HESKA CORP
Form 10-Q
August 08, 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 June 30, 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 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
6,875,256 shares of the Registrant's Public Common Stock, $.01 par value, were outstanding at August 5, 2016.

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

	December 31, 2015	(unaudited) June 30, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	$6,890	$6,669
Accounts receivable, net of allowance for doubtful accounts of $189 and $199, respectively	16,136	14,596
Due from – related parties	308	1,979
Inventories, net	16,101	18,076
Other current assets	1,827	1,367
Total current assets	41,262	42,687
Property and equipment, net	17,020	17,652
Note receivable – related party	1,516	—
Goodwill and other intangibles	20,966	29,248
Deferred tax asset	25,883	24,664
Other long-term assets	3,072	5,374
Total assets	$109,719	$119,625
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$7,624	$6,011
Accrued liabilities	5,416	5,227
Current portion of deferred revenue	5,461	3,926
Line of credit	143	—
Other short-term borrowings, including current portion of long-term note payable	159	412
Total current liabilities	18,803	15,576
Long-term note payable, net of current portion	69	229
Deferred tax liability	—	905
Deferred revenue, net of current portion, and other	11,572	11,391
Total liabilities	30,444	28,101
Commitments and contingencies (Note 11)		
Non-controlling interest	15,747	15,866
Stockholders' equity:		
Preferred stock, $.01 par value, 2,500,000 shares authorized, none issued or outstanding	—	—
Traditional common stock, $.01 par value, 9,000,000 shares authorized, none issued or outstanding	—	—
Public common stock, $.01 par value, 9,000,000 shares authorized, 6,625,287 and 6,873,389 shares issued and outstanding, respectively	66	69
Additional paid-in capital	227,267	235,255
Accumulated other comprehensive income	187	139
Accumulated deficit	(163,992)	(159,805)

Total stockholders' equity	63,528	75,658
Total liabilities and stockholders' equity	$109,719	$119,625

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Revenue:				
Core companion animal health	$20,757	$24,464	$40,329	$47,898
Other vaccines, pharmaceuticals and products	3,153	5,501	6,475	9,213
Total revenue, net	23,910	29,965	46,804	57,111
Cost of revenue	13,613	17,283	26,423	32,987
Gross profit	10,297	12,682	20,381	24,124
Operating expenses:				
Selling and marketing	5,239	5,386	10,699	11,005
Research and development	392	523	811	1,098
General and administrative	2,837	3,217	6,021	6,495
Total operating expenses	8,468	9,126	17,531	18,598
Operating income	1,829	3,556	2,850	5,526
Interest and other expense (income), net	37	34	174	(99)
Income before income taxes	1,792	3,522	2,676	5,625
Income tax expense:				
Current income tax expense	82	87	126	161
Deferred income tax expense	532	693	789	1,275
Total income tax expense	614	780	915	1,436
Net income	1,178	2,742	1,761	4,189
Net income (loss) attributable to non-controlling interest	(19)	220	(34)	482
Net income attributable to Heska Corporation	$1,197	$2,522	$1,795	$3,707
Basic earnings per share attributable to Heska Corporation	$0.19	$0.38	$0.29	$0.56
Diluted earnings per share attributable to Heska Corporation	$0.17	$0.35	$0.26	$0.51
Weighted average outstanding shares used to compute basic earnings per share attributable to Heska Corporation	6,283	6,695	6,232	6,641
Weighted average outstanding shares used to compute diluted earnings per share attributable to Heska Corporation	7,075	7,249	6,980	7,206

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Net income	$1,178	$2,742	$1,761	$4,189
Other comprehensive income (expense):				
Sale of equity investment	—	—	—	(90)
Unrealized gain on available for sale investments	6	—	6	—
Foreign currency translation	87	(47)	163	42
Comprehensive income	1,271	2,695	1,930	4,141
Comprehensive income (loss) attributable to non-controlling interest	(19)	220	(34)	482
Comprehensive income attributable to Heska Corporation	$1,290	$2,475	$1,964	$3,659

See accompanying notes to condensed consolidated financial statements.

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

	Six Months Ended June 30,	
	2015	2016
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$1,761	$4,189
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Depreciation and amortization	2,074	2,211
Deferred tax expense	789	1,275
Stock based compensation	879	1,112
Unrealized (gain) loss on foreign currency translation	44	(2)
Changes in operating assets and liabilities:		
Accounts receivable	552	1,764
Inventories	(6,670)	(3,691)
Other current assets	(70)	363
Accounts payable	1,696	(1,725)
Accrued liabilities and other	458	(367)
Other non-current assets	(562)	(2,889)
Deferred revenue and other	(1,233)	(1,962)
Net cash provided by (used in) operating activities	(282)	278
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from sale of equity investment	—	115
Purchases of property and equipment	(936)	(1,368)
Proceeds from disposition of property and equipment	—	405
Net cash used in investing activities	(936)	(848)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock, net of distributions	680	649
Proceeds from (repayments of) line of credit borrowings, net	1,325	(142)
Repayments of other debt	(69)	(180)
Net cash provided by financing activities	1,936	327
EFFECT OF EXCHANGE RATE CHANGES ON CASH	74	22
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	792	(221)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	5,855	6,890
CASH AND CASH EQUIVALENTS, END OF PERIOD	$6,647	$6,669

See accompanying notes to condensed consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED 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 specialty products. Heska's state-of-the-art offerings include blood testing instruments and supplies, digital imaging products, software and services, and single-use products and data services, allergy testing and immunotherapy, and single-use offerings such as in-clinic diagnostic tests and heartworm preventive products. The Company's core focus is on the canine and feline 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 June 30, 2016, the results of our operations for the three and six months ended June 30, 2016 and 2015 and cash flows for the six months ended June 30, 2016 and 2015.

The unaudited 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 new standard is effective for annual reporting periods beginning after December 15, 2016, with early adoption permitted. We early adopted the standard during the second quarter of 2016 and are therefore required to report the impacts as though the standard had been

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

adopted on January 1, 2016. Accordingly, we recognized additional income tax benefits as an increase to earnings of $0.5 million ($0.07 per diluted share) in the three and six months ended June 30, 2016. The new accounting standard did not impact any periods prior to January 1, 2016, as we applied the changes to the standard on a prospective basis.

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 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. ACQUISITIONS AND RELATED PARTY ITEMS

On May 31, 2016, the Company closed a transaction (the "Merger") to acquire Cuattro Veterinary, LLC ("Cuattro International") from Kevin S. Wilson, and all of the members of Cuattro International (the "Members"). Pursuant to the Merger, the Company issued 175,000 shares of the Company’s common stock, $.01 par value per share (the "Common Stock"), to the Members on the Closing Date, at an aggregate value equal to approximately $6.3 million based on the adjusted closing price per share of the Common Stock as reported on the Nasdaq Stock Market on the Merger closing date. These shares were issued to the Members in a private placement in reliance upon an exemption from the registration requirements of the Securities Act of 1933, as amended, pursuant to Section 4(a)(2) thereof and the safe harbor provided by Rule 506 of Regulation D promulgated thereunder. Effective on the Merger closing date, each of the Members executed lock-up agreements with the Company that restrict their ability to sell any of the shares of Common Stock received in the Merger until 180 days after the Merger closing date. In addition, the Company assumed approximately $1.5 million in debt as part of the transaction.

Mr. Wilson is a founder of Cuattro International, Cuattro, LLC, Cuattro Software, LLC and Cuattro Medical, LLC. Mr. Wilson, Mrs. Wilson and trusts for the benefit of Mr. and Mrs. Wilson’s children and family own a 100% interest in Cuattro, LLC and a majority interest in Cuattro Medical, LLC. Cuattro, LLC owns a 100% interest in Cuattro Software, LLC and, prior to the Merger, owned a majority interest in Cuattro International.

The Company recorded assets acquired and assets assumed at their estimated fair values. Intangible assets were valued based on a report from an independent third party.

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

The following summarizes the aggregate consideration paid by the Company and the allocation of the purchase price (in thousands):

Common stock issued - 175,000 shares	$6,347
Debt assumed	1,535
Total fair value of consideration transferred	$7,882

Accounts receivable	$222
Inventories	39
Due from Cuattro, LLC	963
Property and equipment	80
Other tangible assets	164
Deferred tax asset	56
Intangible assets	2,521
Goodwill	5,783
Accounts payable	(112)
Deferred tax liability	(905)
Other assumed liabilities	(929)
Total fair value of consideration transferred	$7,882

Intangible assets acquired, amortization method and estimated useful lives as of May 31, 2016 was as follows (dollars in thousands):

	Useful Life	Amortization Method	Fair Value
Customer relationships	6.67	Straight-line	$2,521

Cuattro International is a provider to international markets of digital radiography technologies for veterinarians. As a leading provider of advanced veterinary diagnostic and specialty products, we made the acquisition in an effort to combine Cuattro International's international reach with our domestic success in the imaging and blood testing markets in the United States. International markets represent a significant portion of worldwide veterinary revenues for which we intend to compete.

As of the closing date of the Merger, Cuattro International was renamed Heska Imaging International, LLC, and the Company's interest in both Heska Imaging International, LLC ("International Imaging") and Heska Imaging US, LLC ("US Imaging") was transferred to the Company's wholly-owned subsidiary, Heska Imaging Global, LLC ("Global Imaging").

On February 24, 2013, the Company acquired a 54.6% interest in Cuattro Veterinary USA, LLC which was subsequently renamed Heska Imaging US, LLC. The remaining minority position (45.4%) in US 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, US Imaging minority unit holders will be entitled to sell their US Imaging units to Heska.

US 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 US Imaging,

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

respectively. Kevin S. Wilson is the Chief Executive Officer and President of the Company and the spouse of 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.

Cuattro, LLC has charged US Imaging $3.6 million from January 1, 2016 to May 31, 2016 and has charged Global Imaging $0.9 million since June 1, 2016, 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 has charged US Imaging $2.4 million during the six months ended June 30, 2016, primarily related to sales expenses; and Heska Corporation has charged Cuattro, LLC $130 thousand during the six months ended June 30, 2016, primarily related to facility usage and other services.

At June 30, 2016, US Imaging had a $1.5 million note receivable, including accrued interest, from International Imaging, which is due on June 15, 2019 and which eliminated in consolidation of the Company's financial statements. This note was previously listed as "Note receivable – related party" on the Company's consolidated balance sheets and, as discussed above, the note receivable was assumed as part of the Company's acquisition of Cuattro International. At June 30, 2016, Heska Corporation had net accounts receivable from Cuattro, LLC of $25 thousand which is included in "Due from – related parties" on the Company's consolidated balance sheets; International Imaging had a net receivable due from Cuattro, LLC of $546 thousand, which is included in "Due from – related parties" on the Company's consolidated balance sheets; Global Imaging had net prepaid receivables from Cuattro, LLC of $1.4 million which is included in "Due from – related parties" on the Company's consolidated balance sheets; Heska Corporation had accounts receivable from US Imaging of $5.0 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 US Imaging of the unit holders who hold the 45.4% of US Imaging that Heska Corporation does not own (the "Put Value") is being accreted to its estimated redemption value in accordance with US 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 US 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	119
Balance June 30, 2016	$15,866

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED 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 June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Income before income taxes	$1,792	$3,522	$2,676	$5,625
Total income tax expense	614	780	915	1,436
Effective tax rate	34.3 %	22.1 %	34.2 %	25.5 %

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. The rates in the three and six months ended June 30, 2016 benefited from additional tax benefits related to employee share-based payment awards which are now recorded as income tax benefit or expense in earnings effective with the adoption of an accounting standard update during the quarter ended June 30, 2016. We early adopted the accounting standard update during the second quarter of 2016 and are therefore required to report the impacts as though the accounting standard update had been adopted on January 1, 2016. Accordingly, we recognized additional income tax benefits of $0.5 million during the three and six months ended June 30, 2016.
Cash paid for income taxes for each of the three months ended June 30, 2015 and 2016 was $15 thousand and $57 thousand, respectively. Cash paid for income taxes for the six months ended June 30, 2015 and 2016 was $20 thousand and $62 thousand, respectively.

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 and six months ended June 30, 2015 and 2016 (in thousands, except per share data):

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Net income attributable to Heska Corporation	$1,197	$2,522	$1,795	$3,707
Basic weighted-average common shares outstanding	6,283	6,695	6,232	6,641
Assumed exercise of dilutive stock options and restricted stock units	792	554	748	565
Diluted weighted-average common shares outstanding	7,075	7,249	6,980	7,206
Basic earnings per share attributable to Heska Corporation	$0.19	$0.38	$0.29	$0.56
Diluted earnings per share attributable to Heska Corporation	$0.17	$0.35	$0.26	$0.51

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 June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Stock options	27	138	28	138

5. GOODWILL AND OTHER INTANGIBLES

The following summarizes the changes in goodwill during the six months ended June 30, 2016 (in thousands):

	June 30, 2016
Carrying amount, beginning of period	$20,910
Additions and adjustments	5,798
Carrying amount, end of period	$26,708

Other intangibles consisted of the following as of December 31, 2015 and June 30, 2016 (in thousands):

	December 31, 2015	June 30, 2016
Gross carrying amount	$ 788	$3,309
Accumulated amortization	(732)	(769)
Net carrying amount	$ 56	$2,540

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Amortization expense	$65	$ 34	$130	$ 37

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

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)	$194
2017	388
2018	388
2019	388
2020	356
Thereafter	826
	$2,540

6. PROPERTY AND EQUIPMENT

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

	December 31, 2015	June 30, 2016
Land	$377	$377
Building	2,868	2,868
Machinery and equipment	35,284	37,348
Leasehold and building improvements	6,673	6,733
Construction in progress	1,496	1,851
	46,698	49,177
Less accumulated depreciation and amortization	(29,678)	(31,525)
Total property and equipment, net	$17,020	$17,652

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 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 $2.5 million and $1.7 million for the six month periods ended June 30, 2015 and 2016, respectively.

The Company has sold certain customer rental contracts and underlying assets to a third party under the agreement that once the customer has met its 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, US Imaging, provided $59 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 six months ended June 30, 2015. There were no such sales during the six months ended June 30, 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 in accordance with its depreciation policies. The Company had $2.2 million and $1.5 million of net property and equipment related to these transactions as of December 31, 2015 and June 30, 2016, respectively, all related to the Company's 54.6%-owned subsidiary, US Imaging.

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

Depreciation and amortization expense for property and equipment was $1.1 million in each of the three months ended June 30, 2015 and 2016. Depreciation and amortization expense for property and equipment was $2.1 million and $2.2 million for the six months ended June 30, 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 and $0.3 million of such capitalized costs, net of accumulated amortization, on the "property and equipment, net" line of our consolidated balance sheets as of December 31, 2015 and June 30, 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 $44 thousand of capitalized software costs reported on the "purchases of property and equipment" line item of our consolidated statements of cash flows for the six months ended June 30, 2015. There were no capitalized software costs incurred in the six months ended June 30, 2016.

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	June 30, 2016
Raw materials	$ 8,531	$ 10,097
Work in process	2,839	4,089
Finished goods	6,122	5,194
Allowance for excess or obsolete inventory	(1,391)	(1,304)
Total inventory	$ 16,101	$ 18,076

8. ACCRUED LIABILITIES

Accrued liabilities consisted of the following as of December 31, 2015 and June 30, 2016 (in thousands):

	December 31, 2015	June 30, 2016
Accrued payroll and employee benefits	$ 860	$ 1,168
Accrued property taxes	721	506
Accrued purchases	300	—
Other	3,535	3,553
Total accrued liabilities	$ 5,416	$ 5,227

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

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

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- pricing model with the following weighted average assumptions for options granted in the three and six months ended June 30, 2015 and 2016.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Risk-free interest rate	1.17%	1.17%	1.16%	1.19%
Expected lives	3.4 years	4.5 years	3.4 years	4.5 years
Expected volatility	43%	41%	43%	41%
Expected dividend yield	0%	0%	0%	0%

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		Six Months Ended June 30, 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	19,355	$ 39.074
Canceled	(28,440)	$ 10.080	(463)	$ 14.881
Exercised	(251,647)	$ 10.559	(70,507)	$ 11.793
Outstanding at end of period	940,610	$ 14.163	888,995	$ 14.893
Exercisable at end of period	621,559	$ 10.269	633,469	$ 11.489

The total estimated fair value of stock options granted during the six months ended June 30, 2015 and 2016 were computed to be approximately $258 thousand and $267 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 six months ended June 30, 2015 and 2016 was computed to be approximately $8.88 and $13.83, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2015 and 2016 was $1.9 million and $1.6 million, respectively. The cash proceeds from options exercised during the six months ended June 30, 2015 and 2016 was $715 thousand and $660 thousand, respectively.

The following table summarizes information about stock options outstanding and exercisable at June 30, 2016, excluding outstanding options to purchase an aggregate of 4.2 fractional shares resulting from our December 2010 1-for-10 reverse stock split with a weighted average remaining contractual life of 0.5 years, a weighted average exercise price of $18.69 and exercise prices ranging from $17.17-$22.50. We intend to issue whole shares only from option exercises.

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

	Options Outstanding			Options Exercisable	
Exercise Prices	Number of Options Outstanding at June 30, 2016	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Number of Options Exercisable at June 30, 2016	Weighted Average Exercise Price
$ 4.40 - $ 6.90	216,365	4.38	$ 5.598	214,484	$ 5.592
$ 6.91 - $ 8.26	186,964	7.37	$ 7.385	119,329	$ 7.385
$ 8.27 - $17.17	171,853	5.58	$ 10.342	152,355	$ 10.446
$17.18 - $28.39	152,558	5.79	$ 18.465	91,647	$ 18.475
$28.40 - $39.76	161,255	9.43	$ 37.543	55,654	$ 34.361
$ 4.40 - $39.76	888,995	6.40	$ 14.893	633,469	$ 11.489

As of June 30, 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 1.60 years, with approximately $485 thousand to be recognized in the six 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 June 30, 2016. As of June 30, 2016, the aggregate intrinsic value of outstanding options was approximately $20.1 million and the aggregate intrinsic value of exercisable options was approximately $16.3 million.

Employee Stock Purchase Plan (the "ESPP")

For the six months ended June 30, 2015 and 2016, we issued 6,043 and 4,497 shares under the ESPP, respectively. For the three and six months ended June 30, 2015 and 2016, 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 June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Risk-free interest rate	0.24%	0.55%	0.24%	0.53%
Expected lives	1.2 years	1.2 years	1.2 years	1.2 years
Expected volatility	36%	43%	35%	42%
Expected dividend yield	0%	0%	0%	0%

For the six months ended June 30, 2015 and 2016, the weighted-average fair value of the purchase rights granted was $5.67 and $6.87 per share, respectively. For the three months ended June 30, 2015 and 2016, the weighted-average fair value of the purchase rights granted was $5.75 and $7.64 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

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

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.

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	Sale of Equity Investment	Total accumulated other comprehensive income
Balances at December 31, 2015	$ (576)	$ 673	$ 90	$ 187
Current period other comprehensive income (loss)	—	42	(90)	(48)
Balances at June 30, 2016	$ (576)	$ 715	$ —	$ 139

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

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 June 30, 2015 and 2016, royalties of $0.1 million became payable under these agreements. In each of the six months ended June 30, 2015 and 2016, royalties of $0.2 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 June 30, 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.

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 June 30, 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 June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Interest income	$(41)	$(30)	$(99)	$(63)
Interest expense	50	38	103	76
Other, net	28	26	170	(112)
Total	$37	$34	$174	$(99)

Cash paid for interest for the three months ended June 30, 2015 and 2016 was $21 thousand and $19 thousand, respectively. Cash paid for interest for the six months ended June 30, 2015 and 2016 was $40 thousand and $37 thousand, respectively.

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

13. CREDIT FACILITY

At June 30, 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 June 30, 2016, we had no 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. Any interest on borrowings due is 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 June 30, 2016 and our available borrowing capacity based upon eligible accounts receivable and eligible inventory under our revolving line of credit was approximately $12.0 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.

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

Three Months Ended June 30, 2015	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 20,757	$ 3,153	$23,910
Operating Income	1,536	293	1,829
Income before income taxes	1,511	281	1,792
Capital expenditures	142	189	331
Depreciation and amortization	894	174	1,068

Three Months Ended June 30, 2016	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 24,464	$ 5,501	$29,965
Operating Income	2,746	810	3,556
Income before income taxes	2,724	798	3,522
Capital expenditures	82	381	463
Depreciation and amortization	915	200	1,115

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

Six Months Ended June 30, 2015	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 40,329	$ 6,475	$46,804
Operating Income	2,071	779	2,850
Income before income taxes	1,921	755	2,676
Capital expenditures	449	487	936
Depreciation and amortization	1,724	350	2,074

Six Months Ended June 30, 2016	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 47,898	$ 9,213	$57,111
Operating Income	4,504	1,022	5,526
Income before income taxes	4,532	1,093	5,625
Capital expenditures	479	889	1,368
Depreciation and amortization	1,812	399	2,211

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
United States	$22,926	$28,908	$44,339	$54,729
Europe	515	567	1,046	1,120
Other International	469	490	1,419	1,262
Total	$23,910	$29,965	$46,804	$57,111

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

Asset information by reportable segment as of June 30, 2016 is as follows (in thousands):

	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total assets	$ 95,829	$ 23,796	$119,625
Net assets	59,303	16,355	75,658

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

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

	December 31, 2015	June 30, 2016
United States	$106,780	$116,552
Europe	2,939	3,073
Total	$109,719	$119,625

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 August 5, 2016 and we undertake no duty and do not intend to update this information, except as required by applicable laws.

Overview

We sell advanced veterinary diagnostic and specialty products. Heska's state-of-the-art offerings include blood testing instruments and supplies, digital imaging products, software and services, and single use products and data services, allergy testing and immunotherapy, and single-use offerings such as in-clinic diagnostic tests and heartworm preventive products. The Company's core focus is on the canine and feline markets.

Our business consists of two reportable segments, Core Companion Animal Health ("CCA"), which represented 80% of our revenue for the twelve months ended June 30, 2016 (which we define as "LTM") and Other Vaccines, Pharmaceuticals and Products ("OVP"), which represented 20% 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 37% 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 29% 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 33% of our LTM revenue.

Imaging hardware, software and services represented approximately 19% 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. With our acquisition of Cuattro Veterinary, LLC, subsequently renamed Heska Imaging International, LLC, we now sell our imaging solutions both in the United States and internationally. 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 23% 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 their customer. 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 63% and 37%, 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 unaudited condensed consolidated statements of operations (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Revenue	$23,910	$29,965	$46,804	$57,111
Gross Profit	10,297	12,682	20,381	24,124
Operating expenses	8,468	9,126	17,531	18,598
Operating income	1,829	3,556	2,850	5,526
Interest and other expense (income), net	37	34	174	(99)
Income before income taxes	1,792	3,522	2,676	5,625
Provision for income taxes	614	780	915	1,436
Net income	1,178	2,742	1,761	4,189
Net income (loss) attributable to non-controlling interest	(19)	220	(34)	482
Net income attributable to Heska Corporation	$1,197	$2,522	$1,795	$3,707

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Revenue	100.0%	100.0%	100.0%	100.0%
Gross Profit	43.1%	42.3%	43.5%	42.2%
Operating expenses	35.4%	30.5%	37.5%	32.6%
Operating income	7.6%	11.9%	6.1%	9.7%
Interest and other expense (income), net	0.2%	0.1%	0.4%	(0.2)%
Income before income taxes	7.5%	11.8%	5.7%	9.8%
Provision for income taxes	2.6%	2.6%	2.0%	2.5%
Net income	4.9%	9.2%	3.8%	7.3%
Net income (loss) attributable to non-controlling interest	(0.1)%	0.7%	(0.1)%	0.8%
Net income attributable to Heska Corporation	5.0%	8.4%	3.8%	6.5%

Revenue

Total revenue increased 22% to $57.1 million in the six months ended June 30, 2016 compared to $46.8 million in the six months ended June 30, 2015 and increased 25% to $30.0 million in the three months ended June 30, 2016 compared to $23.9 million in the three months ended June 30, 2015.

CCA segment revenue increased 19% to $47.9 million in the six months ended June 30, 2016 compared to $40.3 million in the six months ended June 30, 2015. Greater revenue from our digital radiography products, our instrument consumables, our heartworm preventive and our hematology instruments were key factors in the increase. CCA segment revenue increased 18% to $24.5 million in the three months ended June 30, 2016 compared to $20.8 million in the three months ended June 30, 2015. Greater revenue from our heartworm preventative products, our digital radiography products and our instrument consumables were key factors in the improvement.

OVP segment revenue increased 42% to $9.2 million in the six months ended June 30, 2016 compared to $6.5 million in the six months ended June 30, 2015 and increased 74% to $5.5 million in the three months ended June 30, 2016 compared to $3.2 million in the three months ended June 30, 2015. Revenue from sales under our agreement with Elanco was a key factor in both cases.

Gross Profit

Gross profit increased 18% to $24.1 million in the six months ended June 30, 2016 compared to $20.4 million in the six months ended June 30, 2015. Gross Margin, which is gross profit divided by total revenue, decreased to 42.2% in the six months ended June 30, 2016 compared to 43.5% in the six months ended June 30, 2015. Gross profit increased 23% to 12.7 million in the three months ended June 30, 2016 compared to $10.3 million in the three months ended June 30, 2015. Gross Margin decreased to 42.3% in the three months ended June 30, 2016 compared to 43.1% in the three months ended June 30, 2015. Product mix in our OVP segment, as well as lower gross margin on our chemistry consumables, somewhat offset by higher gross margin on our imaging products, were factors in the decline in both cases.

Operating Expenses

Selling and marketing expenses increased 3% to $11.0 million in the six months ended June 30, 2016 compared to $10.7 million in the six months ended June 30, 2015 and increased 3% to $5.4 million in the three months ended June 30, 2016 compared to $5.2 million in the three months ended June 30, 2015. Increased commissions due to higher revenue from our imaging products was a factor in the change in both cases.

Research and development expenses increased 35% to $1.1 million in the six months ended June 30, 2016, compared to $0.8 million in the six months ended June 30, 2015. Increased development project spending related to imaging products and single use diagnostic products were factors in the change. Research and development expenses increased 33% to $0.5 million in the three months ended June 30, 2016, compared to $0.4 million in the three months ended June 30, 2015. Increased development project spending related to single use diagnostic products was a factor in the change.

General and administrative expenses increased 8% to $6.5 million in the six months ended June 30, 2016, compared to $6.0 million in the six months ended June 30, 2015 and increased 13% to $3.2 million in the three months ended June 30, 2016, compared to $2.8 million in the three months ended June 30, 2015. Expense related to the May 2016 acquisition of Cuattro International was a factor in the change in both cases.

Interest and Other Expense (Income), Net

Interest and other expense (income), net, was income of $99 thousand in the six months ended June 30, 2016, as compared to an expense of $174 thousand in the six months ended June 30, 2015. Interest and other expense (income), net, was an expense of $34 thousand in the three months ended June 30, 2016, as compared to an expense of $37 thousand in the three months ended June 30, 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 $13 thousand in the six months ended June 30, 2016, as compared to an expense of $4 thousand in the six months ended June 30, 2015. Net interest was an expense of $8 thousand in the three months ended June 30, 2016, as compared to an expense of $9 thousand in the three months ended June 30, 2015. Net foreign currency gain was $20 thousand in the six months ended June 30, 2016, as compared to a net foreign currency loss of $170 thousand in the six months ended June 30, 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. Net foreign currency loss was $26 thousand in the three months ended June 30, 2016, as compared to a net foreign currency loss of $28 thousand in the three months ended June 30, 2015. Other income was $92 thousand in the six months ended June 30, 2016 primarily related to the sale of an equity investment during the first quarter of 2016.

Income Tax Expense

In the six months ended June 30, 2016, we had total income tax expense of $1.4 million, including $1.3 million in domestic deferred income tax expense, a non-cash item primarily related to our domestic NOL position, and $0.2 million in current income tax expense. In the six months ended June 30, 2015, we had total income tax expense of $0.9 million, including $0.8 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 June 30, 2016, we had total income tax expense of $0.8 million, including $0.7 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 June 30, 2015, we had total income tax expense of $0.6 million, including $0.5 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. Greater income before income taxes was a key factor in our higher income tax expense in the six and three month periods ended June 30, 2016 as compared to the corresponding periods in 2015. The impact of greater income before income taxes was somewhat offset by additional tax benefits of $0.5 million in the six and three months ended June 30, 2016 related to employee share-based payment awards which are now recorded as income tax benefit or expense in earnings effective with the adoption of an accounting standard update during the quarter ended June 30, 2016.

Net Income

Net income was $4.2 million for the six months ended June 30, 2016, as compared to net income of $1.8 million in the prior year period. Net income was $2.7 million for the three months ended June 30, 2016, as compared to net income of $1.2 million in the prior year period. Increased revenue, somewhat offset by lower Gross Margin and higher operating expenses, was a factor in the improvement in both cases.

Net Income attributable to Heska Corporation

Net income attributable to Heska Corporation was $3.7 million for the six months ended June 30, 2016, as compared to a net income attributable to Heska Corporation of $1.8 million in the prior year period. Net income attributable to Heska Corporation was $2.5 million for the three months ended June 30, 2016, as compared to a net income attributable to Heska Corporation of $1.2 million in the prior year period. The difference between this line item and "Net Income" is the net income or loss attributable to our minority interest in US Imaging, which was net income of $482 thousand in the six months ended June 30, 2016 as compared to a loss of $34 thousand in the six months ended June 30, 2015 and net income of $220 thousand in the three months ended June 30, 2016 as compared to a loss of $19 thousand in the three months ended June 30, 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 six months ended June 30, 2016, we had net income of $4.2 million and net cash provided by operations of $0.3 million. At June 30, 2016, we had $6.7 million of cash and cash equivalents and working capital of $27.1 million. At June 30, 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 June 30, 2016, we had no 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. Any interest on borrowings due is 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 June 30, 2016 and our available borrowing capacity based upon eligible accounts receivable and eligible inventory under our revolving line of credit was approximately $12.0 million.

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

	Six Months Ended June 30,	
	2015	2016
Net cash provided by (used in) operating activities	$(282)	$278
Net cash used in investing activities	(936)	(848)
Net cash provided by financing activities	1,936	327
Effect of currency translation on cash	74	22
Increase (decrease) in cash and cash equivalents	792	(221)
Cash and cash equivalents, beginning of the period	5,855	6,890
Cash and cash equivalents, end of the period	$6,647	$6,669

Net cash provided by operating activities was $0.3 million in the six months ended June 30, 2016, as compared to net cash used by operating activities of $0.3 million in the six months ended June 30, 2015, a favorable increase of approximately $0.6 million. Key factors in the change were a $3.0 million decrease in cash used for inventory, a $2.9 million increase in net income and deferred tax expense, and a $1.7 million increase in cash provided by accounts receivable and other current assets, partially offset by a $4.2 million increase in cash used for accounts payable, accrued liabilities and other short term liabilities and a $3.1 million increase in cash used in deferred revenue and other non-current assets.

Net cash used in investing activities was $0.8 million in the six months ended June 30, 2016 as compared to net cash used in investing activities of $0.9 million in the six months ended June 30, 2015, a favorable decrease of approximately $0.1 million. Proceeds from the disposition of property and equipment and the sale of an equity investment were factors in the change.

Net cash flows from financing activities provided cash of $0.3 million in the six months ended June 30, 2016, as compared to $1.9 million in the six months ended June 30, 2015, which represented a $1.6 million decrease in cash provided by financing activities. The largest factor in the change was net repayments of $1.5 million towards the balance of our revolving line of credit.

At June 30, 2016, Heska Corporation had accounts receivable from US Imaging of $5.0 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 June 30, 2016, we, including the balance sheets of our consolidating subsidiaries, had net prepaid receivables from Cuattro, LLC of $2.0 million. 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 June 30, 2016, US Imaging had a $1.5 million note receivable, including accrued interest, from International Imaging, which is due on June 15, 2019 and which eliminated in consolidation of the Company's financial statements. This note was previously listed as "Note receivable – related party" on the Company's consolidated balance sheets. The note receivable was assumed as part of the Company's acquisition of Cuattro International.

At June 30, 2016, we had $487 thousand of borrowings on our consolidated balance sheet related to the borrowings of International Imaging. This debt bears an interest rate of 5.75% per annum and is due in equal monthly payments, including principal and interest, through June 27, 2018. At June 30, 2016, we had other borrowings outstanding totaling $154 thousand, all of which were obligations of a US Imaging loan from De Lage Landen Financial Services, Inc. ("DLL"). The note bears an interest rate of 6% per annum 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. Principal associated with these borrowings of approximately $412 thousand is listed as "Other short term borrowings" on our consolidated balance sheets as it is due within a year.

At June 30, 2016, our consolidated balance sheets included $15.9 million in non-controlling interest. This represents the value of the aggregate position in US 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 issuance of new term debt secured by the same assets as the term loans which were fully repaid in 2010, the sale of equity securities or the increased sale of customer leases. 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 US Imaging meet certain performance criteria, the Imaging Minority, which has been granted put options, may sell us some or all of the Imaging Minority's remaining 45.4% position in US Imaging following the audit of our 2016 and 2017 financial statements. US Imaging generated $10.8 million in revenue, $4.6 million in gross profit and $1.1 million in operating income in the six months ended June 30, 2016 and $8.6 million in revenue, $3.2 million in gross profit and $17 thousand in operating income in the six months ended June 30, 2015. If US 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 US Imaging's operating income, subject to a maximum valuation of $13.6 million – as well as 25% of US Imaging's cash. If US 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 US Imaging's cash. Furthermore, should US 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 US 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 US Imaging. If US 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 US Imaging's cash. We believe it is likely that we will have the contractual right to 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 US Imaging will meet the required performance criteria for the 2016 lowest strike put, but not the 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 US Imaging's cash, to purchase the 45.4% of US 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 will 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 US Imaging's cash to the Imaging Minority in this circumstance. We believe it is also possible that US Imaging will meet the required performance criteria for the 2016 highest strike put, in which case our cash obligation would be increased as compared to the 2016 lowest strike put as outlined above.

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 $52 thousand to a $22 thousand positive impact in the six months ended June 30, 2016 as compared to a $74 thousand positive impact in the six months ended June 30, 2015. These effects are related to changes in exchange rates between the United States 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 unaudited 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 these unaudited Condensed

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 unaudited 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 June 30, 2016, there were no outstanding borrowings on our line of credit with Wells Fargo. We had approximately $6.7 million of cash and cash equivalents at June 30, 2016, the majority of which was invested in liquid interest bearing accounts. We had no interest rate hedge transactions in place on June 30, 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 $67 thousand negative impact on our pre-tax earnings based on our outstanding balances as of June 30, 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 June 30, 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 June 30, 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 June 30, 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 $114 thousand and a currency loss/gain of $258 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 $192 thousand and a currency gain/loss of $420 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 $280 thousand and a currency loss/gain of $671 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 June 30, 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, as could our May 2016 acquisition of Cuattro Veterinary, LLC, which has been renamed Heska Imaging International, LLC, or other acquisitions.

Under the Amended and Restated Operating Agreement of Heska Imaging (the "Operating Agreement"), should Heska Imaging ("US 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 US Imaging following the audit of our financial statements for 2016 and 2017. Based on US 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 US Imaging's cash (any applicable payment in aggregate to be defined as the "Put Payment") to acquire the outstanding minority interest in US 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 US 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 US 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 US Imaging. Based on US 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 US Imaging's cash (any applicable payment in aggregate to be defined as the "Call Payment") to acquire the outstanding minority interest in US 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 US Imaging units to us for cash of up to $13.6 million based on US 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, US 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.

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Napolitano, Heska Corporation's Chief Operating Officer, Chief Financial Officer, Executive 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 US Imaging pursuant to the puts and/or calls discussed above or (2) the sixth anniversary of the Acquisition, US 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 US 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 US Imaging in certain circumstances.

While the terms of both the Amended and Restated Master License Agreement and the Supply Agreement between US 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 more productive matters.

Mr. Wilson's employment agreement with us acknowledges that Mr. Wilson has business interests in Cuattro, LLC, Cuattro Software, LLC and Cuattro Medical, LLC which may require a portion of his time, resources and attention in his working hours. If Mr. Wilson is distracted 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 US Imaging. Cuattro, LLC owns a 100% interest in Cuattro Software, LLC.

Cuattro, LLC has charged US Imaging $3.6 million from January 1, 2016 through May 31, 2016 and has charged Global Imaging $0.9 million from June 1, 2016 through June 30, 2016, 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 has charged US Imaging $2.4 million during the six months ended June 30, 2016, primarily related to sales and other administrative expenses; and Heska Corporation has charged Cuattro, LLC $130 thousand during the six months ended June 30, 2016, primarily related to facility usage and other services.

At May 31, 2016, US Imaging had a $1.5 million note receivable, including accrued interest, from Cuattro Veterinary, LLC, which was due on June 15, 2016 and previously listed as "Note receivable – related party" on the Company's consolidated balance sheets. The note receivable was assumed as part of the Company's acquisition of Cuattro Veterinary. At June 30, 2016 Heska Corporation had accounts receivable from US Imaging of $5.0 million, including accrued interest; Heska Corporation had net accounts receivable from Cuattro, LLC of $25 thousand; Global Imaging had net prepaid receivables from Cuattro, LLC of $1.4 million; and International Imaging had a net receivable due from Cuattro, LLC of $546 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 US Imaging, respectively, each are a member of US 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

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as they otherwise would have to enhancing our business, to the detriment of our shareholder value. While the Operating Agreement was negotiated at arm's length as part of the Acquisition, and requires that none of the members shall cause US 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 more productive matters.

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

On May 31, 2016, we acquired Cuattro Veterinary, LLC, which we subsequently renamed Heska Imaging International, LLC, and we may acquire other businesses in the future. The success of such transactions will depend on, among other things, our ability to integrate assets and personnel acquired in these transactions and to apply our internal controls process to these acquired businesses. The integration of acquisitions may require significant attention from our management, and the diversion of management's attention and resources could have a material adverse effect on our ability to manage our business. Further more, we may not realize the degree or timing of benefits we anticipated when we first entered into the acquisition transaction. If actual integration costs are higher than amounts originally anticipated, if we are unable to integrate the assets and personnel acquired in an acquisition as anticipated, or if we are unable to fully benefit from anticipated synergies our business, financial condition, results of operations, and cash flows could be materially adversely effected.

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.

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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.

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.

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 11% of our LTM revenue. Revenue from Eli Lilly entities, including Elanco, represented 13% 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, but 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 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. Major suppliers who sell us proprietary products who are responsible for more than 5% of our LTM revenue are FUJIFILM Corporation and Cuattro, LLC. None of these suppliers sold us products which were responsible for more than 25% of our LTM revenue, although products purchased from one of these suppliers was responsible for more than 20% of our LTM revenue and products purchased from another was responsible for more than 10% of our LTM revenue. 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:

- 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. If one of our suppliers is unable to provide a raw material or finished product due to regulatory issues, it could have a material adverse financial impact on our business and could expose us to legal action if we are unable to perform on contracts to our customers involving related products.
- 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.
- 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 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. For example, if Zoetis devotes its significant commercial and financial resources to growing its market share in the veterinary allergy market, our allergy-related sales could suffer significantly. Our competitors may offer broader product lines and have greater name recognition than we do. Our competitors may also develop or 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.

Revenue from Butler Animal Health Supply, LLC d/b/a Henry Schein Animal Health ("Henry Schein") represented approximately 13% and 12% of our consolidated revenue for the six and three months ended June 30, 2016 as well as 11% of our consolidated revenue for the three months ended June 30, 2015. Revenue from Merck entities, including Merck Animal Health, represented approximately 11% and 14% of our consolidated revenue for the six and three months ended June 30, 2016, respectively, as well as 11% and 10% for the six and three months ended June 30, 2015, respectively. Revenue from Eli Lilly entities, including Elanco, represented approximately 11% and 14% of our consolidated revenue for the six and three months ended June 30, 2016, respectively. No other single customer accounted for more than 10% of our consolidated revenue for the six and three months ended June 30, 2016 or 2015.

Merck entities accounted for approximately 21% of our consolidated accounts receivable, Eli Lilly entities accounted for approximately 13% of our consolidated accounts receivable and Henry Schein accounted for approximately 12% of our consolidated accounts receivable at June 30, 2016. No other single customer accounted for more than 10% of our consolidated accounts receivable at June 30, 2016.

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 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.

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 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 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.

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.

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 June 30, 2016, the closing stock price of our Public Common Stock has ranged from a low of $26.26 to a high of $40.73. 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.

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

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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.

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 U.S. 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 $26.7 million at June 30, 2016. There can be no assurance that future goodwill impairments will not occur if projected financial results are not met, or otherwise.

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. For example, 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 increased 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.

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. 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, 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 June 30, 2016, we had an accumulated deficit of $159.8 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. 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

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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 June 30, 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
April 1 - April 30, 2016	2,525	$ 30.60	—	—
May 1 - May 31, 2016	—	—	—	—
June 1 - June 30, 2016	—	—	—	—
Total	2,525	$ 30.60	—	—

(1) Shares of Public Common Stock we purchased between April 1, 2016 and June 30, 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+		Assignment and Assumption Agreement (Supply Agreement) between Heska Imaging US, LLC, Heska Imaging Global, LLC, Cuattro, LLC, and Heska Imaging International, LLC, dated as of March 14, 2016.
10.2+		Assignment and Assumption Agreement (License Agreement) between Heska Imaging US, LLC, Heska Imaging Global, LLC, Cuattro, LLC, and Heska Imaging International, LLC, dated as of March 14, 2016.
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

+	Portions of the exhibit have been omitted pursuant to a request for confidential treatment.
**	Furnished with this report.

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 August 8, 2016.

HESKA CORPORATION

By: /s/ KEVIN S. WILSON
Kevin S. Wilson
Chief Executive Officer and President
(Principal Executive Officer)

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)

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