

HESKA CORP  
Form 10-Q  
August 11, 2008

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended June 30, 2008

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-22427

**HESKA CORPORATION**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**77-0192527**

(I.R.S. Employer Identification Number)

**3760 Rocky Mountain Avenue**

**Loveland, Colorado**

(Address of principal executive offices)

**80538**

(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  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company as defined in Rule 12b-2 of the Exchange Act. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer  (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 Exchange Act).

Yes  No

The number of shares of the Registrant's Common Stock outstanding at August 8, 2008 was 51,806,063.

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DRI-CHEM is a registered trademark of FUJIFILM Corporation. i-STAT is a registered trademark of Abbott Laboratories. SPOTCHEM is a trademark of Arkray, Inc. TRI-HEART is a registered trademark of Schering-Plough Animal Health Corporation ("SPAH") in the United States and is a trademark of Heska Corporation in other countries. HESKA, ALLERCEPT, AVERT, E.R.D.-HEALTHSCREEN, E-SCREEN, FELINE ULTRANASAL, SOLO STEP, THYROMED and VET/OX are registered trademarks and CBC-DIFF, ERD, G2 DIGITAL, HEMATRUEN and VET/IV are trademarks of Heska Corporation in the United States and/or other countries. This 10-Q also refers to trademarks and trade names of other organizations.

**HESKA CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

(dollars in thousands except per share amounts)

(unaudited)

**ASSETS**

	<b>December 31, 2007</b>	<b>June 30, 2008</b>
Current assets:		
Cash and cash equivalents	\$ 5,524	\$ 6,153
Accounts receivable, net of allowance for doubtful accounts of \$96 and \$96, respectively	11,064	10,148
Inventories, net	16,395	15,459
Deferred tax asset, current	1,260	259
Other current assets	884	688
Total current assets	35,127	32,707
Property and equipment, net	10,669	10,054
Goodwill	834	922
Deferred tax asset, net of current portion	28,776	29,486
Other assets	185	185
Total assets	\$ 75,591	\$ 73,354

**LIABILITIES AND STOCKHOLDERS' EQUITY**

Current liabilities:		
Accounts payable	\$ 5,653	\$ 3,216
Accrued liabilities	3,175	3,773
Current portion of deferred revenue	2,977	2,402
Line of credit	12,614	12,720
Current portion of long-term debt and capital leases	776	1,539
Total current liabilities	25,195	23,650
Long-term debt, net of current portion	1,151	—
Deferred revenue, net of current portion, and other	6,362	5,649
Total liabilities	32,708	29,299

Commitments and contingencies

Stockholders' equity:

Preferred stock, \$.001 par value, 25,000,000 shares authorized; none issued or outstanding	—	—
Common stock, \$.001 par value, 75,000,000 shares authorized; 51,447,663 and 51,737,568 shares issued and outstanding, respectively		

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Additional paid-in capital	215,685	216,159
Accumulated other comprehensive income	335	592
Accumulated deficit	(173,188 )	(172,748 )
Total stockholders' equity	42,883	44,055
Total liabilities and stockholders' equity	\$ 75,591	\$ 73,354

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		Six Months Ended	
	June 30, 2007	2008	June 30, 2007	2008
Revenue, net:				
Product revenue, net:				
Core companion animal health	\$ 16,236	\$ 17,324	\$ 33,227	\$ 34,679
Other vaccines, pharmaceuticals and products	3,540	4,874	8,863	9,155
Total product revenue, net	19,776	22,198	42,090	43,834
Research, development and other	311	417	712	699
Total revenue	20,087	22,615	42,802	44,533
Cost of revenue:				
Cost of products sold	11,713	13,860	23,965	27,993
Cost of research, development and other	73	184	176	233
Total cost of revenue	11,786	14,044	24,141	28,226
Gross profit	8,301	8,571	18,661	16,307
Operating expenses:				
Selling and marketing	3,959	4,644	8,377	9,566
Research and development	742	417	1,446	956
General and administrative	2,390	2,124	5,025	4,622
(Gain) on sale of assets	—	—	(47	) —
Total operating expenses	7,091	7,185	14,801	15,144
Income from operations	1,210	1,386	3,860	1,163
Interest and other expense, net	159	181	339	347
Income before income taxes	1,051	1,205	3,521	816
Income tax expense:				
Current	15	83	89	119
Net operating loss usage and other deferred	3	456	5	257
Total income tax expense	18	539	94	376
Net income	\$ 1,033	\$ 666	\$ 3,427	\$ 440
Basic net income per share	\$ 0.02	\$ 0.01	\$ 0.07	\$ 0.01
Diluted net income per share	\$ 0.02	\$ 0.01	\$ 0.06	\$ 0.01

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Weighted average outstanding shares used to compute basic

net income per share	50,946	51,595	50,875	51,538
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Weighted average outstanding shares used to compute diluted net  
income per share

	55,739	53,961	55,047	54,401
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See accompanying notes to condensed consolidated financial statements.

**HESKA CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

	<b>Six Months Ended</b>	
	<b>June 30, 2007</b>	<b>2008</b>
<b>CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:</b>		
Net income	\$ 3,427	\$ 440
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Depreciation and amortization	902	1,586
Deferred tax expense (benefit)	5	295
Stock-based compensation	110	205
(Gain) on disposition of assets	(47 )	—
Unrealized (gain) loss on foreign currency translation	(55 )	29
Changes in operating assets and liabilities:		
Accounts receivable	753	845
Inventories	(672 )	694
Other current assets	156	193
Accounts payable	(601 )	(2,437 )
Accrued liabilities	(550 )	669
Deferred revenue and other liabilities	(1,086 )	(1,289 )
Income taxes payable	(58 )	—
Other	1	—
Net cash provided by (used in) operating activities	2,285	1,230
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from sale of assets, net of related costs	47	—
Purchase of property and equipment	(1,056 )	(720 )
Net cash provided by (used in) investing activities	(1,009 )	(720 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from issuance of common stock	399	270
Proceeds from (repayments of) line of credit borrowings, net	(621 )	106
Proceeds from (repayments of) debt and capital lease obligations, net	(887 )	(388 )
Net cash provided by (used in) financing activities	(1,109 )	(12 )
EFFECT OF EXCHANGE RATE CHANGES ON CASH	39	131
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	206	629
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	5,275	5,524
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 5,481	\$ 6,153

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SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

Cash paid for interest	\$ 486	\$ 390
Non-cash transfer of inventory to property and equipment	\$ 1,488	\$ 243

See accompanying notes to condensed consolidated financial statements.

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**HESKA CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2008**

**(UNAUDITED)**

**1. ORGANIZATION AND BUSINESS**

Heska Corporation ("Heska" or the "Company") develops, manufactures, markets, sells and supports veterinary products. Heska's core focus is on the canine and feline companion animal health markets.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Basis of Presentation*

The accompanying unaudited condensed consolidated financial statements are the responsibility of the Company's management and have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the instructions to Form 10-Q and rules and regulations of the Securities and Exchange Commission (the "SEC"). The condensed consolidated balance sheet as of June 30, 2008, the condensed consolidated statements of operations for the three months and six months ended June 30, 2007 and 2008 and the condensed consolidated statements of cash flows for the six months ended June 30, 2007 and 2008 are unaudited, but include, in the opinion of management, all adjustments (consisting of normal recurring adjustments) which the Company considers necessary for a fair presentation of its financial position, operating results and cash flows for the periods presented. All material intercompany transactions and balances have been eliminated in consolidation. Although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information and footnote disclosures normally included in complete financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the SEC.

Results for any interim period are not necessarily indicative of results for any future interim period or for the entire year. The accompanying financial statements and related disclosures have been prepared with the presumption that users of the interim financial information have read or have access to the audited financial statements for the preceding fiscal year. Accordingly, these financial statements should be read in conjunction with the audited financial statements and the related notes thereto for the year ended December 31, 2007, included in the Company's Annual Report on Form 10-K filed with the SEC on March 3, 2008.

*Use of Estimates*

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The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 amount of revenue and expense during the reported period. Actual results could differ from those estimates. Significant estimates are required when establishing the allowance for doubtful accounts and the provision for excess/obsolete inventory, in determining the period over which the Company's obligations are fulfilled under agreements to license product rights and/or technology rights, and in determining the need for, and the amount of, a valuation allowance on certain deferred tax assets.

*Inventories*

Inventories are stated at the lower of cost or market using the first-in, first-out method. Inventory manufactured by the Company includes the cost of material, labor and overhead. If the cost of inventories exceeds estimated fair value, provisions are made to reduce the carrying value to estimated fair value.

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

	<b>December 31, 2007</b>	<b>June 30, 2008</b>
Raw materials	\$ 4,865	\$ 6,380
Work in process	3,138	2,401
Finished goods	8,969	7,469
Allowance for excess or obsolete inventory	(577 )	(791 )
	<b>\$ 16,395</b>	<b>\$ 15,459</b>

*Basic and Diluted Net Income (Loss) Per Share*

Basic net income (loss) per common share is computed using the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed using the sum of the weighted average number of shares of common stock outstanding, and, if not anti-dilutive, the effect of outstanding common stock equivalents (such as stock options and warrants) determined using the treasury stock method. For the three and six months ended June 30, 2008 and 2007, the Company reported net income and therefore, dilutive common stock equivalent securities, as computed using the treasury stock method, were added to basic weighted average shares outstanding for the period to derive the weighted average shares for the diluted earnings per share calculation. Common stock equivalent securities that were anti-dilutive for the three months ended June 30, 2008 and 2007, and therefore excluded, were outstanding options to purchase 4,626,724 and 1,621,870 shares of common stock, respectively. Common stock equivalent securities that were anti-dilutive for the six months ended June 30, 2008 and 2007, and therefore excluded, were outstanding options to purchase 4,332,372 and 1,818,776 shares of common stock, respectively. These securities are anti-dilutive primarily due to exercise prices greater than the average value of the Company's common stock during the three and six months ended June 30, 2008 and 2007. Should the Company's stock price increase, the number of common stock equivalents considered to be dilutive will increase.

**3. CAPITAL STOCK**

The Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004) "Share-Based Payment" ("SFAS No. 123R") under the modified prospective method of adoption, effective January 1, 2006. SFAS No. 123R requires companies to measure the cost of employee services received in exchange for an award of equity instruments (including stock options) based on the estimated grant-date fair value of the award. The resulting cost is recognized over the period during which an employee is required to provide service in exchange for the award, usually the vesting period.

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, 2008.

	Three Months Ended		Six Months Ended	
	June 30, 2007	2008	June 30, 2007	2008
Risk-free interest rate	4.65%	2.57%	4.65%	2.63%
Expected lives	2.8 years	2.9 years	2.8 years	2.9 years
Expected volatility	58%	50%	58%	51%
Expected dividend yield	0%	0%	0%	0%

A summary of the Company's stock option plans is as follows:

	Year Ended		Six Months Ended	
	December 31, 2007		June 30, 2008	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of period	11,818,823	\$ 1.3575	12,118,417	\$ 1.3979
Granted at market	980,835	\$ 1.9305	455,268	\$ 1.5583
Granted above market	—	\$ —	—	\$ —
Cancelled	(122,746)	) \$ 2.9538	(197,879)	) \$ 3.7395
Exercised	(558,495)	) \$ 1.1348	(203,423)	) \$ 0.8946
Outstanding at end of period	12,118,417	\$ 1.3979	12,172,383	\$ 1.3743
Exercisable at end of period	11,340,083	\$ 1.3675	11,357,323	\$ 1.3461

The estimated fair value of stock options granted during the six months ended June 30, 2008 and 2007 was computed to be approximately \$257 thousand and \$206 thousand, respectively. The amount is amortized ratably over the vesting period of the options. The per share weighted average estimated fair value of options granted during the six months ended June 30, 2008 and 2007 was computed to be approximately \$0.57 and \$0.93, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2008 and 2007 was \$111 thousand and \$269 thousand, respectively. The cash proceeds from options exercised during the six months ended June 30, 2008 and 2007 were \$182 thousand and \$292 thousand, respectively. In the three and six months ended June 30, 2008, the Company's domestic net operating loss carryforward ("NOL") was increased by \$13 thousand and \$62 thousand, respectively, due to option exercises. As the Company maintained an equal and offsetting valuation allowance for all deferred tax assets in the three and six months ended June 30, 2007, no net tax benefit was realized for accounting purposes due to option exercises during that period.

The following table summarizes information about stock options outstanding and exercisable at June 30, 2008:

Options Outstanding

Options Exercisable

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	<b>Number of Options Outstanding at June 30, 2008</b>	<b>Weighted Average Remaining Contractual Life in Years</b>	<b>Weighted Average Exercise Price</b>	<b>Number of Options Exercisable at June 30, 2008</b>	<b>Weighted Average Exercise Price</b>
<b>Exercise Prices</b>					
\$0.34 - \$0.87	1,858,726	4.61	\$ 0.6453	1,858,726	\$ 0.6453
\$0.88 - \$1.06	2,779,782	5.59	\$ 0.9396	2,779,782	\$ 0.9396
\$1.07 - \$1.25	2,521,993	5.88	\$ 1.2133	2,521,993	\$ 1.2133
\$1.26 - \$1.82	2,461,957	7.07	\$ 1.5838	2,304,040	\$ 1.5931
\$1.83 - \$13.75	2,549,925	6.01	\$ 2.3365	1,892,782	\$ 2.5079
\$0.34 - \$13.75	12,172,383	5.89	\$ 1.3743	11,357,323	\$ 1.3461

As of June 30, 2008, there was approximately \$714 thousand of total unrecognized compensation expense related to outstanding stock options. That expense is expected to be recognized over a weighted average period of 2.1 years, with approximately \$159 thousand to be recognized in the six months ending December 31, 2008 and all cost to be recognized as of April 2012, assuming all options vest according to the vesting schedules in place at June 30, 2008. As of June 30, 2008, the aggregate intrinsic value of outstanding options was approximately \$1.8 million and the aggregate intrinsic value of exercisable options was approximately \$1.8 million.

#### 4. SEGMENT REPORTING

The Company is comprised 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. These products are sold directly by the Company as well as through independent third-party distributors and other distribution relationships. CCA segment products manufactured at the Des Moines, Iowa production facility included in our OVP segment's assets are transferred at cost and are not recorded as revenue for our 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 and fish. All OVP products are sold by third parties under third party labels.

Additionally, the Company generates non-product revenue from research and development projects for third parties, licensing of technology and royalties. The Company performs these research and development projects for both companion animal and livestock purposes.

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

	<b>Core Companion Animal Health</b>	<b>Other Vaccines, Pharmaceuticals and Products</b>	<b>Total</b>
<b>Six Months Ended</b>			
<b>June 30, 2007:</b>			
Total revenue	\$ 33,881	\$ 8,921	\$ 42,802
Operating income (loss)	729	3,131	3,860
Interest expense	236	167	403
Total assets	25,157	13,456	38,613
Capital expenditures	442	614	1,056
Depreciation and amortization	464	438	902
<b>Six Months Ended</b>			
<b>June 30, 2008:</b>			
Total revenue	\$ 35,233	\$ 9,300	\$ 44,533
Operating income (loss)	(1,094 )	2,257	1,163
Interest expense	288	94	382
Total assets	60,733	12,621	73,354

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Capital expenditures	409	311	720
Depreciation and amortization	1,127	459	1,586



	<b>Core Companion Animal Health</b>	<b>Other Vaccines, Pharmaceuticals and Products</b>	<b>Total</b>
<b>Three Months Ended</b>			
<b>June 30, 2007:</b>			
Total revenue	\$ 16,496	\$ 3,591	\$ 20,087
Operating income (loss)	213	997	1,210
Interest expense	77	74	151
Total assets	25,157	13,456	38,613
Capital expenditures	217	421	638
Depreciation and amortization	264	216	480
<b>Three Months Ended</b>			
<b>June 30, 2008:</b>			
Total revenue	\$ 17,595	\$ 5,020	\$ 22,615
Operating income (loss)	135	1,251	1,386
Interest expense	128	42	170
Total assets	60,733	12,621	73,354
Capital expenditures	84	118	202
Depreciation and amortization	581	230	811

## 5. COMPREHENSIVE INCOME

Comprehensive income includes net income plus the results of certain stockholders' equity changes not reflected in the Condensed Consolidated Statements of Operations. Such changes primarily include foreign currency translation items. Total comprehensive income for the three months ended June 30, 2007 and 2008 was \$1.0 million and \$599 thousand, respectively. Total comprehensive income for the six months ended June 30, 2007 and 2008 was \$3.4 million and \$697 thousand, respectively.

**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 "Selected Consolidated Financial Data" and the Unaudited Condensed Consolidated Financial Statements and related Notes included in Part I Item 1 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, general and administrative expenses, research and development expenses, capital resources, capital expenditures and additional financings or borrowings, 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 August 11, 2008, and we do not intend to update this forward-looking information.

**Overview**

We develop, manufacture, market, sell and support veterinary products. Our business is comprised of two reportable segments, Core Companion Animal Health, which represented 82% of our product revenue for the twelve months ended June 30, 2008 and Other Vaccines, Pharmaceuticals and Products, which represented 18% of our product revenue for the twelve months ended June 30, 2008.

The Core Companion Animal Health ("CCA") segment includes diagnostic instruments and supplies as well as single use diagnostic and other tests, pharmaceuticals and vaccines, primarily for canine and feline use.

Diagnostic instruments and supplies represented approximately 47% of our product revenue for the twelve months ended June 30, 2008. 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 32% of our product revenue for the twelve months ended June 30, 2008 resulted from the sale of such consumables to an installed base of instruments and approximately 15% of our product revenue was from new hardware sales. A loss of or disruption in supply of consumables we are selling to an installed base of instruments could substantially harm our business. All products in this area 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 handheld blood analysis instruments, our chemistry instruments and our hematology instruments and their affiliated operating consumables. Revenue from products in these three areas, including revenues from consumables, represented approximately 43% of our product revenue for the twelve months ended June 30, 2008.

Single use diagnostic and other tests, pharmaceuticals and vaccines and other products represented approximately 35% of our product revenue for the twelve months ended June 30, 2008. Since items in this area are single use by their nature, our 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 in this area include our heartworm diagnostic tests, our heartworm preventive, our allergy test kits, our allergy immunotherapy and our allergy diagnostic tests. Combined revenue from heartworm-related products and allergy-related products represented approximately 31% of our product revenue for the twelve months ended June 30, 2008.

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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. We strive to provide high value products and advance the state of veterinary medicine.

All our CCA products are ultimately sold to or through veterinarians. In many cases, veterinarians will mark up their costs to the end user. The acceptance of our products by veterinarians is critical to our success. CCA products are sold directly by us as well as through independent third party distributors and other distribution relationships, such as corporate agreements. Revenue from direct sales, independent third-party distributors and other distribution relationships represented approximately 49%, 29% and 22%, respectively, of CCA product revenue for the twelve months ended June 30, 2008.

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. 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 distributor's time and focus given other products the distributor may be carrying, potentially including those of our competitors. We believe that one of our largest competitors, IDEXX Laboratories, Inc. ("IDEXX"), in effect prohibits its distributors from selling competitive products, including our diagnostic instruments and heartworm diagnostic tests. We believe the IDEXX restrictions limit our ability to engage national distributors to sell our full distribution line of products.

We intend to sustain profitability through a combination of revenue growth, gross margin improvement and expense control. Accordingly, we closely monitor product revenue growth trends in our CCA segment. Product revenue in this segment grew 5% for the twelve months ended June 30, 2008 as compared to the twelve months ended June 30, 2007 and has grown at a compounded annual growth rate of 17% since 1998, our first full year as a public company.

The Other Vaccines, Pharmaceuticals and Products segment ("OVP") includes our 168,000 square foot USDA- and FDA-licensed production facility in Des Moines, Iowa. We view this facility as a strategic asset which will allow us to control our cost of goods on any vaccines and pharmaceuticals that we may commercialize in the future. We are increasingly integrating this facility with our operations elsewhere. For example, virtually all our U.S. inventory is now stored at this facility and 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 including small mammals and fish. All OVP products are sold by third parties under third party labels.

We have developed our own line of bovine vaccines that are licensed by the USDA. We have a long-term agreement with a distributor, Agri Laboratories, Ltd., ("AgriLabs"), for the marketing and sale of certain of these vaccines which are sold primarily under the Titanium® and MasterGuard® brands which are registered trademarks of AgriLabs. This agreement generates a significant portion of our OVP segment's revenue. Subject to certain purchase minimums, under our long-term agreement AgriLabs has the exclusive right to sell the aforementioned bovine vaccines in the United States, Africa and Mexico until at least December 2009. Our OVP segment also produces vaccines and pharmaceuticals for other third parties.

Additionally, we generate non-product revenues from licensing of technology, royalties and sponsored research and development projects for third parties. We perform these sponsored research and development projects for both companion animal and livestock product purposes.



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## Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based upon the consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities as of the date of the financial statements, and the reported amounts of revenue and expense during the periods. These estimates are based on historical experience and various other assumptions that we believe to be reasonable under the circumstances. We have identified those critical accounting policies used in reporting our financial position and results of operations based upon a consideration of those accounting policies that involve the most complex or subjective decisions or assessment. We consider the following to be our critical policies.

### Revenue Recognition

We generate our revenue through the sale of products, licensing of technology product rights, royalties and sponsored research and development. Our policy is to recognize revenue when the applicable revenue recognition criteria have been met, which generally include the following:

- Persuasive evidence of an arrangement exists;
- Delivery has occurred or services rendered;
- Price is fixed or determinable; and
- Collectibility is reasonably assured.

Revenue from the sale of products is recognized after both the goods are shipped to the customer and acceptance has been received, if required, with an appropriate provision for estimated returns and allowances. We do not permit general returns of products sold. Certain of our products have expiration dates. Our policy is to exchange certain outdated, expired product with the same product. We record an accrual for the estimated cost of replacing the expired product expected to be returned in the future, based on our historical experience, adjusted for any known factors that reasonably could be expected to change historical patterns, such as regulatory actions which allow us to extend the shelf lives of our products. Revenue from both direct sales to veterinarians and sales to independent third-party distributors are generally recognized when goods are shipped. Our products are shipped complete and ready to use by the customer. The terms of the customer arrangements generally pass title and risk of ownership to the customer at the time of shipment. Certain customer arrangements provide for acceptance provisions. Revenue for these arrangements is not recognized until the acceptance has been received or the acceptance period has lapsed. We reduce our product revenue by the estimated cost of any rebates, allowances or similar programs, which are used as promotional programs.

Recording revenue from the sale of products involves the use of estimates and management judgment. We must make a determination at the time of sale whether the customer has the ability to make payments in accordance with arrangements. While we do utilize past payment history, and, to the extent available for new customers, public credit information in making our assessment, the determination of whether collectibility is reasonably assured is ultimately a judgment decision that must be made by management. We must also make estimates regarding our future obligation relating to returns, rebates, allowances and similar other programs.

License revenue under arrangements to sell or license product rights or technology rights is recognized as obligations under the agreement are satisfied, which generally occurs over a period of time. Generally, licensing revenue is deferred and recognized over the estimated life of the related agreements, products, patents or technology. Nonrefundable licensing fees, marketing rights and milestone payments received under contractual arrangements are deferred and recognized over the



remaining contractual term using the straight-line method. Revenue from licensing technology and product rights is included in our research, development and other revenue line item. An example of the former, i.e., licensing technology, is a patent we own under which we have granted a third party exclusive rights to the human healthcare market for the life of the patent in exchange for an upfront payment and royalty payments on sales of any product based on the patent. The upfront payment will be amortized over the life of the patent and reported along with any affiliated royalty payments in our research, development and other revenue line item. An example of the latter, i.e., product rights, is our July 2002 agreement to license Intervet Inc. certain rights to patents, trademarks and know-how for our Flu AVERT I.N. equine influenza vaccine, the world's first intranasal influenza vaccine for horses. As we have no further rights to manufacture, market or sell this vaccine without Intervet Inc.'s permission, we are reporting the amortization of the upfront payment we received in this agreement along with any affiliated royalty payments in our research, development and other revenue line item. The upfront payment is being amortized over the estimated life of the product.

Recording revenue from license arrangements involves the use of estimates. The primary estimate made by management is determining the useful life of the related agreement, product, patent or technology. We evaluate all of our licensing arrangements by estimating the useful life of either the product or the technology, the length of the agreement or the legal patent life and defer the revenue for recognition over the appropriate period.

Occasionally we enter into arrangements that include multiple elements. Such arrangements may include the licensing of technology and manufacturing of product. In these situations we must determine whether the various elements meet the criteria to be accounted for as separate elements. If the elements cannot be separated, revenue is recognized once revenue recognition criteria for the entire arrangement have been met or over the period that the Company's obligations to the customer are fulfilled, as appropriate. If the elements are determined to be separable, the revenue is allocated to the separate elements based on relative fair value and recognized separately for each element when the applicable revenue recognition criteria have been met. In accounting for these multiple element arrangements, we must make determinations about whether elements can be accounted for separately and make estimates regarding their relative fair values.

#### **Allowance for Doubtful Accounts**

We maintain an allowance for doubtful accounts receivable based on client-specific allowances, as well as a general allowance. Specific allowances are maintained for clients which are determined to have a high degree of collectibility risk based on such factors, among others, as: (i) the aging of the accounts receivable balance; (ii) the client's past payment experience; (iii) a deterioration in the client's financial condition, evidenced by weak financial condition and/or continued poor operating results, reduced credit ratings, and/or a bankruptcy filing. In addition to the specific allowance, the Company maintains a general allowance for credit risk in its accounts receivable which is not covered by a specific allowance. The general allowance is established based on such factors, among others, as: (i) the total balance of the outstanding accounts receivable, including considerations of the aging categories of those accounts receivable; (ii) past history of uncollectible accounts receivable write-offs; and (iii) the overall creditworthiness of the client base. A considerable amount of judgment is required in assessing the realizability of accounts receivable. Should any of the factors considered in determining the adequacy of the overall allowance change, an adjustment to the provision for doubtful accounts receivable may be necessary.



## **Inventories**

Inventories are stated at the lower of cost or market, cost being determined on the first-in, first-out method. Inventories are written down if the estimated net realizable value of an inventory item is less than its recorded value. We review the carrying cost of our inventories by product each quarter to determine the adequacy of our reserves for obsolescence. In accounting for inventories we must make estimates regarding the estimated net realizable value of our inventory. This estimate is based, in part, on our forecasts of future sales and shelf life of product.

## **Deferred Tax Assets – Valuation Allowance**

Our deferred tax assets, such as an NOL, are reduced by an offsetting valuation allowance based on judgmental assessment of available evidence if we are unable to conclude that it is more likely than not that some or all of the related deferred tax assets will be realized. If we are able to conclude it is more likely than not that we will realize a future benefit from a deferred tax asset, we will reduce the related valuation allowance by an amount equal to the estimated quantity of income taxes we would pay in cash if we were not to utilize the deferred tax asset in the future. The first time this occurs in a given jurisdiction, it will result in a net deferred tax asset on our balance sheet and an income tax benefit of equal magnitude in our statement of operations in the period we make the determination. In future periods, we will then recognize as income tax expense the estimated quantity of income taxes we would have paid in cash had we not utilized the related deferred tax asset. The corresponding journal entry will be a reduction of our deferred tax asset. If there is a change regarding our tax position in the future, we will make a corresponding adjustment to the related valuation allowance.

## **Results of Operations**

### ***Revenue***

Total revenue consists of two components: 1) product revenue and 2) research, development and other revenue. Total revenue increased 4% to \$44.5 million for the six months ended June 30, 2008 as compared to \$42.8 million for the corresponding period in 2007. Product revenue increased 4% to \$43.8 million for the six months ended June 30, 2008 as compared to \$42.1 million for the corresponding period in 2007. Total revenue increased 13% to \$22.6 million for the three months ended June 30, 2008 as compared to \$20.1 million for the corresponding period in 2007. Product revenue increased 12% to \$22.2 million for the three months ended June 30, 2008 as compared to \$19.8 million for the corresponding period in 2007.

Product revenue from our CCA segment was \$34.7 million for the six months ended June 30, 2008, an increase of 4% as compared to \$33.2 million for the corresponding period in 2007. Key factors in the increase were higher sales of our chemistry instruments, our heartworm diagnostic tests, both internationally and domestically, our instrument consumables and our hematology instruments, somewhat offset by decreased sales of our handheld diagnostic instruments, our IV pumps and our heartworm preventive internationally. Product revenue from our CCA segment was \$17.3 million for the three months ended June 30, 2008, an increase of 7% as compared to \$16.2 million for the corresponding period in 2007. Key factors in the increase were higher sales of our chemistry instruments, our instrument consumables and our heartworm preventive domestically, somewhat offset by decreased sales of our handheld diagnostic instruments and our IV pumps.

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Product revenue from our Other Vaccines, Pharmaceuticals and Products segment ("OVP") increased by \$292 thousand to \$9.2 million for the six months ended June 30, 2008 as compared to \$8.9 million in the corresponding period in 2007. The largest factor in the increase was greater sales of our fish vaccines. This was largely offset by approximately \$1.6 million in revenue recognized (the "United Revenue") in the first quarter of 2007, upon receipt of a payment for product previously shipped and "take or pay" minimums for 2005 and 2006 which previously had not been paid as part of a now settled dispute with United Vaccines, Inc. ("UV"), a former

customer. Sales of bovine vaccines for Canadian distribution also declined. Product revenue from our Other Vaccines, Pharmaceuticals and Products segment ("OVP") increased by \$1.3 million to \$4.9 million for the three months ended June 30, 2008 as compared to \$3.5 million in the corresponding period in 2007. Greater sales of our fish vaccines was the largest factor in the increase with greater sales of our bulk bovine biologicals also contributing to the change.

Research, development and other revenue was \$699 thousand in the six months ended June 30, 2008, down slightly from \$712 thousand in the corresponding period in 2007. A key factor in the decrease was \$100 thousand in revenue recognized from a service contract in the three months ended March 31, 2007 which did not occur in the corresponding 2008 period. The service contract was completed in 2007 and related to a worldwide patent portfolio covering a number of major allergens and the genes that encode them (the "Allergopharma Portfolio"). The decline in revenue from this service contract was somewhat offset by an increase in revenue recognized from sponsored research and development. Research, development and other revenue was \$417 thousand in the three months ended June 30, 2008, up from \$311 thousand in the corresponding period in 2007. A key factor in the increase was an increase in revenue recognized from sponsored research and development.

In 2008, we expect continued growth in our Core Companion Animal Health segment product revenue. We anticipate 2008 OVP product revenue to be approximately \$13.5 million, a decrease as compared to 2007. We expect research, development and other revenue to be approximately \$1.3 million in 2008, a decrease as compared to 2007.

### *Cost of Revenue*

Cost of revenue consists of two components: 1) cost of products sold and 2) cost of research, development and other revenue, both of which correspond to their respective revenue categories. Cost of revenue totaled \$28.2 million for the first six months of 2008, a 17% increase as compared to \$24.1 million for the corresponding period in 2007. Gross profit decreased by \$2.4 million to \$16.3 million for the six months ended June 30, 2008 as compared to \$18.7 million in the prior year corresponding period. Gross Margin, i.e. gross profit divided by total revenue, decreased to 36.6% for the six months ended June 30, 2008 as compared to 43.6% in the corresponding period in 2007. Cost of revenue totaled \$14.0 million for the three months ended June 30, 2008, a 19% increase as compared to \$11.8 million for the corresponding period in 2007. Gross profit increased by \$270 thousand to \$8.6 million for the three months ended June 30, 2008 as compared to \$8.3 million in the prior year corresponding period. Gross Margin decreased to 37.9% for the three months ended June 30, 2008 as compared to 41.3% in the corresponding period in 2007.

Cost of products sold increased by \$4.0 million to \$28.0 million in the six months ended June 30, 2008 from \$24.0 million in the prior year period. Gross profit on product revenue decreased by \$2.3 million to \$15.8 million for the six months ended June 30, 2008 as compared to \$18.1 million in the prior year period. Product Gross Margin, i.e. gross profit on product revenue divided by product revenue, was 36.1% for the six months ended June 30, 2008, a decrease from 43.1% in the corresponding period in 2007. The largest factor in the decrease was recognition of the United Revenue in the three months ended March 31, 2007, for which the affiliated Cost of products sold had been recognized in prior periods and for which no corresponding revenue or gross profit was recognized in the 2008 comparable period. In addition, product mix and increased reserves taken against inventory we expect to expire prior to sale, primarily related to consumables for our handheld diagnostic instruments, were factors in the decrease. Cost of products sold increased by \$2.1 million to \$13.9 million in the three months ended June 30, 2008 from \$11.7 million in the prior year period. Gross profit on product revenue increased by \$275 thousand to \$8.3 million for the three months ended June 30, 2008 as compared to \$8.1 million in the prior year period. Product Gross Margin, i.e. gross profit on product revenue divided by product revenue, was 37.6% for the three months ended June 30, 2008, a decrease from 40.8% in the corresponding period in 2007. A key factor in the decline was lower margins on higher revenue in our OVP segment. Net positive production variances in 2007 as compared to net negative production variances in 2008, increased idle plant charge and increased scrap inventory charges were all factors in the lower year-over-year margins in this segment.

Cost of research, development and other revenue was \$233 thousand in the six months ended June 30, 2008, an increase of \$57 thousand as compared to \$176 thousand in the prior year period. Gross profit on research, development and other revenue was \$466 thousand for the six months ended June 30, 2008, a \$70 thousand decrease as compared to \$536 thousand in the prior year period. Other Gross Margin, i.e. gross profit on research, development and other revenue divided by research, development and other revenue, was 66.7% for the six months ended June 30, 2008, down from 75.3% in the prior year period. A key factor in the decrease was increased revenue recognized from sponsored research and development, an activity which tends to yield below average margins. Cost of research, development and other revenue was \$184 thousand in the three months ended June 30, 2008, an increase of \$111 thousand as compared to \$73 thousand in the prior year period. Gross profit on research, development and other revenue was \$233 thousand for the three months ended June 30, 2008, a \$5 thousand decrease as compared to \$238 thousand in the prior year period. Other Gross Margin, i.e. gross profit on research, development and other revenue divided by research, development and other revenue, was 55.9% for the three months ended June 30, 2008, down from 76.5% in the prior year period. A key factor in the decrease was an increase in revenue recognized from sponsored research and development, an activity which tends to yield below average margins.

We expect Gross Margin to decline for 2008 as a whole compared to 2007.

### *Operating Expenses*

Total operating expenses increased 2% to \$15.1 million in the six months ended June 30, 2008 as compared to \$14.8 million in the prior year period. Total operating expenses increased 1% to \$7.2 million in the three months ended June 30, 2008 as compared to \$7.1 million in the prior year period.

Selling and marketing expenses increased 14% to \$9.6 million in the six months ended June 30, 2008 as compared to \$8.4 million in the corresponding period in 2007. Key factors in the change were an increase in personnel, greater advertising expenses and expenses related to the recent launch of new instrument offerings. Selling and marketing expenses increased 17% to \$4.6 million in the three months ended June 30, 2008 as compared to \$4.0 million in the corresponding period in 2007. Key factors in the change were an increase in personnel and greater advertising expenses.

Research and development expenses were \$956 thousand for the six months ended June 30, 2008, a decline of approximately \$490 thousand as compared to \$1.4 million in the corresponding period in 2007. Research and development expenses were \$417 thousand for the three months ended June 30, 2008, a decline of approximately \$325 thousand compared to \$742 thousand in the corresponding period in 2007. In both cases, a key factor in the change was less space at our corporate headquarters being used for research and development activities. In late 2007, we implemented a plan to move and expand space for certain activities within our corporate headquarters, which reduced the space dedicated to research and development activities.

General and administrative expenses were \$4.6 million in the six months ended June 30, 2008, down 8% from \$5.0 million in the prior year period. General and administrative expenses were \$2.1 million in the three months ended June 30, 2008, down 11% from \$2.4 million in the prior year period. In both cases, a key factor in the change was a lower expense accrual related to our Management Incentive Program ("MIP") in 2008 as compared to 2007.

In the six months ended June 30, 2007, we recognized a gain of approximately \$47 thousand on the sale of certain patents we held, net of costs. We had no corresponding gain on asset sale in the 2008 period.

In 2008, we expect total operating expenses to increase as compared to 2007. We expect operating expenses generally will increase more slowly than increases in revenue.



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***Interest and Other Expense, Net***

Interest and other expense, net was \$347 thousand in the six months ended June 30, 2008, an increase of \$8 thousand as compared to \$339 thousand in the prior year period, and was \$181 thousand in the three months ended June 30, 2008, an increase of \$22 thousand as compared to \$159 thousand in the prior year period. Interest and other expense, net can be broken into two components: net interest expense and net foreign currency gain (or loss). Net interest expense was \$345 thousand in the six months ended June 30, 2008, a decrease of \$16 thousand from \$361 thousand in the prior year period. Lower interest rates due to decreases in the Prime rate and lower interest rate spreads based on our achievement of negotiated milestones under our credit and security agreement with Wells Fargo Bank, National Association ("Wells Fargo"), largely offset by increased borrowings, were responsible for the decline. Net interest expense was \$157 thousand in the three months ended June 30, 2008, an increase of \$28 thousand from \$129 thousand in the prior year period. The increase was due to greater borrowings, somewhat offset by decreases in the Prime rate. In the six months ended June 30, 2008, net foreign currency loss was \$2 thousand, a change of \$24 thousand from a net foreign currency gain of \$22 thousand in the prior year period. In the three months ended June 30, 2008, net foreign currency loss was \$24 thousand, a change of \$6 thousand from a net foreign currency loss of \$30 thousand in the prior year period.

We expect interest and other expense, net to increase in 2008 as compared to 2007 due to greater borrowings.

***Income Tax Expense***

Income tax expense was \$376 thousand in the six months ended June 30, 2008, a \$282 thousand increase as compared to \$94 thousand in the prior year period. Income tax expense was \$539 thousand in the three months ended June 30, 2008, a \$521 thousand increase as compared to \$18 thousand in the prior year period.

Current income tax expense was \$119 thousand in the six months ended June 30, 2008, an increase of \$30 thousand from \$89 thousand as compared to the prior year period. The change was due to the recognition of certain state income taxes in the 2008 period, somewhat offset by a lower accrual of domestic Federal alternative minimum tax. Current income tax expense was \$83 thousand in the three months ended June 30, 2008, an increase of \$68 thousand as compared to \$15 thousand in the prior year period. The primary reason for the change was the recognition of certain state income taxes in the 2008 period.

Net operating loss usage and other deferred income tax expense was \$257 thousand in the six months ended June 30, 2008, an increase of \$252 thousand from \$5 thousand in the prior year period. Net operating loss usage and other deferred tax expense was \$456 thousand in the three months ended June 30, 2008, an increase of \$453 thousand from \$3 thousand in the prior year period. In both cases, the change was due to the recognition of domestic net operating loss usage and other deferred income tax expense in the 2008 period, but not in the 2007 period, for the reasons outlined in the next paragraph.

In the fourth quarter of 2007, based on our profitable domestic operating performance, we concluded that a portion of our domestic deferred tax assets, which primarily consist of our domestic NOL, was realizable on a more-likely-than-not basis and the related valuation allowance was reduced, resulting in an income tax benefit of \$30 million, reported as a valuation allowance adjustment income tax benefit. This resulted in a net deferred tax asset of \$30 million for our domestic deferred tax assets. We do not expect to have any valuation allowance adjustment income tax expense or benefit in 2008 and expect to record valuation allowance adjustment income tax expense or benefit infrequently, if at all, in future years.

We expect to report a higher percentage of our pre-tax income as income tax expense for 2008 as compared to 2007 due to the recognition of domestic net operating loss usage and other deferred income tax expense related to domestic taxable income. We did not recognize domestic

net operating loss usage and other deferred income tax expense in 2007 as we did not reduce the related valuation allowance until year end.

### *Net Income*

Net income was \$440 thousand in the six months ended June 30, 2008, a decrease of approximately \$3.0 million compared to net income of \$3.4 million in the prior year period. As discussed above, the decrease was primarily due to lower Gross Margin, higher operating expenses and increased income tax expense. Net income was \$666 thousand in the three months ended June 30, 2008, a decrease of approximately \$367 thousand compared to net income of \$1.0 million in the prior year period. As discussed above, the decrease was primarily due to increased income tax expense.

We expect to generate net income in 2008 for the reasons outlined above.

### **Liquidity and Capital Resources**

We have incurred net cumulative negative cash flow from operations since our inception in 1988. For the six months ended June 30, 2008, we had a net income of \$440 thousand. During the six months ended June 30, 2008, our operations provided cash of approximately \$1.2 million. At June 30, 2008, we had \$6.2 million of cash and cash equivalents, \$9.1 million of working capital, \$12.7 million of outstanding borrowings under our revolving line of credit, discussed below, and \$1.5 million of other debt and capital leases.

Net cash provided by operating activities was approximately \$1.2 million for the six months ended June 30, 2008 as compared to \$2.3 million provided by operating activities in the prior year period. Major factors in the decrease in cash provided by operating activities for the six months ended June 30, 2008 as compared to the same period in 2007 were the \$3.0 million decrease in net income and a \$1.8 million increase in cash used for accounts payable. These factors were somewhat offset by a \$1.4 million decrease in cash used to purchase inventory, a \$1.2 million reduction in cash used for accrued liabilities, an increase of \$684 thousand in depreciation and amortization, and a \$290 thousand increase in deferred tax expense. A key factor in the increase in depreciation and amortization was increased rental units. The increase in deferred tax expense was primarily related to our conclusion in the fourth quarter of 2007 that a portion of our domestic deferred tax assets was realizable on a more-likely-than-not basis and the corresponding recognition of tax expense related to these assets in 2008, but not 2007.

Net cash flows from investing activities used cash of \$720 thousand in the six months ended June 30, 2008, compared to \$1.0 million during the corresponding period in 2007. The reduced usage of cash was primarily due to a decrease in capital expenditures of \$336 thousand in 2008.

Net cash flows used in financing activities was \$12 thousand during the six months ended June 30, 2008 as compared to \$1.1 million during the corresponding period in 2007. We repaid approximately \$500 thousand less in term debt in the 2008 period as a \$500 thousand term loan from a customer matured and was repaid in the 2007 period. Proceeds from the issuance of common stock decreased by approximately \$129 thousand, primarily due to lower proceeds from option exercises. Our revolving line of credit with Wells Fargo provided an increase of \$727 thousand in cash, as we repaid over \$600 thousand in the six months ended June 30, 2007 as opposed to borrowing over \$100 thousand in the six months ended June 30, 2008.

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At June 30, 2008, we had a \$15.0 million asset-based revolving line of credit with Wells Fargo which has a maturity date of June 30, 2009 as part of our credit and security agreement with Wells Fargo. At June 30, 2008, \$12.7 million was outstanding under this line of credit. Our ability to borrow under this facility varies based upon available cash, eligible accounts receivable and eligible inventory. On June 30, 2008, interest was charged at a stated rate of prime plus 0% and was payable monthly. We are required to comply with various financial and non-financial covenants, and we have made various representations and warranties. Among the financial covenants is a requirement to maintain a minimum liquidity (cash plus excess borrowing base) of \$1.5 million.



Additional requirements include covenants for minimum capital monthly and minimum net income quarterly. 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. Any default under the Wells Fargo agreement could also accelerate the repayment of our other borrowings. We were in compliance with all financial covenants as of June 30, 2008. At June 30, 2008, we had no available borrowing capacity based upon eligible accounts receivable and eligible inventory under our revolving line of credit.

At June 30, 2008, we also had outstanding obligations for long-term debt and capital leases totaling approximately \$1.5 million primarily related to three term loans with Wells Fargo. One term loan is secured by real estate in Iowa and had an outstanding balance at June 30, 2008 of approximately \$375 thousand due in monthly installments of \$17,658 plus interest, with a balloon payment of approximately \$163 thousand due upon maturity of the credit facility agreement on June 30, 2009. The term loan had a stated interest rate of prime plus 0% on June 30, 2008. The other two term loans are secured by machinery and equipment at our Des Moines, Iowa and Loveland, Colorado locations, respectively (the "Equipment Notes"). The Equipment Notes had a stated interest rate of prime plus 0% as of June 30, 2008. The Equipment Notes had an outstanding balance at June 30, 2008 of approximately \$1.2 million with principal payments on the Equipment Notes of \$46,296 plus interest due in monthly installments, with a balloon payment of approximately \$602 thousand due upon maturity of the credit facility agreement on June 30, 2009. Our capital lease obligations totaled approximately \$7 thousand at June 30, 2008.

At June 30, 2008, we had deferred revenue and other long-term liabilities, net of current portion, of approximately \$5.6 million. Included in this total is approximately \$4.6 million of deferred revenue related to up-front fees that have been received for certain product rights and technology rights out-licensed. These deferred amounts are being recognized on a straight-line basis over the remaining lives of the agreements, products, patents or technology.

Our primary short-term need for capital, which is subject to change, is to fund our operations, which consist of continued sales and marketing, general and administrative and research and development efforts, working capital associated with increased product sales and capital expenditures relating to maintaining and developing our manufacturing operations. Our future liquidity and capital requirements will depend on numerous factors, including the extent to which our marketing and selling efforts, as well as those of third parties who market and sell our products, are successful in increasing revenue, the extent to which currently planned products and/or technologies are successfully developed, launched and sold, changes required by regulatory bodies to maintain our operations and other factors.

Our financial plan for 2008 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 2008 and into 2009. Our financial plan for 2008 anticipates we will be profitable in the third and fourth quarters of the year and expects that we will have positive cash flow from operations, primarily through increased revenue. 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 sale of equity or refinancing loans currently outstanding on assets with historical appraised values significantly in excess of related debt. 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. If we cannot raise the additional funds through these options on acceptable terms or with the necessary timing, management could also reduce discretionary spending to decrease our cash burn rate through actions such as delaying or canceling budgeted research activities or marketing plans. These actions would likely extend the then available cash and cash equivalents, and then available borrowings to some degree.

### **Net Operating Loss Carryforwards**

As of December 31, 2007, we had a net domestic operating loss carryforward, or NOL, of approximately \$164.6 million, a domestic alternative minimum tax credit of approximately \$146 thousand and a domestic research and development tax credit carryforward of approximately \$307 thousand. Our NOL is scheduled to expire in various years beginning in 2010 and ending in 2025, with the majority scheduled to expire in 2018 or later. The NOL and tax credit carryforwards are subject to alternative minimum tax limitations and to examination by the tax authorities. In addition, we had a "change of ownership" as defined under the provisions of Section 382 of the Internal Revenue Code of 1986, as amended (an "Ownership Change"). We believe the latest Ownership Change occurred at the time of our initial public offering in July 1997. We do not believe this Ownership Change will place a significant restriction on our ability to utilize our NOLs in the future. We also had net operating loss carryforwards in Switzerland of approximately \$920 thousand as of December 31, 2007 related to losses previously recorded by Heska AG which are scheduled to expire at the end of 2008.

### **Recent Accounting Pronouncements**

None.

### **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 and against other foreign currency exchange rates. These exposures are directly related to our normal operating and funding activities.

#### **Interest Rate Risk**

The interest payable on certain of our lines of credit and other borrowings is variable based on the United States prime rate and, therefore, is affected by changes in market interest rates. At June 30, 2008, approximately \$14.3 million was outstanding on these lines of credit and other borrowings with a weighted average interest rate of 5%. We also had approximately \$6.2 million of cash and cash equivalents at June 30, 2008, the majority of which was invested in liquid interest bearing accounts. We had no interest rate hedge transactions in place on June 30, 2008. We completed an interest rate risk sensitivity analysis based on the above and an assumed one-percentage point increase/decrease in interest rates. If market rates increase/decrease by one percentage point, we would experience an increase/decrease in annual net interest expense of approximately \$81 thousand based on our outstanding balances as of June 30, 2008.

**Foreign Currency Risk**

Our investment in foreign assets consists primarily of our investment in our European 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, 2008.

We have a wholly-owned subsidiary in Switzerland which uses the Swiss Franc as its functional currency. We purchase inventory in foreign currencies, primarily Japanese Yen and Euros, and sell corresponding products in U.S. dollars. We also sell products in foreign currencies, primarily Japanese Yen and Euros, where our inventory costs are in U.S. dollars. Based on our results of operations for the most recent 12 months, if foreign currency exchange rates were to strengthen/weaken by 25% against the dollar, we would expect a resulting pre-tax loss/gain of approximately \$1.3 million.

**Item 4.**

**CONTROLS AND PROCEDURES**

(a) *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 end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our chief executive officer and our chief financial officer have concluded that our disclosure controls and procedures are adequate 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 periods 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 required disclosure.

(b) *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.

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## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

From time to time, we may be involved in litigation relating to claims arising out of our operations. As of June 30, 2008, we were not a party to any legal proceedings that are expected, individually or in the aggregate, to have a material effect on our business, financial condition or operating results.

### 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 these factors and the possible impact of these factors on future results of 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 common stock could decline and you could experience losses on your investment.

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

We rely on third party suppliers to manufacture those products we do not manufacture ourselves. Proprietary products provided by these suppliers represent a majority of our product revenue. We currently rely on these suppliers for our veterinary instruments and consumable supplies for these instruments, for our point-of-care diagnostic and other tests, for the manufacture of our allergy immunotherapy treatment products as well as for the manufacture of other products. Major suppliers who sell us proprietary products which are responsible for more than 5% of our trailing 12-month product revenue are Arkray, Boule, i-STAT Corporation (a unit of Abbott Laboratories) and Quidel. None of these suppliers sell us proprietary products which are responsible for more than 20% of our trailing 12-month product revenue, although the proprietary products of one is responsible for more than 15% of our revenue and one other is responsible for more than 10% of our 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 veterinary diagnostic instruments, we are typically entitled to non-exclusive access to consumable supplies 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 have arrangements to ensure supply of our major product offerings in the marketplace through at least the end of 2008, 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:

- *Loss of exclusivity.* In the case of our veterinary diagnostic 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.



- *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 diagnostic 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 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.
- *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.
- *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. An example of such a situation arose in 2006 when Dolphin Medical Inc. (a majority-owned subsidiary of OSI Systems, Inc.) discontinued production of our VET/OX G2 DIGITAL Monitor as part of an agreement with Masimo Corporation to settle a patent dispute.
- *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 unless it is under terms that are less advantageous.
- *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 and state agencies for compliance with strictly enforced Good Manufacturing Practices, regulations and similar foreign standards, and we do not have control over



our suppliers' compliance with these regulations and standards. Violations could potentially lead to interruptions in supply that could cause us to lose sales to readily available competitive products.

- *Developmental delays.* We may experience delays in the scale-up quantities needed for product development that could delay regulatory submissions and commercialization of our products in development, causing us to miss key opportunities.
- *Limited intellectual property rights.* We typically do not have intellectual property rights, or may have to share intellectual property rights, to the products themselves and any improvements to the manufacturing processes or new manufacturing processes for our products.

Potential problems with suppliers such as those discussed above could substantially decrease sales, lead to higher costs, 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 effectively sell our products and substantially harm our business.

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

We may not successfully develop and maintain marketing and/or sales capabilities, 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.

The market for companion animal healthcare products is highly fragmented. Because our Core Companion Animal Health proprietary products are generally available only to veterinarians or by prescription and our medical instruments require technical training to operate, we ultimately sell our Core Companion Animal Health products predominantly 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.

We currently sell most of our Core Companion Animal Health products in the United States to veterinarians through an outside sales force of approximately 40 individuals, an inside sales force of approximately 22 individuals, approximately 12 independent third-party distributors who carry our full distribution product line and approximately 6 independent third-party distributors who carry portions of our distribution product line. To be successful in these endeavors, we will have to effectively market our products and continue to develop and train our direct sales force as well as the sales personnel of our independent third-party distributors.

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 distributor's time and focus 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. In addition, most of our independent third-party distributor agreements can be terminated on 60 days notice and we believe that IDEXX, one of our largest competitors, in effect prohibits its distributors from selling competitive products, including our diagnostic instruments and heartworm diagnostic tests. We believe this restriction limits our ability to engage national independent third-party distributors to sell our full distribution line of products. In the second quarter of 2005, our largest distributor purchased an IDEXX distributor and subsequently informed us that they no longer would carry our instruments and heartworm diagnostic tests. We

believe IDEXX in effect prohibits this distributor from carrying our diagnostic instruments and heartworm diagnostic tests as a condition for having access to buy the IDEXX product line.

***The loss of significant customers could harm our operating results.***

Sales to Novartis AG and its business units ("Novartis") represented approximately 11% and 12% of consolidated revenue for the three and six month periods ended June 30, 2008, respectively. Aqua Health, a business unit of Novartis AG, purchased approximately \$4.0 million in fish vaccines from our OVP segment in the twelve months ended June 30, 2008. Aqua Health has informed us they intend to produce their fish vaccines in-house beginning immediately and intend to purchase fish vaccines from us only when they do not have the capacity to do so themselves. We do not expect to make any sales to Aqua Health in the next twelve months, if at all. No other customer accounted for more than 10% of our consolidated revenue for the three and six month periods ended June 30, 2008. SPAH accounted for approximately 13% of our consolidated accounts receivable at June 30, 2008. Novartis accounted for approximately 11% of our consolidated accounts receivable at June 30, 2008. No other customer accounted for more than 10% of accounts receivable at June 30, 2008. Sales to SPAH accounted for approximately 10% of consolidated revenue for the six month period ended June 30, 2007 and SPAH accounted for approximately 13% of our consolidated accounts receivable at June 30, 2007. No other customer accounted for more than 10% of revenue for the six month period ended June 30, 2007 or more than 10% of accounts receivable at June 30, 2007. 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.

***Our 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.***

Our common stock is listed on the Nasdaq Capital Market. The Nasdaq has several quantitative and qualitative requirements companies must comply with to maintain this listing, including a \$1.00 minimum bid price. While we believe we are currently in compliance with all Nasdaq requirements, we have not always been able to maintain compliance in the past and there can be no assurance we will maintain compliance in the future. If we are delisted from the Nasdaq Capital Market, our 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 common stock, which could severely limit market liquidity of the common stock and your ability to sell our securities in the secondary market. This lack of liquidity would also make it more difficult for us to raise capital in the future.

***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, Abaxis, Inc. and Synbiotics Corporation. 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 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, Merial Limited, Novartis AG, Pfizer Inc., Schering-Plough Corporation, Vétoquinol S.A., Virbac S.A. and Wyeth, may be marketing or developing products that compete with our products or would compete with them if developed. These and other competitors and potential competitors may have substantially greater financial, technical, research and other resources and larger, more established marketing, sales and service organizations than we do. Our competitors may offer broader product lines and have greater name

recognition than we do. Our competitors may 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. We believe that one of our largest competitors, IDEXX, in effect prohibits its distributors from selling competitive products, including our diagnostic

instruments and heartworm diagnostic tests. 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.

***If the third parties to whom we granted substantial marketing rights for certain of our existing products or future products under development are not successful in marketing those products, then our sales and financial position may suffer.***

Our agreements with our corporate marketing partners generally contain no or small minimum purchase requirements in order for them to maintain their exclusive or co-exclusive marketing rights. We are party to an agreement with SPAH which grants distribution and marketing rights in the U.S. for our canine heartworm preventive product, TRI-HEART Plus Chewable Tablets. AgriLabs has the exclusive right to sell certain of our bovine vaccines in the United States, Africa and Mexico. Novartis Japan markets and distributes our SOLO STEP CH heartworm test and our E.R.D. Healthscreen urine test products in Japan under an exclusive arrangement. One or more of these marketing partners may not devote sufficient resources to marketing our products. Furthermore, there may be nothing to prevent these partners from pursuing alternative technologies or products that may compete with our products in current or future agreements. In the future, third-party marketing assistance may not be available on reasonable terms, if at all. If any of these events occur, we may not be able to commercialize our products and our sales will decline. In addition, both our agreements with SPAH and AgriLabs require us to potentially pay penalties if we are unable to supply product over an extended period of time.

***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 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.

***Our stock price has historically experienced high volatility, which may increase in the future, and which could affect our ability to raise capital in the future or make it difficult for investors to sell their shares.***

The securities markets have experienced significant price and volume fluctuations and the market prices of securities of many microcap and smallcap companies have in the past been, and can in the future be expected to be, especially volatile. During the past 12 months, our closing stock price has ranged from a low of \$1.01 to a high of \$2.34. Fluctuations in the trading price or liquidity of our 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 common stock include:

- stock sales by large stockholders or by insiders;
- our quarterly operating results, including as compared to our revenue, earnings or other guidance and in comparison to historical results;

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- 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;
- changes in regulatory policies;
- 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.

***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, 2008, we had an accumulated deficit of \$172.7 million. We have achieved only one quarter with income before income taxes greater than \$1.5 million. Accordingly, relatively small differences in our performance metrics may cause us to lose money 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 Core Companion Animal Health 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 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.

***If we are unable to maintain various financial and other covenants under 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 Bank, National Association ("Wells Fargo") we are required to comply with various financial and non-financial covenants in order to borrow under the agreement. The availability of borrowings under this agreement is essential to continue to fund our operations. Among the financial covenants is a requirement to maintain minimum liquidity (cash plus excess borrowing base) of \$1.5 million. Additional requirements include covenants for minimum capital monthly and minimum net income quarterly. 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 in the past. Although Wells Fargo 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.

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Failure to comply with any of the covenants, representations or warranties, or failure to modify them to allow future compliance, could result in our being in default and could cause all outstanding borrowings under our credit and security agreement to become immediately due and payable, or impact our ability to borrow under the agreement. We intend 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 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.***

If our actual performance deviates from our operating plan, which anticipates we will be profitable in each of the last two quarters of 2008, we may be required to raise additional capital in the future. If necessary, we expect to raise these additional funds by the sale of equity securities or refinancing loans currently outstanding on assets with historical appraised values in excess of related debt. 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. 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. Additionally, 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. 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.

***Obtaining and maintaining regulatory approvals in order to market our regulated products may be costly and delay the marketing and sales of our products.***

Many of the products we develop, market or manufacture are subject 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 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 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 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.

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. In addition, certain of our agreements 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.





*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;
- the introduction of new products by our competitors or by us;
- competition and pricing pressures from competitive products;
- our ability to maintain relationships with independent third-party distributors;
- large customers failing to purchase at historical levels, including changes in independent third-party distributor purchasing patterns and inventory 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 for personnel and marketing. Many of these expenses are fixed in the short term. If any of the factors listed above cause our revenues to decline, our operating results could be substantially harmed.

*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 are developing for the veterinary marketplace may not perform up to 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 in commercialization and/or market acceptance of the product. For example, veterinarians may be slow to adopt a product 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 use of such a product. For example, while we believe our E.R.D.-HEALTHSCREEN urine tests for dogs and cats represent a significant scientific breakthrough in companion animal annual health examinations, these products have achieved significantly lower market acceptance than we anticipated. 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.

*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. 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. A legal dispute leading to an unfavorable ruling or settlement could have significant material adverse consequences on our business.

We may become subject to additional 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 affected 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. An example of such a situation arose in 2006 when Dolphin Medical Inc. (a majority-owned subsidiary of OSI Systems, Inc.) discontinued production of our VET/OX G2 DIGITAL Monitor as part of an agreement with Masimo Corporation to settle a patent dispute.

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 proceeding 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.

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

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") has increased our required administrative actions as a public company. The increase in general and administrative costs of complying with Sarbanes-Oxley will depend on how it is interpreted over time. Of particular concern are the level and timing 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 are anticipating, 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. Even if we and our auditors are able to conclude that our internal controls over financial reporting are designed and operating effectively in such a circumstance, our general and administrative costs are likely to increase. Thus, our general and administrative costs increased in 2007 from what they would have been in the absence of Sarbanes-Oxley and may increase in the future. 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.



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*Changes to financial accounting standards may affect our results of operations and cause us to change our business practices.*

We prepare our financial statements in conformance with United States generally accepted accounting principles, or GAAP. These accounting principles are established by and are subject to interpretation by the SEC, the Financial Accounting Standards Board, the American Institute of Certified Public Accountants, 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 or the way we conduct our business.

*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. 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 an employment agreement 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 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 clean up 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 biohazardous 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**

None.

**Item 3. Defaults upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

Our 2008 annual meeting of stockholders (the "2008 Annual Meeting") was held on May 6, 2008 in Loveland, Colorado. Two proposals, as described in our Proxy Statement dated April 15, 2008, were voted on at the meeting. Following is a brief description of the matters voted upon and the results of the voting:

1. Election of Directors:

<u>Nominee</u>	<u>Number of Shares</u>	
Louise L. McCormick	For	46,222,076
	Withheld	816,143
John F. Sasen, Sr.	For	46,176,834
	Withheld	861,385

2. Ratification of the Appointment of Ehrhardt Keefe Steiner & Hottman PC as Heska Corporation's Independent Registered Public Accountant:

For 46,325,346	Against 630,660	Abstain 82,213
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**Item 5. Other Information**

None.

**Item 6. Exhibits**

(a) Exhibits

<u>Number</u>	<u>Notes</u>	<u>Description</u>
10.1		1997 Employee Stock Purchase Plan of Registrant, as amended.
31.1		Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, 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, 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.



**HESKA CORPORATION**

**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.

**HESKA CORPORATION**

Date:	August 11, 2008	By	<u>/s/ Robert B. Grieve</u> ROBERT B. GRIEVE Chairman of the Board and Chief Executive Officer (on behalf of the Registrant and as the Registrant's Principal Executive Officer)
Date:	August 11, 2008	By	<u>/s/ Jason A. Napolitano</u> JASON A. NAPOLITANO Executive Vice President and Chief Financial Officer (on behalf of the Registrant and as the Registrant's Principal Financial Officer)