HESKA CORP
Form 10-Q
August 10, 2009

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

[ X ] **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2009
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** | **77-0192527** |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification Number) |

**3760 Rocky Mountain Avenue**

| **Loveland, Colorado** | **80538** |
|---|---|
| (Address of principal executive offices) | (Zip Code) |

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes [ X ] No [ ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes [ ] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer 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 [ X ] |
| 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 [ X ]

The number of shares of the Registrant's Common Stock outstanding at August 7, 2009 was 52,122,944.

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**HESKA CORPORATION AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

(dollars in thousands except per share amounts)

(unaudited)

**ASSETS**

| | December 31, 2008 | June 30, 2009 |
|---|---|---|
| Current assets: | | |
| Cash and cash equivalents | $ 4,705 | $ 5,324 |
| Accounts receivable, net of allowance for doubtful accounts of $209 and $227, respectively | 9,514 | 8,698 |
| Inventories, net | 15,249 | 13,013 |
| Deferred tax asset, current | 869 | 747 |
| Other current assets | 953 | 809 |
| Total current assets | 31,290 | 28,591 |
| Property and equipment, net | 8,509 | 7,374 |
| Goodwill | 890 | 865 |
| Deferred tax asset, net of current portion | 29,749 | 29,144 |
| Total assets | $ 70,438 | $ 65,974 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 3,904 | $ 4,139 |
| Accrued liabilities | 3,128 | 2,866 |
| Accrued restructuring | 578 | 38 |
| Current portion of deferred revenue | 2,806 | 2,337 |
| Line of credit | 11,042 | 6,985 |
| Current portion of long-term debt | 770 | 719 |
| Total current liabilities | 22,228 | 17,084 |
| Long-term debt, net of current portion | 381 | 46 |
| Deferred revenue, net of current portion, and other | 5,306 | 5,151 |
| Total liabilities | 27,915 | 22,281 |
| 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; 52,010,928 and 52,122,944 shares issued and outstanding, respectively | 52 | 52 |
| Additional paid-in capital | 216,463 | 216,674 |
| Accumulated other comprehensive income (loss) | 46 | (34) |

| | | |
|---|---|---|
| Accumulated deficit | (174,038) | (172,999) |
| Total stockholders' equity | 42,523 | 43,693 |
| Total liabilities and stockholders' equity | $ 70,438 | $ 65,974 |

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, 2008 | 2009 | June 30, 2008 | 2009 |
| Revenue, net: | | | | |
| Core companion animal health | $ 17,596 | $ 16,879 | $ 35,233 | $ 35,016 |
| Other vaccines, pharmaceuticals and products | 5,019 | 1,750 | 9,300 | 3,754 |
| Total revenue, net | 22,615 | 18,629 | 44,533 | 38,770 |
| Cost of revenue | 14,044 | 11,598 | 28,226 | 24,366 |
| Gross profit | 8,571 | 7,031 | 16,307 | 14,404 |
| Operating expenses: | | | | |
| Selling and marketing | 4,644 | 3,622 | 9,566 | 7,380 |
| Research and development | 417 | 405 | 956 | 851 |
| General and administrative | 2,124 | 1,994 | 4,622 | 4,146 |
| Total operating expenses | 7,185 | 6,021 | 15,144 | 12,377 |
| Operating income | 1,386 | 1,010 | 1,163 | 2,027 |
| Interest and other expense, net | 181 | 41 | 347 | 206 |
| Income before income taxes | 1,205 | 969 | 816 | 1,821 |
| Income tax expense | 539 | 390 | 376 | 782 |
| Net income | $ 666 | $ 579 | $ 440 | $ 1,039 |
| Basic net income per share | $ 0.01 | $ 0.01 | $ 0.01 | $ 0.02 |
| Diluted net income per share | $ 0.01 | $ 0.01 | $ 0.01 | $ 0.02 |
| Weighted average outstanding shares used to compute basic net income per share | 51,595 | 52,012 | 51,538 | 52,012 |
| Weighted average outstanding shares used to compute diluted net income per share | 53,961 | 52,035 | 54,401 | 52,013 |

See accompanying notes to condensed consolidated financial statements.

**HESKA CORPORATION AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

| | Six Months Ended | |
|---|---|---|
| | **June 30, 2008** | **2009** |
| CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES: | | |
| Net income | $ 440 | $ 1,039 |
| Adjustments to reconcile net income to cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 1,586 | 1,324 |
| Deferred tax expense (benefit) | 295 | 727 |
| Stock-based compensation | 205 | 175 |
| Unrealized (gain) loss on foreign currency translation | 29 | 13 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 845 | 816 |
| Inventories | 694 | 2,169 |
| Other current assets | 193 | 131 |
| Accounts payable | (2,437) | 235 |
| Accrued liabilities | 669 | (802) |
| Deferred revenue and other liabilities | (1,289) | (622) |
| Net cash provided by (used in) operating activities | 1,230 | 5,205 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of property and equipment | (720) | (126) |
| Net cash provided by (used in) investing activities | (720) | (126) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from issuance of common stock | 270 | 36 |
| Proceeds from (repayments of) line of credit borrowings, net | 106 | (4,057) |
| Proceeds from (repayments of) debt and capital lease obligations, net | (388) | (386) |
| Net cash provided by (used in) financing activities | (12) | (4,407) |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH | 131 | (53) |
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 629 | 619 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 5,524 | 4,705 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | $ 6,153 | $ 5,324 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | |
| Cash paid for interest | $ 390 | $ 267 |
| Non-cash transfer of inventory to property and equipment | $ 243 | $ 63 |

See accompanying notes to condensed consolidated financial statements.

**HESKA CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2009**

**(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, 2009, the condensed consolidated statements of operations for the three months and six months ended June 30, 2008 and 2009 and the condensed consolidated statements of cash flows for the six months ended June 30, 2008 and 2009 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, 2008, included in the Company's Annual Report on Form 10-K filed with the SEC on March 16, 2009.

*Use of Estimates*

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.

*Reclassifications*

Certain prior year numbers have been reclassified to be consistent with the current year presentation. These reclassifications include revenue previously reflected as Research, Development and Other Revenue which is now included in revenue by segment and costs previously reflected as Cost of Research, Development and Other Revenue which are now included in Cost of Revenue.

*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):

| | **December 31, 2008** | **June 30, 2009** |
|---|---|---|
| Raw materials | $ 6,893 | $ 6,246 |
| Work in process | 2,957 | 2,336 |
| Finished goods | 6,370 | 5,394 |
| Allowance for excess or obsolete inventory | (971) | (963) |
| | $ 15,249 | $ 13,013 |

*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, 2009 and June 30, 2008, 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 six months ended June 30, 2009 and June 30, 2008, and therefore excluded, were outstanding options to purchase 12,249,156 and 4,332,372 shares of common stock, respectively. Common stock equivalent securities that were anti-dilutive for the three months ended June 30, 2009 and June 30, 2008, and therefore excluded, were outstanding options to purchase 12,012,753 and 4,626,724 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, 2009 and 2008. Should the Company's stock price increase, the number of common stock equivalents considered to be dilutive will increase.

*Subsequent Events*

The Company has evaluated known subsequent events through the close of business on August 7, 2009, the last full business day prior to the public issuance of the financial statements on which the Company committed to publicly issue the financial statements. The Company has not evaluated known subsequent events occurring after the close of business on August 7, 2009 in preparing the accompanying unaudited condensed consolidated financial statements.

**3. CAPITAL STOCK**

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 and 2009.

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2008 | 2009 | June 30, 2008 | 2009 |
| Risk-free interest rate | 2.57% | 1.42% | 2.63% | 1.41% |
| Expected lives | 2.9 years | 2.8 years | 2.9 years | 2.8 years |
| Expected volatility | 50% | 67% | 51% | 67% |
| Expected dividend yield | 0% | 0% | 0% | 0% |

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

| | Year Ended December 31, 2008 | | Six Months Ended June 30, 2009 | |
|---|---|---|---|---|
| | Options | Weighted Average Exercise Price | Options | Weighted Average Exercise Price |
| Outstanding at beginning of period | 12,118,417 | $ 1.3979 | 12,835,269 | $ 1.2836 |
| Granted at market | 1,575,268 | $ 0.7694 | 280,000 | $ 0.4532 |
| Cancelled | (573,898) | $ 2.5005 | (671,141) | $ 1.7211 |
| Exercised | (284,518) | $ 0.8526 | — | $ — |
| Outstanding at end of period | 12,835,269 | $ 1.2836 | 12,444,128 | $ 1.2413 |
| Exercisable at end of period | 11,042,716 | $ 1.3360 | 10,978,497 | $ 1.2830 |

The estimated fair value of stock options granted during the six months ended June 30, 2009 and 2008 was computed to be approximately $56 thousand and $257 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, 2009 and 2008 was computed to be approximately $0.20 and $0.57, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2009 and 2008 was $0 and $111 thousand, respectively. The cash proceeds from options exercised during the six months ended June 30, 2009 and 2008 were $0 and $182 thousand, respectively.

The following table summarizes information about stock options outstanding and exercisable at June 30, 2009:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Exercise Prices | Number of Options Outstanding at June 30, 2009 | Weighted Average Remaining Contractual Life in Years | Weighted Average Exercise Price | Number of Options Exercisable at June 30, 2009 | Weighted Average Exercise Price |
| $0.27 - $0.70 | 2,829,715 | 6.17 | $ 0.5334 | 1,912,202 | $ 0.5788 |
| $0.71 - $1.06 | 2,901,007 | 4.61 | $ 0.9281 | 2,884,757 | $ 0.9281 |
| $1.07 - $1.28 | 2,490,638 | 4.87 | $ 1.2184 | 2,490,638 | $ 1.2184 |
| $1.29 - $1.82 | 1,992,685 | 6.16 | $ 1.6043 | 1,919,768 | $ 1.6112 |
| $1.83 - $4.12 | 2,230,083 | 5.35 | $ 2.2482 | 1,771,132 | $ 2.3565 |
| $0.27 - $4.12 | 12,444,128 | 5.40 | $ 1.2413 | 10,978,497 | $ 1.2830 |

As of June 30, 2009, there was approximately $594 thousand of total unrecognized compensation expense related to outstanding stock options. That expense is expected to be recognized over a weighted average period of 2.2 years, with approximately $132 thousand to be recognized in the six months ending December 31, 2009 and all the cost to be recognized as of February 2013, assuming all options vest according to the vesting schedules in place at June 30, 2009. As of June 30, 2009, the aggregate intrinsic value of outstanding options was approximately $11 thousand and the aggregate intrinsic value of exercisable options was approximately $10 thousand.

**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.

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

| Six Months Ended | Core Companion Animal Health | Other Vaccines, Pharmaceuticals and Products | Total |
|---|---|---|---|
| **June 30, 2008:** | | | |
| 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 |
| Net assets | 37,644 | 6,411 | 44,055 |
| Capital expenditures | 409 | 311 | 720 |
| Depreciation and amortization | 1,127 | 459 | 1,586 |
| **Six Months Ended** | | | |
| **June 30, 2009:** | | | |
| Total revenue | $ 35,016 | $ 3,754 | $ 38,770 |
| Operating income (loss) | 2,352 | (325) | 2,027 |
| Interest expense | 228 | 42 | 270 |
| Total assets | 56,155 | 9,819 | 65,974 |
| Net assets | 37,161 | 6,532 | 43,693 |
| Capital expenditures | 121 | 5 | 126 |
| Depreciation and amortization | 855 | 469 | 1,324 |

| Three Months Ended | Core Companion Animal Health | Other Vaccines, Pharmaceuticals and Products | Total |
|---|---|---|---|
| **June 30, 2008:** | | | |
| Total revenue | $ 17,596 | $ 5,019 | $ 22,615 |
| Operating income | 135 | 1,251 | 1,386 |
| Interest expense | 128 | 42 | 170 |
| Total assets | 60,733 | 12,621 | 73,354 |
| Net assets | 37,644 | 6,411 | 44,055 |
| Capital expenditures | 84 | 118 | 202 |
| Depreciation and amortization | 581 | 230 | 811 |
| **Three Months Ended** | | | |
| **June 30, 2009:** | | | |
| Total revenue | $ 16,879 | $ 1,750 | $ 18,629 |
| Operating income (loss) | 1,163 | (153) | 1,010 |
| Interest expense | 96 | 19 | 115 |
| Total assets | 56,155 | 9,819 | 65,974 |
| Net assets | 37,161 | 6,532 | 43,693 |
| Capital expenditures | 99 | 5 | 104 |
| Depreciation and amortization | 428 | 234 | 662 |

**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 six months ended June 30, 2009 and 2008 was $959 thousand and $697 thousand, respectively. Total comprehensive income for the three months ended June 30, 2009 and 2008 was $714 thousand and $599 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 10, 2009, 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 90% of our revenue for the twelve months ended June 30, 2009 and Other Vaccines, Pharmaceuticals and Products, which represented 10% of our revenue for the twelve months ended June 30, 2009.

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 50% of our revenue for the twelve months ended June 30, 2009. 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 37% of our revenue for the twelve months ended June 30, 2009 resulted from the sale of such consumables to an installed base of instruments and approximately 13% of our 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. For example, the supplier of our handheld blood analysis instruments has informed us of the cancellation of our contractual agreement as of November 1, 2009 and that they will not supply us with any instruments or consumables after that date. We have established a large installed base of handheld blood analysis instruments and sales of instruments and consumables in this area represented 18% of our revenue in the twelve months ended June 30, 2009, the largest percentage of any of our product areas. We anticipate a significant decline in revenue and gross margin related to our handheld blood analysis instruments following the termination of supply of these products. All diagnostic instruments and supplies are supplied by third parties, who typically own the product rights and supply the product to us under marketing and/or distribution agreements. In many cases, we have collaborated with a third party to adapt a human instrument for veterinary use. Major products in this area include our 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 45% of our revenue for the twelve months ended June 30, 2009.

Other CCA revenue, including single use diagnostic and other tests, pharmaceuticals and vaccines as well as research and development, licensing and royalty revenue, represented approximately 40% of our revenue for the twelve months ended June 30, 2009. Since items in this area are often single use by their nature, our typical aim is to build customer satisfaction and loyalty for each product, generate repeat annual

sales from existing customers and expand our customer base in the future. Products in this area are both supplied by third parties

and provided by us. Major products 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 35% of our revenue for the twelve months ended June 30, 2009.

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 relationships, such as corporate agreements. Revenue from direct sales, independent third-party distributors and other relationships represented approximately 50%, 28% and 22%, respectively, of CCA revenue for the twelve months ended June 30, 2009.

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 over the long term through a combination of revenue growth, gross margin improvement and expense control. Accordingly, we closely monitor revenue growth trends in our CCA segment. Revenue in this segment declined 1% for the twelve months ended June 30, 2009 as compared to the twelve months ended June 30, 2008. We believe poor economic conditions over the past year have impacted our revenue growth as, for example, veterinarians have delayed or deferred capital expenditures on new diagnostic instrumentation.

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 such as small mammals. 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 December 2009. Our OVP segment also produces vaccines and pharmaceuticals for other third parties.

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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, as well as through 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 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.

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 decreased 13% to $38.8 million for the six months ended June 30, 2009 as compared to $44.5 million for the corresponding period in 2008. Total revenue decreased 18% to $18.6 million for the three months ended June 30, 2009 as compared to $22.6 million for the corresponding period in 2008.

Revenue from our CCA segment was $35.0 million for the six months ended June 30, 2009, a 1% decrease as compared to $35.2 million for the corresponding period in 2008. Key factors in the decline were lower sales of our chemistry instruments and our hematology instruments, somewhat offset by increased sales of our heartworm diagnostic tests and our instrument consumables. Revenue from our CCA segment was $16.9 million for the three months ended June 30, 2009, a decrease of 4% as compared to $17.6 million for the corresponding period in 2008. Key factors in the decline were lower sales of our chemistry instruments and our hematology instruments, somewhat offset by increased international sales of our heartworm diagnostic tests.

Revenue from our Other Vaccines, Pharmaceuticals and Products segment ("OVP") decreased by $5.5 million to $3.8 million for the six months ended June 30, 2009 as compared to $9.3 million in the corresponding period in 2008. Revenue from our OVP segment decreased by $3.2 million to $1.8 million for the three months ended June 30, 2009 as compared to $5.0 million in the corresponding period in 2008. In both cases, the largest factor in this decline was loss of fish vaccine revenue from AquaHealth, a unit of Novartis, a customer who had previously informed us that they would be taking their production in-house and accordingly ordered no product from us in the first half of 2009. Lower revenue under our contract with AgriLabs and lower sales of bulk bovine biologicals also contributed to the year-over-year revenue decline in this segment.

We expect 2009 total revenue to decline as compared with 2008.

***Cost of Revenue***

Cost of revenue totaled $24.4 million for the first six months of 2009, a 14% decrease as compared to $28.2 million for the corresponding period in 2008. Gross profit decreased by $1.9 million to $14.4 million for the six months ended June 30, 2009 as compared to $16.3 million in the

prior year corresponding period. Gross Margin, i.e. gross profit divided by total revenue, increased to 37.2% for the six months ended June 30, 2009 as compared to 36.6% in the corresponding period in 2008. Product mix, somewhat offset by significantly lower margins in our OVP segment where our fixed costs were spread over a significantly lower revenue base, was a key factor in the increase in Gross Margin.

Cost of revenue totaled $11.6 million for the three months ended June 30, 2009, a decrease of $2.4 million as compared to $14.0 million for the corresponding period in 2008. Gross profit decreased by $1.6 million to $7.0 million for the three months ended June 30, 2009 as compared to $8.6 million in the prior year period. Gross Margin, i.e. gross profit divided by total revenue, decreased to 37.7% for the three months ended June 30, 2009 from 37.9% in the prior year period. Significantly lower margins in our OVP segment where our fixed costs were spread over a significantly lower revenue base, somewhat offset by product mix, was a key factor in the change in Gross Margin.

We expect Gross Margin to be flat or down slightly for 2009 as compared to 2008.

***Operating Expenses***

Total operating expenses decreased 18% to $12.4 million in the six months ended June 30, 2009 as compared to $15.1 million in the prior year period. Total operating expenses decreased 16% to $6.0 million in the three months ended June 30, 2009 as compared to $7.2 million in the prior year period.

Selling and marketing expenses decreased 23% to $7.4 million in the six months ended June 30, 2009 as compared to $9.6 million in the corresponding period in 2008. Selling and marketing expenses decreased 22% to $3.6 million in the three months ended June 30, 2009 as compared to $4.6 million in the corresponding period in 2008. In both cases, key factors in the decline were lower expenses related to product launches and lower commissions.

Research and development expenses were $851 thousand for the six months ended June 30, 2009, an 11% decline as compared to $956 thousand in the corresponding period in 2008. Research and development expenses were $405 thousand for the three months ended June 30, 2009, a 3% decline as compared to $417 thousand in the corresponding period in 2008. In both cases, a key factor in the decline was lower spending on research and development resources, such as laboratory supplies.

General and administrative expenses were $4.1 million in the six months ended June 30, 2009, down 10% from $4.6 million in the prior year period. General and administrative expenses were $2.0 million in the three months ended June 30, 2009, down 6% from $2.1 million in the prior year period. In both cases, a factor in the change was savings resulting from our year-end restructuring.

We expect 2009 operating expenses will be lower than in 2008.

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

Interest and other expense, net was $206 thousand in the six months ended June 30, 2009, a decrease of $141 thousand as compared to $347 thousand in the prior year period. Interest and other expense, net was $41 thousand in the three months ended June 30, 2009, a decrease of $140 thousand as compared to $181 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 $241 thousand in the six months ended June 30, 2009, a decrease of $104 thousand from $345 thousand in the prior year period. Lower loan balances and lower market interest rates, somewhat offset by an increased interest rate spread negotiated with Wells Fargo Bank, National Association ("Wells Fargo") in December, were responsible for the decline. In the six months ended June 30, 2009, net foreign currency gain was $35 thousand, a change of $37 thousand from a net foreign currency loss of $2 thousand in the prior year period. Net interest expense was $102 thousand in the three months ended June 30, 2009, a decrease of $55 thousand from $157 thousand in the prior year period. Lower loan balances and lower market interest rates, somewhat offset by

an increased interest rate spread negotiated with Wells Fargo in December, were responsible for the decline. In the three months ended June 30, 2009, net foreign currency gain was $61 thousand, a change of $85 thousand from a net foreign currency loss of $24 thousand in the prior year period.

We expect interest and other expense, net to decrease in 2009 as compared to 2008 based on lower market interest rates and lower average borrowings, somewhat offset by an increase in our interest rate spread.

***Income Tax Expense***

Income tax expense was $782 thousand in the six months ended June 30, 2009, a $406 thousand increase as compared to a tax expense of $376 thousand in the prior year period. In both periods, the tax entry was primarily non-cash and offsetting a decrease in our deferred tax assets. Tax expense was greater in the 2009 period due to greater income before income taxes in that period. Income tax expense was $390 thousand in the three months ended June 30, 2009, a $149 thousand decrease as compared to a tax expense of $539 thousand in the prior year period. In both periods, the tax entry was primarily non-cash and a decrease in our deferred tax assets. Tax expense was greater in the 2008 period due to greater income before income taxes in that period.

In 2009, we expect to recognize income tax expense as compared to an income tax benefit in 2008 as we expect to generate income before income taxes as opposed to the loss before income taxes we experienced in 2008.

***Net Income***

Net income was $1.0 million in the six months ended June 30, 2009, an increase of approximately $599 thousand compared to net income of $440 thousand in the prior year period. As discussed above, the increase was primarily due to lower operating expenses, somewhat offset by lower revenue. Net income was $579 thousand in the three months ended June 30, 2009, a decrease of approximately $87 thousand compared to net income of $666 thousand in the prior year period. As discussed above, the decrease was primarily due to lower revenue, somewhat offset by lower operating expenses.

In 2009, we expect to generate net income as opposed to the net loss we reported in 2008, primarily as a result of lower operating expenses.

**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, 2009, we had a net income of $1.0 million. During the six months ended June 30, 2009, our operations provided cash of approximately $5.2 million. At June 30, 2009, we had $5.3 million of cash and cash equivalents, $11.5 million of working capital, $7.0 million of outstanding borrowings under our revolving line of credit, discussed below, and $765 thousand of other debt.

Net cash provided by operating activities was approximately $5.2 million for the six months ended June 30, 2009 as compared to $1.2 million of cash provided by operating activities in the prior year period, an improvement of approximately $4.0 million. Major factors in the change were a $1.5 million increase in cash provided by inventory as we reduced our overall inventory levels, a net improvement of $1.2 million in cash used by accounts payable and accrued liabilities in which a factor was a ramp in vendor spending late in 2007 which did not occur late in 2008 and an increase in net income of $599 thousand.

Net cash flows from investing activities used cash of $126 thousand in the six months ended June 30, 2009, a decline of approximately $594 thousand compared to $720 thousand during the corresponding period in 2008. All expenditures were for the purchase of property and equipment in both cases.

Net cash flows used in financing activities was $4.4 million during the six months ended June 30, 2009, a large increase as compared to $12 thousand used during the corresponding period in 2008. The primary reason for the change is a $4.2 million change related to our revolving line of credit with Wells Fargo, where we borrowed an additional $106 thousand in the six months ended June 30, 2008 and repaid nearly $4.1 million in the six months ended June 30, 2009. In addition, proceeds from the issuance of common stock declined by approximately

$234 thousand as a result of option exercises which occurred in the six months ended June 30, 2008, but not 2009.

At June 30, 2009, we had a $15.0 million asset-based revolving line of credit with Wells Fargo which has a maturity date of June 30, 2011 as part of our credit and security agreement with Wells Fargo. At June 30, 2009, $7.0 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, 2009, interest was charged at a stated rate of prime plus 2.50% 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. We were in compliance with all financial covenants as of June 30, 2009. At June 30, 2009, we had $3.3 million borrowing capacity based upon eligible accounts receivable and eligible inventory under our revolving line of credit.

At June 30, 2009, we also had outstanding obligations for long-term debt totaling approximately $765 thousand 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, 2009 of approximately $163 thousand due in monthly installments of $17,658 plus interest. The term loan had a stated interest rate of prime plus 2.50% on June 30, 2009 and is to be paid in full in April 2010. 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 an outstanding balance at June 30, 2009 of approximately $602 thousand with principal payments on the Equipment Notes of $46,296 plus interest due in monthly installments. The Equipment Notes had a stated interest rate of prime plus 2.50% as of June 30, 2009 and are to be paid in full in August 2010.

At June 30, 2009, we had deferred revenue and other long-term liabilities, net of current portion, of approximately $5.2 million. Included in this total is approximately $3.5 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, competition, the impact of the loss of access to our current handheld blood diagnostic instruments and consumables, 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 2009 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 2009 and into 2010. 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.

**Recent Accounting Pronouncements**

In May 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 165, which provides new disclosure requirements for the Company's evaluation of subsequent events. This statement is effective for periods ending after June 15, 2009. The Company adopted this statement in the quarter ended June 30, 2009, and included appropriate disclosures.

**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, 2009, approximately $7.8 million was outstanding on these lines of credit and other borrowings with a weighted average interest rate of 5.75%. We also had approximately $5.3 million of cash and cash equivalents at June 30, 2009, the majority of which was invested in liquid interest bearing accounts. We had no interest rate hedge transactions in place on June 30, 2009. 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 $24 thousand based on our outstanding balances as of June 30, 2009.

**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 customers and suppliers 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, 2009.

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 $560 thousand.

**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.

**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, 2009, 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 some of these factors and the possible impact of these factors on future results of operations. The risks and uncertainties described below are not the only ones we face. Additional risks or uncertainties not presently known to us or that we deem to be currently immaterial also may impair our business operations. If any of the following factors actually occur, our business, financial condition or results of operations could be harmed. In that case, the price of our 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. We recently received notice that one of our major third-party suppliers has decided to cancel our agreement and we expect to lose access to the corresponding product line in November 2009.***

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 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.

Currently, the largest of these suppliers is Abbott Point of Care Inc. ("APOC"), formerly known as i-STAT Corporation, a unit of Abbott Laboratories. Approximately 18% of our revenue for the 12 months ended June 30, 2009 is related to the proprietary products manufactured by APOC (the "iSTAT Products"). The iSTAT Products generate slightly below average Gross Margin as compared to our overall business. On May 1, 2009, APOC informed us that they were canceling our contractual agreement as of November 1, 2009. Under our agreement with APOC, our rights became non-exclusive upon receipt of such notice. We subsequently learned through an 8-K filing with the SEC that Abaxis, Inc. ("Abaxis"), one of our major competitors, had signed an agreement with APOC to distribute certain iSTAT Products into the animal health market and that such rights are to be exclusive outside of Japan on November 1, 2009. Through November 1, we may face severe competition to service the customers who purchase iSTAT Products, including the currently existing base of users and customers who also purchase our other products, which could significantly lower our revenue and gross margin and increase our sales and marketing and other expenses. After November 1, our ability to compete in this area will be severely hampered as we do not expect to have access to iSTAT Products to sell to our installed base of customers and anticipate a significant decline in revenue and gross margin related to iSTAT Products as a result. There can be no assurance we will be able to find an alternative product to the iSTAT Products, that any such product could compete effectively against the

iSTAT Products, directly or in a niche, or that any such product will be available in a timely or economic manner. In addition, under our contract with APOC, we may only sell inventory for a given period after contract termination, so that we could face significant inventory reserves and losses if we do not sell iSTAT Products as currently expected.

Other major suppliers who sell us proprietary products which are responsible for more than 5% of our revenue for the 12 months ended June 30, 2009 are Arkray Global Business, Inc., Boule Medical AB, FUJIFILM Corporation and Quidel Corporation. None of these suppliers sell us proprietary products which are responsible for more than 20% of our revenue, although the proprietary products of one supplier is responsible for more than 15% of our revenue and another 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 other major product offerings other than the iSTAT products in the marketplace through at least the end of 2009, 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:

- *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.
- *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.
- *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, state and foreign 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, and/or damage our reputation with our customers due to factors such as poor quality goods or delays in order fulfillment, resulting in our being unable to sell our products effectively and substantially 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 loss of distribution rights for products or failure to gain access to new products may cause damage to our reputation and adversely affect our business and future prospects.

We believe the recent worldwide economic weakness has had a negative effect on our business, and this may continue in the future. This is particularly notable in the sale of new instruments, which is a capital expenditure many, if not most, veterinarians may choose to defer in times of perceived economic weakness. Even if the overall economy begins to grow in the future, there may be a lag before veterinarians display

confidence such growth will continue and return to historical capital expenditure purchasing patterns. As the vast majority of cash flow to veterinarians ultimately is funded by pet owners without private insurance or government support, our business may be more susceptible to severe economic downturns than other health care businesses which rely less on individual consumers.

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 predominately sell all our Core Companion Animal Health products to or through veterinarians ultimately. 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 market and sell most of our Core Companion Animal Health products in the United States to veterinarians through an outside field organization of approximately 36 individuals, an inside sales force of approximately 21 individuals, approximately 11 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, as well as through trade shows and print advertising. 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 and has caused large distributors of our products in the past to no longer carry our instruments and heartworm diagnostic tests upon commencing distribution of the IDEXX product line.

***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 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 (a company jointly owned by Merck & Co., Inc. and Sanofi-Aventis), 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. Another of our competitors, Abaxis, recently launched a canine heartworm diagnostic test competitive with ours. On May 1, 2009, APOC informed us that they were canceling our contractual agreement as of November 1, 2009. Under our agreement with APOC, our rights became non-exclusive upon receipt of such notice. We subsequently learned through an 8-K filing with the SEC that Abaxis had signed an agreement with APOC to distribute certain iSTAT Products into the animal health market and that such rights are to be exclusive outside of Japan on November 1, 2009. Through November 1, we may face severe competition to service the customers who purchase iSTAT Products, including the currently existing base of users and customers who also purchase our other products, which could significantly lower our revenue and gross margin and increase our sales and marketing and other expenses. After November 1, our ability to compete in this area will be severely hampered as we do not expect to have access to iSTAT Products to sell to our installed base of customers and anticipate a significant decline in revenue and gross margin related to iSTAT Products as a result. There can be no assurance we will be able to find an alternative product to the iSTAT Products, that any such product could compete effectively against the iSTAT Products, directly or in a niche, or that any such product will be available in a timely or economic manner.

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. For example, on March 9, 2009, Merck & Co., Inc. ("Merck") and Schering-Plough Corporation ("SGP") announced plans to merge. SGP is the parent company of SPAH. Merck and Sanofi-Aventis each own 50% of Merial Limited ("Merial"), a company which sells a canine heartworm preventive competitive with ours. On July 30, 2009, Merck and Sanofi-Aventis announced that they had entered into an agreement under which Merck is to sell its interest in Merial to Sanofi-Aventis and that Sanofi-Aventis is to receive a call option exercisable after the merger of Merck and SGP to essentially combine Merial with SPAH in a new joint venture company equally owned by Sanofi-Aventis and the company created from the merger of Merck and SGP. If SGP, SPAH or any related entity is required to divest or cease operations related to our heartworm preventive in order to complete a merger or other combination, our sales could decline significantly and our business could be damaged. Similarly, if SPAH personnel are distracted or experience turmoil as a result of the announced merger between Merck and SGP, a future combination between SPAH and Merial or for other reasons, our sales could decline significantly. 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. For example, we believe a unit of SPAH has obtained FDA approval for a canine heartworm preventive product with additional claims compared with our TRI-HEART Plus Chewable Tablets. Should SPAH decide to emphasize sales and marketing efforts of this product rather than our TRI-HEART Plus Chewable Tablets or cancel our agreement

regarding canine heartworm preventive distribution and marketing, our sales could decline significantly. In 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, our agreement with AgriLabs requires us to potentially pay penalties if we are unable to supply product over an extended period of time.

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

Under our credit and security agreement with Wells Fargo we are required to comply with various 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. Failure to comply with any of the covenants, representations or warranties, or failure to modify them to allow future compliance, could result in our being in default and could cause all outstanding borrowings under our credit and security agreement to become immediately due and payable, or impact our ability to borrow under the agreement. In addition, Wells Fargo has discretion in setting the advance rates which we may borrow against eligible assets. We 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 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, 2009, we had an accumulated deficit of $173.0 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. In addition, we anticipate the loss of access to the iSTAT Products will put significant financial pressure on us in 2010. 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 generate, sustain or increase profitability on a quarterly or annual basis. If we cannot achieve or sustain profitability for an extended period, we may not be able to fund our expected cash needs, including the repayment of debt as it comes due, or continue our operations.

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

Sales to SPAH accounted for 11% and 12% of total revenue for the three and six months ended June 30, 2009. Sales to no other single customer accounted for more than 10% of our consolidated revenue for the three and six months ended June 30, 2009. Sales to Novartis AG and its business units ("Novartis") accounted for approximately 11% and 12% of consolidated revenue for the three and six months ended June 30, 2008. Sales to no other customer accounted for more than 10% of our consolidated revenue for the three and six months ended June 30, 2008. No single customer accounted for more than 10% of our consolidated accounts receivable at June 30, 2009. SPAH accounted for 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 our consolidated accounts receivable at June 30, 2008. 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.

***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, 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. We believe the credit markets are particularly restrictive and difficult to obtain funding in versus recent history. Furthermore, even if additional capital is available, it may not be of the magnitude required to meet our needs under these or other scenarios. If additional funds are required and are not available, it would likely have a material adverse effect on our business, financial condition and our ability to continue as a going concern.

***Our 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. We are currently not in compliance with the $1.00 minimum bid price and we have received a communication from Nasdaq so advising us. Nasdaq announced a temporary suspension of minimum bid price enforcement until August 3, 2009; we are to have 180 calendar days from August 3, 2009 to regain compliance with the minimum bid price requirement, which requires our stock to have a minimum closing bid price of $1.00 for a minimum of 10 consecutive trading days. If we fail to regain compliance with the minimum bid price requirement within 180 days, Nasdaq has informed us we will be eligible for an additional 180 calendar day compliance period if we satisfy the Nasdaq Capital Market initial listing criteria other than the minimum bid price requirement at that time. There can be no assurance we will meet these criteria at that point, that Nasdaq will interpret these criteria in the same manner we do if we believe we meet the criteria, or that Nasdaq will not change such criteria to include requirements we do not meet in the future, any of which could cause us to fail to obtain the additional 180 day compliance period. 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 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.

***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. We are currently collaborating with FUJIFILM on a line extension of our chemistry instrument offering. We expect to sell the resulting new instrument prior to year end. If FUJIFILM fails to complete the anticipated development activities in a timely fashion, we will not generate any sales of this new instrument prior to year end and our 2009 revenue will likely be lower than our current expectations as a result.

***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, including those related to personnel. 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 may be 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 or shortfalls 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.

***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 $0.17 to a high of $1.01. 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;
- changes in the outlook for our business, including any changes in our earnings guidance;
- our quarterly operating results, including as compared to our revenue, earnings or other guidance and in comparison to historical results;
- termination, cancellation or expiration of our third-party supplier relationships;
- announcements of technological innovations or new products by our competitors or by us;
- litigation;
- regulatory developments, including delays in product introductions;
- developments or disputes concerning patents or proprietary rights;
- availability of our revolving line of credit and compliance with debt covenants;
- releases of reports by securities analysts;
- 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.

***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 may subject us to extensive regulation by one or more of the USDA, the FDA, the EPA and foreign and other regulatory authorities. These regulations govern, among other things, the development, testing, manufacturing, labeling, storage, pre-market approval, advertising, promotion and sale of some of our products. Satisfaction of these requirements can take several years and time needed to satisfy them may vary substantially, based on the type, complexity and novelty of the product.

The 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.

***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 and expenses 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 of standards for internal control evaluation and reporting adopted under Section 404 of Sarbanes-Oxley. If our regulators and/or auditors adopt or interpret more stringent standards than we anticipate, we and/or our auditors may be unable to conclude that our internal controls over financial reporting are designed and operating effectively, which could adversely affect investor confidence in our financial statements. 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. In addition, actions by other entities, such as enhanced rules to maintain our listing on the Nasdaq Capital Market, could also increase our general and administrative costs or have other adverse effects on us, as could further legislative, regulatory or rule-making action or more stringent interpretations of existing legislation, regulations and rules.

***We 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.

***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 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 2009 annual meeting of stockholders (the "2009 Annual Meeting") was held on May 5, 2009 in Loveland, Colorado. Three proposals, as described in our Proxy Statement dated April 6, 2009, 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:

| Nominee | Number of Shares | |
|---|---|---|
| William A. Aylesworth | For | 45,900,017 |
| | Withheld | 2,126,165 |
| Robert B. Grieve, Ph.D. | For | 36,528,971 |
| | Withheld | 11,497,211 |

2. Approval of an amendment to our 1997 Stock Incentive Plan:

| For | Against | Abstain | Non-votes |
|---|---|---|---|
| 18,675,864 | 10,420,727 | 66,182 | 18,863,409 |

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

| For | Against | Abstain |
|---|---|---|
| 47,154,022 | 845,807 | 26,353 |

**Item 5. Other Information**

None.

**Item 6. Exhibits**

(a) Exhibits

| Number | Notes | Description |
|---|---|---|
| 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 10, 2009 | By | /s/ Robert B. Grieve<br>ROBERT B. GRIEVE<br>Chairman of the Board and Chief Executive Officer<br>(on behalf of the Registrant and as the Registrant's Principal Executive Officer) |
| Date: | August 10, 2009 | By | /s/ Jason A. Napolitano<br>JASON A. NAPOLITANO<br>Executive Vice President and Chief Financial Officer<br>(on behalf of the Registrant and as the Registrant's Principal Financial Officer) |