our Board of Directors has procedures under our Certificate of Incorporation to remedy a Transfer Violation including requiring the shares causing such Transfer Violation to be sold and any profit resulting from such sale to be transferred to a charitable entity chosen by the Company's Board of Directors in specified circumstances. The Amendment could have an adverse impact on the value and trading liquidity of our stock if certain buyers who would otherwise have bid on or purchased our stock, including buyers who may not be comfortable owning stock with transfer restrictions, do not bid on or purchase our stock as a result of the Amendment. In addition, because some corporate takeovers occur through the acquirer's purchase, in the public market or otherwise, of sufficient shares to give it control of a company, any provision that restricts the transfer of shares can have the effect of preventing a takeover. The Amendment could discourage or otherwise prevent accumulations of substantial blocks of shares in which our stockholders might receive a substantial premium above market value and might tend to insulate management and the Board of Directors against the possibility of removal to a greater degree than had the Amendment not passed.

We often depend on third parties for products we intend to introduce in the future. If our current relationships and collaborations are not successful, we may not be able to introduce the products we intend to introduce in the future.

We are often dependent on third parties and collaborative partners to successfully and timely perform research and development activities to successfully develop new products. For example, we jointly developed point-of-care diagnostic products with Quidel Corporation. In other cases, we have discussed Heska marketing in the veterinary market an instrument being developed by a third party for use in the human health care market. In the future, one or more of these third parties or collaborative partners may not complete research and development activities in a timely fashion, or at all. Even if these third parties are successful in their research and development activities, we may not be able to come to an economic agreement with them. If these third parties or collaborative partners fail to complete research and development activities, fail to complete them in a timely fashion, or if we are unable to negotiate economic agreements with such third parties or collaborative partners, our ability to introduce new products will be impacted negatively and our revenues may decline. For example, we have experienced significant delays compared to our expectations in our development of products in collaboration with Rapid Diagnostek, Inc.

Our Public Common Stock is listed on the Nasdaq Capital Market and we may not be able to maintain that listing, which may make it more difficult for you to sell your shares. In addition, we have less than 300 holders of record, which would allow us to terminate voluntarily the registration of our common stock with the SEC and after which we would no longer be eligible to maintain the listing of our Public Common Stock on the Nasdaq Capital Market.

Our Public Common Stock is listed on the Nasdaq Capital Market. The Nasdaq has several quantitative and qualitative requirements companies must comply with to maintain this listing, including a $1.00 minimum bid price. We completed a 1-for-10 reverse stock split effective December 30, 2010 in order to resolve an ongoing minimum bid price deficiency. While we believe we are currently in compliance with all Nasdaq requirements, there can be no assurance we will continue to meet Nasdaq listing requirements including the minimum bid price, that Nasdaq will interpret these requirements in the same manner we do if we believe we meet the requirements, or that Nasdaq will not change such requirements or add new requirements to include requirements we do not meet in the future. If we are delisted from the Nasdaq Capital Market, our Public Common Stock may be considered a penny stock under the regulations of the SEC and would therefore be subject to rules that impose additional sales practice requirements on broker-dealers who sell our securities. The additional burdens imposed upon broker-dealers may discourage broker-dealers from effecting transactions in our Public Common Stock, which could severely limit market liquidity of the Public Common Stock and any stockholder's ability to sell our securities in the secondary market. This lack of liquidity would also likely make it more difficult for us to raise capital in the future.

We have less than 300 holders of record as of our latest information, a fact which would make us eligible to terminate voluntarily the registration of our common stock with the SEC and therefore suspend our reporting obligations with the SEC under the Exchange Act and become a non-reporting company. If we were to cease reporting with the SEC, we would no longer be eligible to maintain the listing of our common stock on the Nasdaq Capital Market, which we would expect to materially adversely affect the liquidity and market price for our common stock.

We may not be able to continue to achieve sustained profitability or increase profitability on a quarterly or annual basis.

Prior to 2005, we incurred net losses on an annual basis since our inception in 1988 and, as of March 31, 2016, we had an accumulated deficit of $162.5 million. Relatively small differences in our performance metrics may cause us to generate an operating or net loss in future periods. Our ability to continue to be profitable in future periods will depend, in part, on our ability to increase sales in our CCA segment, including maintaining and growing our installed base of instruments and related consumables, to maintain or increase gross margins and to limit the increase in our operating expenses to a reasonable level as well as avoid or effectively manage any unanticipated issues. We may not be able to generate, sustain or increase profitability on a quarterly or annual basis. If we cannot achieve or sustain profitability for an extended period, we may not be able to fund our expected cash needs, including the repayment of debt as it comes due, or continue our operations.

Many of our expenses are fixed and if factors beyond our control cause our revenue to fluctuate, this fluctuation could cause greater than expected losses, cash flow and liquidity shortfalls.
We believe that our future operating results will fluctuate on a quarterly basis due to a variety of factors which are generally beyond our control, including:

- supply of products from third-party suppliers or termination, cancellation or expiration of such relationships;
- competition and pricing pressures from competitive products;
- the introduction of new products or services by our competitors or by us;

- large customers failing to purchase at historical levels;
- fundamental shifts in market demand;
- manufacturing delays;
- shipment problems;
- information technology problems, which may prevent us from conducting our business effectively, or at all, and may also raise our costs;
- regulatory and other delays in product development;
- product recalls or other issues which may raise our costs;
- changes in our reputation and/or market acceptance of our current or new products; and
- changes in the mix of products sold.

We have high operating expenses, including those related to personnel. Many of these expenses are fixed in the short term and may increase over time. If any of the factors listed above cause our revenues to decline, our operating results could be substantially harmed.

If we are unable to maintain various financial and other covenants required by our credit facility agreement we will be unable to borrow any funds under the agreement and fund our operations.

Under our credit and security agreement with Wells Fargo, we are required to comply with various covenants, both financial and non-financial, in order to borrow under the agreement. The availability of borrowings under this agreement is expected to be important to continue to fund our operations. Beginning January 1, 2015 a key financial covenant is based on a fixed charge coverage ratio, as defined in the credit and security agreement with Wells Fargo. Although we believe we will be able to maintain compliance with all these covenants and any covenants we may negotiate in the future, there can be no assurance thereof. We have not always been able to maintain compliance with all covenants under our credit and security agreement with Wells Fargo. Although Wells Fargo has granted us a waiver of non-compliance in each case, there can be no assurance we will be able to obtain similar waivers or other modifications if needed in the future on economic terms, if at all. Failure to comply with any of the covenants, representations or warranties, or failure to modify them to allow future compliance, could result in our being in default and could cause all outstanding borrowings under our credit and security agreement to become immediately due and payable, or impact our ability to borrow under the agreement. In addition, Wells Fargo has discretion in setting the advance rates which we may borrow against eligible assets. We may need to rely on available borrowings under the credit and security agreement to fund our operations in the future. If we are unable to borrow funds under this agreement, we will need to raise additional capital from other sources to continue our operations, which capital may not be available on acceptable terms, or at all.

We may face product returns and product liability litigation in excess of, or not covered by, our insurance coverage or indemnities and/or warranties from our suppliers. If we become subject to product liability claims resulting from defects in our products, we may fail to achieve market acceptance of our products and our sales could substantially decline.

The testing, manufacturing and marketing of our current products as well as those currently under development entail an inherent risk of product liability claims and associated adverse publicity. Following the introduction of a product, adverse side effects may be discovered. Adverse publicity regarding such effects could affect sales of our other products for an indeterminate time period. To date, we have not experienced any material product liability claims, but any claim arising in the future could substantially harm our business. Potential product liability claims may exceed the amount of our insurance coverage or may be excluded from coverage under the terms of the policy. We may not be able to continue to obtain adequate insurance at a reasonable cost, if at all. In the event that we are held liable for a claim against which we are not indemnified or for damages exceeding the $10 million limit of our insurance coverage

or which results in significant

adverse publicity against us, we may lose revenue, be required to make substantial payments which could exceed our financial capacity and/or lose or fail to achieve market acceptance.

We may be held liable for the release of hazardous materials, which could result in extensive remediation costs or otherwise harm our business.

Certain of our products and development programs produced at our Des Moines, Iowa facility involve the controlled use of hazardous and bio hazardous materials, including chemicals and infectious disease agents. Although we believe that our safety procedures for handling and disposing of such materials comply with the standards prescribed by applicable local, state and federal regulations, we cannot eliminate the risk of accidental contamination or injury from these materials. In the event of such an accident, we could be held liable for any fines, penalties, remediation costs or other damages that result. Our liability for the release of hazardous materials could exceed our resources, which could lead to a shutdown of our operations, significant remediation costs and potential legal liability. In addition, we may incur substantial costs to comply with environmental regulations if we choose to expand our manufacturing capacity.

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

The following table sets forth information about our purchases of our outstanding Public Common Stock during the quarter ended March 31, 2016:

| Period | Total Number of Shares Purchased (1) | Average Price Paid per Share (1) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| January 1 - January 31, 2016 | — | $ — | — | — |
| February 1 - February 29, 2016 | — | — | — | — |
| March 1 - March 31, 2016 | 4,788 | 33.64 | — | — |
| Total | 4,788 | $ 33.64 | — | — |

(1) Shares of Public Common Stock we purchased between January 1, 2016 and March 31, 2016 were solely for the cancellation of shares of restricted stock to pay withholding taxes.

Item 3. Defaults Upon Senior Securities

None
Item 4. Mine Safety Disclosures

N/A
Item 5. Other Information.
None.

Item 6. Exhibits.

| Exhibit Number | Notes | Description of Document |
|---|---|---|
| 31.1 | | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended. |
| 31.2 | | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended. |
| 32.1** | | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 10.1+ | | Amendment No. 5 to Supply and License Agreement between Registrant and Intervet Inc., d.b.a. Merck Animal Health, effective as of October 30, 2015. |
| 10.2+ | (1) | Agreement and Plan of Merger among Heska Corporation, Cuattro Veterinary, LLC, Kevin S. Wilson, Cuattro LLC, Lane Naffziger, Clint Roth, DVM and Doug G. Wilson, III, dated as of March 14, 2016. |
| 10.3 | (2) | Letter Agreement between Heska Imaging US, LLC and Cuattro Veterinary, LLC, dated as of March 14, 2016. |
| 10.4 | | 1997 Stock Incentive Plan Restricted Stock Grant Agreement. |
| 10.5 | | 1997 Stock Incentive Plan Restricted Stock Grant Agreement (Management Incentive Plan Award). |
| 10.6 | | 2003 Equity Incentive Plan Restricted Stock Grant Agreement. |
| 10.7 | | 2003 Equity Incentive Plan Restricted Stock Grant Agreement (Management Incentive Plan Award). |
| 101.INS | | XBRL Instance Document. |
| 101.SCH | | XBRL Taxonomy Extension Schema Document. |
| 101.CAL | | XBRL Taxonomy Extension Calculation Linkbase Document. |
| 101.DEF | | XBRL Taxonomy Extension Definition Linkbase Document. |
| 101.PRE | | XBRL Taxonomy Extension Presentation Linkbase Document. |
| 101.LAB | | XBRL Taxonomy Extension Label Linkbase Document. |

Notes

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|---|---|
| + | Portions of the exhibit have been omitted pursuant to a request for confidential treatment. |
| ** | Furnished with this report. |
| (1) | Incorporated by reference to Exhibit No. 10.77 to the Registrants' Form 10-K filed for the year ended December 31, 2015. |
| (2) | Incorporated by reference to the Registrants' Form 8-K filed on March 15, 2016. |

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized on May 10, 2016.

HESKA CORPORATION

By: /s/ KEVIN S. WILSON
Kevin S. Wilson
Chief Executive Officer and President
By: /s/ JASON A. NAPOLITANO
Jason A. Napolitano
Chief Operating Officer, Chief Financial Officer,
Executive Vice President and Secretary
(Principal Financial Officer)
By: /s/ JOHN MCMAHON
John McMahon
Vice President, Financial Operations and Controller
(Principal Accounting Officer)

Exhibit Index

| Exhibit Number | Notes | Description of Document |
|---|---|---|
| 31.1 | | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended. |
| 31.2 | | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended. |
| 32.1** | ** | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 10.1+ | + | Amendment No. 5 to Supply and License Agreement between Registrant and Intervet Inc., d.b.a. Merck Animal Health, effective as of October 30, 2015. |
| 10.2+ | (1) | Agreement and Plan of Merger among Heska Corporation, Cuattro Veterinary, LLC, Kevin S. Wilson, Cuattro LLC, Lane Naffziger, Clint Roth, DVM and Doug G. Wilson, III, dated as of March 14, 2016. |
| 10.3 | (2) | Letter Agreement between Heska Imaging US, LLC and Cuattro Veterinary, LLC, dated as of March 14, 2016. |
| 10.4 | | 1997 Stock Incentive Plan Restricted Stock Grant Agreement. |
| 10.5 | | 1997 Stock Incentive Plan Restricted Stock Grant Agreement (Management Incentive Plan Award). |
| 10.6 | | 2003 Equity Incentive Plan Restricted Stock Grant Agreement. |
| 10.7 | | 2003 Equity Incentive Plan Restricted Stock Grant Agreement (Management Incentive Plan Award). |
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