HESKA CORP
Form 10-Q
November 03, 2017

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

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

For the quarterly period ended September 30, 2017
OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____
Commission file number: 0-22427
HESKA CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	77-0192527
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

3760 Rocky Mountain Avenue	
Loveland, Colorado	80538
(Address of principal executive offices)	(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x

7,243,787 shares of the Registrant's Public Common Stock, $.01 par value, were outstanding at November 2, 2017.

TABLE OF CONTENTS

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

	September 30, 2017 (unaudited)	December 31, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	$7,423	$10,794
Accounts receivable, net of allowance for doubtful accounts of $196 and $237, respectively	13,492	20,857
Due from – related parties	22	100
Inventories, net	30,013	20,395
Other current assets	6,022	3,127
Total current assets	56,972	55,273
Property and equipment, net	16,147	16,581
Goodwill	26,688	26,647
Other intangible assets, net	2,055	2,346
Deferred tax asset, net	20,299	21,122
Other non-current assets	13,485	8,875
Total assets	$135,646	$130,844
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$10,374	$7,154
Accrued liabilities	4,649	6,469
Current portion of deferred revenue	3,466	3,439
Obligation to purchase minority interest	—	14,602
Line of credit and other short-term borrowings	6,313	750
Total current liabilities	24,802	32,414
Deferred revenue, net of current portion, and other	9,817	11,455
Total liabilities	34,619	43,869
Commitments and contingencies (Note 11)		
Stockholders' equity:		
Preferred stock, $.01 par value, 2,500,000 shares authorized, none issued or outstanding	—	—
Traditional common stock, $.01 par value, 10,000,000 shares authorized, none issued or outstanding	—	—
Public common stock, $.01 par value, 10,000,000 shares authorized, 7,243,648 and 7,026,051 shares issued and outstanding, respectively	72	70
Additional paid-in capital	242,998	238,635
Accumulated other comprehensive income	222	97
Accumulated deficit	(142,265)	(151,827)
Total stockholders' equity	101,027	86,975
Total liabilities and stockholders' equity	$135,646	$130,844

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Revenue:				
Core companion animal health	$26,670	$26,386	$78,299	$74,284
Other vaccines, pharmaceuticals and products	4,758	7,044	17,847	16,257
Total revenue, net	31,428	33,430	96,146	90,541
Cost of revenue	17,875	19,712	54,455	52,699
Gross profit	13,553	13,718	41,691	37,842
Operating expenses:				
Selling and marketing	5,815	5,490	17,908	16,495
Research and development	601	507	1,576	1,605
General and administrative	3,359	3,229	11,081	9,724
Total operating expenses	9,775	9,226	30,565	27,824
Operating income	3,778	4,492	11,126	10,018
Interest and other expense (income), net	(6)	14	(186)	(85)
Income before income taxes	3,784	4,478	11,312	10,103
Income tax expense:				
Current income tax expense	8	123	25	284
Deferred income tax expense	693	1,012	762	2,287
Total income tax expense	701	1,135	787	2,571
Net income	3,083	3,343	10,525	7,532
Net income (loss) attributable to non-controlling interest	—	(4)	(498)	477
Net income attributable to Heska Corporation	$3,083	$3,347	$11,023	$7,055
Basic earnings per share attributable to Heska Corporation	$0.43	$0.49	$1.58	$1.05
Diluted earnings per share attributable to Heska Corporation	$0.40	$0.45	$1.45	$0.97
Weighted average outstanding shares used to compute basic earnings per share attributable to Heska Corporation	7,139	6,871	6,985	6,727
Weighted average outstanding shares used to compute diluted earnings per share attributable to Heska Corporation	7,668	7,454	7,580	7,299

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Net income	$3,083	$3,343	$10,525	$7,532
Other comprehensive income:				
Sale of equity investment	—	—	—	(90)
Foreign currency translation	(45)	28	125	71
Comprehensive income	3,038	3,371	10,650	7,513
Comprehensive income (loss) attributable to non-controlling interest	—	(4)	(498)	477
Comprehensive income attributable to Heska Corporation	$3,038	$3,375	$11,148	$7,036

See accompanying notes to condensed consolidated financial statements.

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

	Nine Months Ended September 30,	
	2017	2016
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$10,525	$7,532
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	3,586	3,418
Deferred tax expense	762	2,287
Stock based compensation	2,094	1,685
Unrealized benefit on foreign currency translation	—	(1)
Changes in operating assets and liabilities:		
Accounts receivable	7,376	377
Inventories	(10,490)	(5,661)
Other current assets	(2,748)	197
Accounts payable	3,218	(1,817)
Accrued liabilities and other	(1,824)	475
Other non-current assets	(4,606)	(3,997)
Deferred revenue and other	(1,615)	(2,614)
Net cash provided by operating activities	6,278	1,881
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from sale of equity investment	—	115
Purchase of minority interest	(13,757)	—
Purchases of property and equipment	(1,998)	(2,126)
Proceeds from disposition of property and equipment	6	716
Net cash used in investing activities	(15,749)	(1,295)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	2,287	567
Repurchase of equity instruments	(860)	—
Distributions to non-controlling interest members	(963)	—
Proceeds from line of credit borrowings	40,307	25,417
Repayments of line of credit borrowings	(34,666)	(24,006)
Repayments of other debt	(78)	(279)
Net cash provided by financing activities	6,027	1,699
EFFECT OF EXCHANGE RATE CHANGES ON CASH	73	39
DECREASE IN CASH AND CASH EQUIVALENTS	(3,371)	2,324
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	10,794	6,890
CASH AND CASH EQUIVALENTS, END OF PERIOD	$7,423	$9,214

See accompanying notes to condensed consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

Heska Corporation and its wholly-owned subsidiaries ("Heska", the "Company", "we" or "our") sell advanced veterinary diagnostic and specialty products. Our offerings include blood testing instruments and supplies, digital imaging products, software and services, vaccines, local and cloud-based data services, allergy testing and immunotherapy, and single-use offerings such as in-clinic diagnostic tests and heartworm preventive products. Our core focus is on supporting veterinarians in the canine and feline healthcare space.

In the opinion of management, the accompanying unaudited Condensed Consolidated Financial Statements contain all adjustments, consisting of normal, recurring adjustments, necessary to present fairly the financial position of the Company at September 30, 2017, and the results of our operations for the three and nine months ended September 30, 2017 and 2016 and cash flows for the nine months ended September 30, 2017 and 2016.

The unaudited Condensed Consolidated Financial Statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") have been condensed or omitted pursuant to such rules and regulations. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements and Notes thereto contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016 and other financial information filed with the SEC.

Use of Estimates

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

Critical Accounting Policies

Our accounting policies are described in our audited Consolidated Financial Statements and Notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2016, except as noted below.

Revenue Recognition

We generate our revenue through the sale of products, either by outright purchase by our customers or through a subscription agreement whereby our customers receive specified blood-testing equipment and pay us a monthly fee for the usage of the equipment as well as the consumables needed to conduct testing. Additionally, we may recognize rental revenue for certain of our equipment in our digital imaging product line in which we are paid a monthly rental fee for usage of the equipment. We also may recognize revenue 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:

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

•Persuasive evidence of an arrangement exists;
•Delivery has occurred or services have been rendered;
•Price is fixed or determinable; and
•Collectability is reasonably assured.

Revenue from the outright sale of products to customers 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 our subscription agreements is recognized based on the length of the agreements that are signed by our customers. Among other factors, the length of the agreement determines whether a subscription is considered an operating lease or capital lease. For subscription agreements that are considered operating leases, we recognize revenue of our subscriptions ratably over the term of the agreement. The equipment is transferred from inventory to property, plant and equipment and depreciated into cost of goods sold over the term of the agreement, based on the assets' useful life. Revenue from subscription agreements that are considered capital leases is recognized, along with the associated cost of the equipment, at the time of placement in our customer's location. The amount of revenue recognized at the time of lease inception is based on, along with other factors, observable prior sales prices of similar equipment sold by us over the prior twelve months, which is the amount determined to be the fair value.

Revenue from our rentals of digital imaging equipment is recognized ratably over the term of the rental agreement, which is typically over a 26-month period. The equipment is transferred from inventory to property, plant and equipment and depreciated over the assets' useful life.

Recording revenue from the sale of products involves the use of estimates and management's 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 collectability is reasonably assured is ultimately a judgment decision that must be made by management. We must also make estimates regarding our future obligations 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.

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

We may enter into arrangements that include multiple elements. 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.

Recent Accounting Pronouncements

In May 2017, the Financial Accounting Standards Board ("FASB") issued ASU 2017-09, “Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting.” ASU 2017-09 was issued to provide clarity and reduce both 1) diversity in practice and 2) cost and complexity when applying the guidance in Topic 718 to a change in the terms or conditions of a share-based payment award. ASU 2017-09 provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting under Topic 718. The amendments in ASU 2017-09 are effective for fiscal years, and interim periods within those years, beginning after December 15, 2017. Early adoption is permitted, including adoption in any interim period. The amendments in ASU 2017-09 should be applied prospectively to an award modified on or after the adoption date. Heska adopted the new guidance in its second quarter of fiscal year 2017 and will apply the guidance to any future changes to the terms or conditions of its share-based payment awards.

In January 2017, the FASB issued ASU 2017-04, “Intangibles - Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment,” to simplify financial reporting by eliminating the need to determine the fair value of individual assets and liabilities of a reporting unit to measure goodwill impairment. Under ASU 2017-04, an entity should perform its goodwill impairment test by comparing the fair value of the reporting unit with its carrying amount and recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit’s fair value, up to the amount of goodwill allocated to that reporting unit. The new guidance effectively eliminates “Step 2” from the previous goodwill impairment test. ASU 2017-04 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2019. Early adoption is permitted for goodwill impairment tests performed on testing dates after January 1, 2017. Heska plans to adopt the new guidance in its fourth quarter of fiscal year 2017 when it performs its annual goodwill impairment test as of December 15, 2017. Heska does not expect the adoption of ASU 2017-04 to have a significant impact on the results of its goodwill impairment testing.

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

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

In May 2014, the FASB issued ASU 2014-09, “Revenue from Contracts with Customers” and has subsequently issued several supplemental and/or clarifying ASUs (collectively “ASC 606”). ASC 606 prescribes a single common revenue standard that replaces most existing U.S. GAAP revenue recognition guidance. ASC 606 outlines a five-step model, under which Heska will recognize revenue as performance obligations within a customer contract are satisfied. ASC 606 is intended to provide more consistent interpretation and application of the principles outlined in the standard across filers in multiple industries and within the same industries compared to current practices, which should improve comparability.

Adoption of ASC 606 is required for annual reporting periods beginning after December 15, 2017, including interim periods within the reporting period. Upon adoption, Heska must elect to adopt either retrospectively to each prior reporting period presented (full retrospective method) or using the cumulative effect transition method with the cumulative effect of initial adoption recognized at the date of initial application (modified retrospective method). Based on evaluation of the accounting impact of ASC 606 on our revenue streams, Heska has elected to adopt the modified retrospective method.

Heska assessed the impact that the future adoption of ASC 606 is expected to have on its Consolidated Financial Statements by analyzing its current portfolio of customer contracts and various revenue streams, including a review of historical accounting policies and practices to identify potential differences in applying the guidance of ASC 606. Heska is also performing a comprehensive review of its current processes and systems to determine and implement changes required to support the adoption of ASC 606 on January 1, 2018.

Based on Heska’s review of its customer contracts, Heska has determined that the timing of revenue recognition on the majority of its customer contracts will continue to be recognized as they are currently, generally upon shipment of products, consistent with Heska’s current revenue recognition model. While Heska believes that the timing of revenue recognition is consistent with current practice, we are still evaluating the allocation of the standalone selling price of goods and services and this could have an impact on the amount of revenue recognized at a point in time versus over time. As such, Heska believes the adoption of ASC 606 will have an impact on both the timing of revenue recognition and various line items within the Consolidated Balance Sheet.

Heska generally expenses costs to obtain contracts (i.e. sales commissions) as a period expense for all contracts, despite the length of the arrangement. ASC 606, states that "an asset recognized in accordance with the incremental costs of obtaining a contract shall be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates." Because a significant number of Heska’s customers are under noncancelable contracts for periods extending beyond one year with the delivery of goods and services occurring throughout the duration, Heska anticipates recording an asset related to the prepayment of such contract acquisition costs.

In addition, ASC 606 will require more comprehensive disclosures about revenue streams and contracts with customers, including significant judgments required. Heska is currently evaluating potential changes to its processes for preparing required disclosures and to information systems that support the financial reporting process.

Heska is also evaluating implications to the Company’s system of internal controls, relative to revenue recognition and the related revenue disclosures.

2. ACQUISITIONS AND RELATED PARTY ITEMS

Cuattro Veterinary, LLC

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

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

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

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

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

Common stock issued - 175,000 shares	$6,347
Debt assumed	1,535
Total fair value of consideration transferred	$7,882
Accounts receivable	$222
Inventories	39
Due from Cuattro, LLC	963
Property and equipment	80
Other tangible assets	164
Deferred tax asset	56
Intangible assets	2,521
Goodwill	5,783
Accounts payable	(112)
Deferred tax liability	(905)
Other assumed liabilities	(929)
Total fair value of consideration transferred	$7,882

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

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

Cuattro International is a provider to international markets of digital radiography technologies for veterinarians. As a leading provider of advanced veterinary diagnostic and specialty products, we made the acquisition in an effort to combine Cuattro International's international reach with our domestic success in the

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

imaging and blood testing markets in the United States. International markets represent a significant portion of worldwide veterinary revenues for which we intend to compete.

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

Cuattro Veterinary USA, LLC

On February 24, 2013, the Company acquired a 54.6% interest in Cuattro Veterinary USA, LLC, which was subsequently renamed Heska Imaging US, LLC. The remaining minority position (45.4%) in US Imaging was subject to purchase by Heska under performance-based puts and calls following the audit of our financial statements for 2016 and 2017. The required performance criteria were met in 2016, we considered notice given on March 3, 2017 that the put option was being exercised and on May 31, 2017, we delivered $13.8 million in cash to obtain the remaining minority position in US Imaging.

Prior to the purchase of the minority position (the "Imaging Minority"), Shawna M. Wilson, Clint Roth, DVM, Steven M. Asakowicz, Rodney A. Lippincott, Kevin S. Wilson and Cuattro, LLC owned approximately 29.75%, 8.39%, 4.09%, 3.07%, 0.05% and 0.05% of US Imaging, respectively. Kevin S. Wilson is the Chief Executive Officer and President of the Company and the spouse of Shawna M. Wilson. Steven M. Asakowicz serves as Executive Vice President, Companion Animal Health Sales for the Company. Rodney A. Lippincott serves as Executive Vice President, Companion Animal Health Sales for the Company. On April 3, 2017, and in accordance with the terms of its Operating Agreement, US Imaging distributed $2.1 million based on past operating performance, including $1.0 million to its minority interest members.

On June 1, 2017, the Company consolidated its assets and liabilities in the US Imaging and International Imaging companies into Global Imaging, which was re-named Heska Imaging, LLC ("Heska Imaging").

Related Party Activities

Cuattro, LLC charged Heska Imaging $13.9 million during the nine months ended September 30, 2017, primarily related to digital imaging products, for which there is an underlying supply contract with minimum purchase obligations, software and services as well as other operating expenses; Heska Corporation charged Heska Imaging $2.9 million during the five months ended May 31, 2017, prior to the purchase of the Imaging Minority on June 1, 2017, primarily related to sales expenses; and Heska Corporation charged Cuattro, LLC $0.1 million during the nine months ended September 30, 2017, primarily related to facility usage and other services.

As of September 30, 2017, Heska Corporation had receivables from Cuattro, LLC of $22 thousand, which is included in "Due from – related parties" on the Company's consolidated balance sheet.

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

3. INCOME TAXES

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Income before income taxes	$3,784	$4,478	$11,312	$10,103
Total income tax expense	701	1,135	787	2,571
Effective tax rate	18.5 %	25.3 %	7.0 %	25.4 %

We are subject to income taxes in the U.S. federal jurisdiction, and various foreign, state and local jurisdictions. Tax regulations within each jurisdiction are subject to the interpretation of the related tax laws and regulations and require significant judgment to apply.

During interim periods, the Company generally utilizes the estimated annual effective tax rate method which involves the use of forecasted information. Under this method, the provision is calculated by applying an estimate of the annual effective tax rate for the full fiscal year to “ordinary” income or loss (pretax income or loss excluding unusual or infrequently occurring discrete items) for the reporting period. The Company’s effective tax rate decreased to 18.5% for the three months ended September 30, 2017, compared to 25.3% for the three months ended September 30, 2016. The Company's effective tax rate decreased to 7% for the nine months ended September 30, 2017, compared to 25.4% for the nine months ended September 30, 2016. The decreases in rates for both periods was primarily attributable to an increase in stock-based compensation excess tax benefits, which are now recorded as income tax expense or benefit in accordance with our policy.
As of September 30, 2017, the Company assessed whether the reduction of taxable income due to large benefits created by stock option exercises and vesting of restricted stock and the excess tax benefits would cause a larger portion of our DTAs to likely expire unrealized. The Company assessed its ability to realize the DTAs by evaluating all available positive and negative evidence, including (1) cumulative results of operations in recent years, (2) sources of recent pre-tax losses, (3) estimates of future taxable income, and (4) the length of Net Operating Loss ("NOL") carryforward periods. Additionally, the Company considered the length of NOL carryforward periods and an objectively verifiable estimate of future income based on operating results from the Company’s recent history, as well as an estimate of future income that incorporates the Company's forecasted operating results for fiscal 2017. Due to the significant amount of additional stock based compensation excess tax deduction generated, the Company determined that the negative evidence outweighed the positive evidence and that the threshold of more-likely-than-not was not met and that sufficient taxable income may not be generated to realize all of the DTAs as of September 30, 2017. As such, an additional $1.3 million and $3.1 million was recorded to the current partial valuation allowance against the Company’s DTAs during the three and nine months ended September 30, 2017, respectively, which was partially offset by other adjustments to the valuation allowance. The Company will continue to closely monitor the need for an additional valuation allowance against its DTAs in each subsequent reporting period which can be impacted by actual operating results compared to the Company's forecast.
There were $2 thousand cash payments for income taxes for the three months ended September 30, 2017 and there were $225 thousand cash payments for income taxes for the three month period ended September 30, 2016.

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

There were $146 thousand cash payments for income taxes for the nine months ended September 30, 2017 and there were $288 thousand cash paid for income taxes for the nine month period ended September 30, 2016.

4. EARNINGS PER SHARE

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

The following is a reconciliation of the weighted-average shares outstanding used in the calculation of basic and diluted earnings per share for the three and nine months ended September 30, 2017 and 2016 (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Net income attributable to Heska	$3,083	$3,347	$11,023	$7,055
Basic weighted-average common shares outstanding	7,139	6,871	6,985	6,727
Assumed exercise of dilutive stock options and restricted shares	529	583	595	572
Diluted weighted-average common shares outstanding	7,668	7,454	7,580	7,299
Basic earnings per share attributable to Heska	$0.43	$0.49	$1.58	$1.05
Diluted earnings per share attributable to Heska	$0.40	$0.45	$1.45	$0.97

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Stock options	27	100	132	135

5. GOODWILL AND OTHER INTANGIBLES

The following summarizes the change in goodwill during the nine months ended September 30, 2017 (in thousands):

Carrying amount, December 31, 2016	$26,647
Foreign currency adjustments	41
Carrying amount, September 30, 2017	$26,688

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

Other intangibles consists of the following as of September 30, 2017 and December 31, 2016 (in thousands):

	September 30, 2017	December 31, 2016
Gross carrying amount	$ 3,309	$ 3,309
Accumulated amortization	(1,254)	(963)
Net carrying amount	$ 2,055	$ 2,346

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Amortization expense	$ 97	$ 97	$291	$134

Estimated amortization expense related to intangibles for each of the five years from 2017 (remaining) through 2021 and thereafter is as follows (in thousands):

Year Ending December 31,	
2017 (remaining)	$97
2018	388
2019	388
2020	388
2021	384
Thereafter	410
	$2,055

6. PROPERTY AND EQUIPMENT

Property and equipment, net consists of the following (in thousands):

	September 30, 2017	December 31, 2016
Land	$377	$377
Building	2,868	2,868
Machinery and equipment	38,124	36,588
Leasehold and building improvements	8,129	7,662
Construction in progress	2,169	1,655
	51,667	49,150
Less accumulated depreciation	(35,520)	(32,569)
Total property and equipment, net	$16,147	$16,581

The Company has subscription agreements whereby its instruments in inventory may be placed in a customer's location on a rental basis. The cost of these instruments is transferred to machinery and equipment and depreciated, typically over a five to seven year period depending on the circumstance under which the instrument is placed with the customer. Total costs transferred from inventory were approximately $0.7

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

million and $1.8 million for the nine months ended September 30, 2017 and the annual period ended December 31, 2016, respectively.

The Company has sold certain customer rental contracts and underlying assets to third parties under agreements that once the customer has met its obligations under the contract, ownership of the assets underlying the contract would be returned to the Company. The Company enters a debit to cash and a corresponding credit to deferred revenue at the time of these sales. Since the Company anticipates it will regain ownership of the assets underlying these sales, it reports these assets as part of property and equipment and depreciates these assets in accordance with its depreciation policies. The Company had $0.2 million and $0.3 million of net property and equipment related to these transactions as of September 30, 2017 and December 31, 2016, respectively, all related to Heska Imaging.

Depreciation expense for property and equipment was $1.1 million and $1.2 million for the three months ended September 30, 2017 and 2016, respectively. Depreciation expense was $3.3 million and $3.4 million for the nine months ended September 30, 2017 and 2016, respectively.

7. INVENTORIES, NET

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

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

	September 30, 2017	December 31, 2016
Raw materials	$ 12,779	$ 10,807
Work in process	5,553	3,820
Finished goods	13,082	7,087
Allowance for excess or obsolete inventory	(1,401)	(1,319)
Total inventory, net	$ 30,013	$ 20,395

8. ACCRUED LIABILITIES

Accrued liabilities consists of the following (in thousands):

	September 30, 2017	December 31, 2016
Accrued payroll and employee benefits	$ 1,591	$ 2,166
Accrued property taxes	606	748
Accrued purchases	—	664
Other	2,452	2,891
Total accrued liabilities	$ 4,649	$ 6,469

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

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

9. CAPITAL STOCK

Stock Option Plans

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option- pricing model with the following weighted average assumptions for options granted in the nine months ended September 30, 2017 and 2016.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Risk-free interest rate	1.83%	1.14%	1.75%	1.19%
Expected lives	4.9 years	4.5 years	4.9 years	4.5 years
Expected volatility	39%	40%	41%	41%
Expected dividend yield	0%	0%	0%	0%

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

	Nine Months Ended September 30, 2017		Year Ended December 31, 2016	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of period	829,617	$ 23.203	940,610	$ 14.163
Granted at Market	26,550	$ 99.127	129,855	$ 67.706
Canceled	(3,895)	$ 45.635	(463)	$ 14.881
Exercised	(189,350)	$ 10.877	(240,385)	$ 11.886
Outstanding at end of period	662,922	$ 29.633	829,617	$ 23.203
Exercisable at end of period	445,542	$ 17.075	532,703	$ 12.140

The total estimated fair value of stock options granted during the nine months ended September 30, 2017 and 2016 was computed to be approximately $993 thousand and $277 thousand, respectively. The amounts are amortized ratably over the vesting periods of the options. The weighted average estimated fair value of options granted during the nine months ended September 30, 2017 and 2016 was computed to be approximately $37.41 and $13.96, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2017 and 2016 was $16.5 million and $2.8 million, respectively. The cash proceeds from options exercised during the nine months ended September 30, 2017 and 2016 was $1.8 million and $740 thousand, respectively.

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

The following table summarizes information about stock options outstanding and exercisable at September 30, 2017:

	Options Outstanding			Options Exercisable	
Exercise Prices	Number of Options Outstanding at September 30, 2017	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Number of Options Exercisable at September 30, 2017	Weighted Average Exercise Price
$ 4.40 - $ 6.90	97,835	2.94	$ 5.405	97,835	$ 5.405
$ 6.91 - $ 7.36	106,544	6.14	$ 7.360	98,784	$ 7.360
$ 7.37 - $18.13	158,575	6.33	$ 13.469	128,286	$ 12.417
$18.14 - $39.76	167,893	7.30	$ 35.030	101,104	$ 32.449
$39.77 - $108.25	132,075	9.32	$ 78.093	19,533	$ 75.675
$ 4.40 - $108.25	662,922	6.64	$ 29.633	445,542	$ 17.075

As of September 30, 2017, there was approximately $4.2 million in total unrecognized compensation cost related to outstanding stock options. That cost is expected to be recognized over a weighted average period of 1.59 years, with all cost to be recognized by the end of July 2021, assuming all options vest according to the vesting schedules in place at September 30, 2017. As of September 30, 2017, the aggregate intrinsic value of outstanding options was approximately $39.0 million and the aggregate intrinsic value of exercisable options was approximately $31.7 million.

Employee Stock Purchase Plan (the "ESPP")

For the three months ended September 30, 2017 and 2016, we issued 2,515 and 3,583 shares under the ESPP, respectively. For the nine months ended September 30, 2017 and 2016, we issued 8,058 and 13,965 shares under the ESPP, respectively.

For the three and nine months ended September 30, 2017 and 2016, we estimated the fair values of stock purchase rights granted under the ESPP using the Black-Scholes pricing model. The weighted average assumptions used for the periods presented were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Risk-free interest rate	0.76%	0.57%	0.70%	0.54%
Expected lives	1.2 years	1.2 years	1.2 years	1.2 years
Expected volatility	45%	44%	45%	43%
Expected dividend yield	0%	0%	0%	0%

For the three months ended September 30, 2017 and 2016, the weighted-average fair value of the purchase rights granted was $16.49 and $9.87 per share, respectively. For the nine months ended September 30, 2017 and 2016, the weighted-average fair value of the purchase rights granted was $15.90 and $7.64 per share, respectively.

Restricted Stock Issuance

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

On March 26, 2014, we issued 110,000 shares to Mr. Wilson pursuant to an employment agreement between Mr. Wilson and the Company effective as of March 26, 2014 (the "Wilson Employment Agreement"). The shares were issued in four equal tranches and subject to time-based vesting and other provisions outlined in the Wilson Employment Agreement. As of March 26, 2017, all tranches have vested.

On March 17, 2015, the Company issued unvested shares to certain Executive Officers related to performance-based restricted stock grants (the "Performance Grants"). The Company issued 52,956 shares under the Performance Grants. The Performance Grants have met the underlying performance condition based on the Company's 2015 financial performance and are to cliff vest on March 17, 2018, subject to other vesting provisions in the underlying restricted stock grant agreement.

On March 2, 2016, the Company issued 15,000 unvested shares to certain Executive Officers related to performance-based restricted stock grants as part of the Company’s 2016 Management Incentive Plan (the "2016 MIP Grants"). Of these, 14,629 vested, 371 were forfeited, and 4,133 were withheld for tax. The 2016 MIP Grants vested during the three months ended March 31, 2017.

On May 1, 2017, the Company issued 2,720 shares of our Common Stock to the Company's non-employee directors. These grants are to vest (the "Vesting Time") in full on the latter of (i) the one year anniversary of the date of grant and (ii) the Company’s Annual Meeting of Stockholders for the year following the year of grant for the award (the "Vesting Meeting"), subject to (i) the non-employee director's continued service to the Company through the Vesting Time, unless the non-employee director’s current term expires at the Vesting Meeting in which case vesting is subject to the non-employee director’s service to the Vesting Meeting and (ii) the non-employee director not engaging in “competition”, as defined in a restricted stock grant agreement executed by the non-employee director, to the Vesting Time.

On May 31, 2017, the Company issued 23,700 unvested performance-based restricted stock shares to certain key employees. The vesting of these shares is subject to the achievement of certain Company performance and market conditions that must be met on or before May 30, 2024.

On June 15, 2017, the Company issued 6,594 unvested restricted shares to certain Executive Officers related to performance-based restricted stock grants as part of the Company’s 2017 Management Incentive Plan (the "2017 MIP Grants"). The 2017 MIP Grants have a one year vesting period from date of grant, subject to the Company’s achievement of certain financial goals and other vesting provisions in the underlying restricted stock grant agreement.

Restrictions on the transfer of Company stock

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

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

10. ACCUMULATED OTHER COMPREHENSIVE INCOME

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

	Minimum pension liability	Foreign currency translation	Total accumulated other comprehensive income
Balances at December 31, 2016	$ (501)	$ 598	$ 97
Current period other comprehensive income	—	125	125
Balances at September 30, 2017	$ (501)	$ 723	$ 222

11. COMMITMENTS AND CONTINGENCIES

The Company holds certain rights to market and manufacture all products developed or created under certain research, development and licensing agreements with various entities. In connection with such agreements, the Company has agreed to pay the entities royalties on net product sales. In each of the the three months ended September 30, 2017 and 2016, royalties of $0.1 million became payable under these agreements. In each of the nine months ended September 30, 2017 and 2016, royalties of $0.3 million became payable under these agreements.

The Company has contracts with suppliers for unconditional annual minimum inventory purchases in the amounts of approximately $0.3 million for the remainder of 2017 and $0.6 million in 2018.

From time to time, the Company may be involved in litigation relating to claims arising out of its operations. On March 12, 2015, a complaint was filed against us by Shaun Fauley in the United States District Court Northern District of Illinois alleging our transmittal of unauthorized faxes in violation of the federal Telephone Consumer Protection Act of 1991, as amended by the Junk Fax Prevention Act of 2005, as a class action seeking stated damages of the greater of actual monetary loss or five hundred dollars per violation. The Company intends to defend itself vigorously in this matter and at this time is unable to estimate a possible loss or range of loss. As of September 30, 2017, the Company was not a party to any other legal proceedings that were expected, individually or in the aggregate, to have a material adverse effect on its business, financial condition or operating results.

The Company's current terms and conditions of sale include a limited warranty that its products and services will conform to published specifications at the time of shipment and a more extensive warranty related to certain of its products. The Company also sells a renewal warranty for certain of its products. The typical remedy for breach of warranty is to correct or replace any defective product, and if not possible or practical, the Company will accept the return of the defective product and refund the amount paid. The Company's warranty reserve was $0.4 million at both September 30, 2017 and December 31, 2016.

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

12. INTEREST AND OTHER INCOME, NET

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Interest income	$(41)	$(30)	$(122)	$(93)
Interest expense	81	54	156	130
Other expense (income), net	(46)	(10)	(220)	(122)
Total interest and other expense (income), net	$(6)	$14	$(186)	$(85)

Cash paid for interest for the three months ended September 30, 2017 and 2016 was $67 thousand and $20 thousand, respectively. Cash paid for interest for the nine months ended September 30, 2017 and 2016 was $125 thousand and $56 thousand, respectively.

13. CREDIT FACILITY

On July 27, 2017, we entered into a Credit Agreement (the "Credit Agreement") with JP Morgan Chase Bank, N.A. ("Chase"), which provides for a new revolving credit facility of up to $30.0 million (the "Credit Facility"). The Credit Facility provides us with the ability to borrow up to $30.0 million, although the amount of the Credit Facility may be increased by an additional $20.0 million up to a total of $50.0 million subject to receipt of additional lender commitments and other conditions. Any interest on borrowings due is to be charged at either the (i) rate of interest per annum publicly announced from time to time by Chase as its prime rate in effect at its principal offices in New York City, subject to a floor, minus 1.65%, or (ii) the interest rate per annum equal to (a) LIBOR for the interest period in effect multiplied by (b) Chase's Statutory Reserve Rate (as defined in the Credit Agreement), plus 1.10% and payable monthly. There is an annual minimum interest charge of $60 thousand under the Credit Agreement. Borrowings under the Credit Facility are subject to certain financial and non-financial covenants and are available for various corporate purposes, including general working capital, capital investments, and certain permitted acquisitions. The Credit Agreement also permits us to issue letters of credit. The maturity date of the Credit Facility is July 27, 2020. The foregoing discussion of the new Credit Facility is a summary only and is qualified in its entirety by reference to the full text of the Credit Agreement, a copy of which has been filed as an exhibit to the Company's Current Report on Form 8-K filed with the SEC on August 2, 2017. At September 30, 2017, we had $6.3 million borrowings outstanding on this line of credit and we were in compliance with all financial covenants.

Concurrent with the Credit Agreement, we repaid all outstanding balances and closed our asset-based revolving line of credit with Wells Fargo, which had a maturity date of December 31, 2017. Our outstanding balance under this arrangement at December 31, 2016 was $0.7 million.

14. SEGMENT REPORTING

The Company consists of two reportable segments, Core Companion Animal Health ("CCA") and Other Vaccines, Pharmaceuticals and Products ("OVP"). The 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. The CCA segment also includes digital radiography and ultrasound products along with embedded software and support, data hosting and other services. These products are sold directly by the Company as well as through independent third-party distributors and through other distribution relationships. CCA segment products manufactured at the Des Moines, Iowa production facility included in the OVP

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

segment's assets are transferred at cost and are not recorded as revenue for the OVP segment. The OVP segment includes private label vaccine and pharmaceutical production, primarily for cattle, but also for other animals including small mammals. All OVP products are sold by third parties under third-party labels.

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

Three Months Ended September 30, 2017	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 26,670	$ 4,758	$31,428
Operating income	3,068	710	3,778
Income before income taxes	3,074	710	3,784
Capital purchases	34	669	703
Depreciation and amortization	935	259	1,194
Three Months Ended September 30, 2016	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 26,386	$ 7,044	$33,430
Operating income	2,995	1,497	4,492
Income before income taxes	2,994	1,484	4,478
Capital purchases	202	556	758
Depreciation and amortization	996	212	1,208
Nine months ended September 30, 2017	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 78,299	$ 17,847	$96,146
Operating income	6,763	4,363	11,126
Income before income taxes	6,971	4,341	11,312
Capital purchases	119	1,879	1,998
Depreciation and amortization	2,837	749	3,586
Nine months ended September 30, 2016	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 74,284	$ 16,257	$90,541
Operating income	7,499	2,519	10,018
Income before income taxes	7,526	2,577	10,103
Capital purchases	681	1,445	2,126
Depreciation and amortization	2,807	611	3,418

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
United States	$28,795	$30,003	$87,824	$83,958
Europe	736	1,398	1,820	2,830
Canada	974	918	3,255	1,724
Other International	923	1,111	3,247	2,029
Total	$31,428	$33,430	$96,146	$90,541

Asset information by reportable segment as of September 30, 2017 is as follows (in thousands):

	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total assets	$ 112,453	$ 23,193	$135,646
Net assets	77,783	23,244	101,027

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

	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total assets	$ 110,995	$ 19,849	$130,844
Net assets	68,072	18,903	86,975

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

	September 30, 2017	December 31, 2016
United States	$ 132,734	$127,827
Europe	2,912	3,017
Total	$ 135,646	$130,844

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the unaudited Condensed Consolidated Financial Statements and related Notes included in Part I Item 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, research and development expenses, general and administrative expenses, capital resources, additional financings or borrowings and additional losses, are subject to risks and uncertainties, including, but not limited to, those discussed below and elsewhere in this Form 10-Q, particularly in Part II, Item 1A "Risk Factors," that could

cause actual results to differ materially from those projected. The forward-looking statements set forth in this Form 10-Q are as of the close of business on

November 3, 2017 and we undertake no duty and do not intend to update this information, except as required by applicable laws.

Overview

We sell advanced veterinary diagnostic and specialty products. Our offerings include blood testing instruments and supplies, digital imaging products, software and services, vaccines, local and cloud-based data services, allergy testing and immunotherapy, and single-use offerings such as in-clinic diagnostic tests and heartworm preventive products. Our core focus is on supporting veterinarians in the canine and feline healthcare space.

Our business consists of two reportable segments, Core Companion Animal Health ("CCA"), which represented 85% and 81% of our revenue for the three and nine months ended September 30, 2017, respectively, and Other Vaccines, Pharmaceuticals and Products ("OVP"), which represented 15% and 19% of our revenue for the three and nine months ended September 30, 2017, respectively.

The CCA segment includes, primarily for canine and feline use, blood testing instruments and supplies, digital imaging products, software and services, local and cloud-based data services, allergy testing and immunotherapy, and single use offerings such as in-clinic diagnostic tests and heartworm preventive products.

Revenue from blood testing instruments and consumable supplies represented $14.9 million and $43.6 million for the three and nine months ended September 30, 2017, respectively. Revenue in this area primarily involves 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 $10.4 million and $30.6 million of our revenue resulted from the sale of such consumables to an installed base of instruments for the three and nine months ended September 30, 2017, respectively. Approximately $4.5 million and $13.0 million of our revenue was from instrument revenue for the three and nine months ended September 30, 2017, respectively. Instruments placed are considered operating or capital leases, depending on the duration and other factors of the underlying subscription agreement. A loss of, or disruption in, the supply of consumables we are selling to an installed base of instruments could substantially harm our business. All of our blood testing and other non-imaging instruments and supplies are supplied by third parties, who typically own the product rights and supply the product to us under marketing and/or distribution agreements. In many cases, we have collaborated with a third party to adapt a human instrument for veterinary use. Major products in this area include our instruments for chemistry, hematology, blood gas, and immunodiagnostic testing and their affiliated operating consumables.

Imaging hardware, software and services represented approximately $4.3 million and $13.6 million of our revenue for the three and nine months ended September 30, 2017, respectively. Digital radiography is the largest product offering in this area, which also includes ultrasound instruments. Digital radiography solutions typically consist of a combination of hardware and software placed with a customer, often combined with an ongoing service and support contract. We sell our imaging solutions both in the United States and internationally. Our experience has been that most of the revenue is generated at the time of sale in this area, in contrast to the blood testing category discussed above where ongoing consumable revenue is often a larger component of economic value as a given blood testing instrument is used.

Other CCA revenue, including single use diagnostic and other tests, pharmaceuticals and biologicals as well as research and development, licensing and royalty revenue, represented approximately $7.5 million and $21 million of our revenue for the three and nine months ended September 30, 2017, respectively. Since items in this area are often single use by their nature, our typical aim is to build customer satisfaction and loyalty for each product, generate repeat annual sales from existing customers and expand our customer base

in the future. Products in this area are both supplied by third parties and provided by us. Major products and services in this area include heartworm diagnostic tests and preventives, and allergy test kits, allergy immunotherapy and testing.

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

All of our CCA products are ultimately sold primarily to or through veterinarians. In many cases, veterinarians will mark up their costs to their customer. The acceptance of our products by veterinarians is critical to our success. CCA products are sold directly to end users by us as well as through distribution relationships, such as our agreement with Merck Animal Health, the sale of kits to conduct blood testing to third-party veterinary diagnostic laboratories and independent third-party distributors. Revenue from direct sales and distribution relationships represented approximately 57% and 43%, respectively, of CCA revenue for the nine months ended September 30, 2017.

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

Our OVP segment includes private label vaccine and pharmaceutical production, primarily for cattle but also for other species including equine, porcine, avian, feline and canine. All OVP products are sold by third parties under third-party labels.

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

Results of Operations

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Revenue	$31,428	$33,430	$96,146	$90,541
Gross profit	13,553	13,718	41,691	37,842
Operating expenses	9,775	9,226	30,565	27,824
Operating income	3,778	4,492	11,126	10,018
Interest and other expense (income), net	(6)	14	(186)	(85)
Income before income taxes	3,784	4,478	11,312	10,103
Income tax expense	701	1,135	787	2,571
Net income	3,083	3,343	10,525	7,532
Net income (loss) attributable to non-controlling interest	—	(4)	(498)	477
Net income attributable to Heska	$3,083	$3,347	$11,023	$7,055

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Revenue	100.0 %	100.0 %	100.0 %	100.0 %
Gross profit	43.1 %	41.0 %	43.4 %	41.8 %
Operating expenses	31.1 %	27.6 %	31.8 %	30.7 %
Operating income	12.0 %	13.4 %	11.6 %	11.1 %
Interest and other expense (income), net	— %	— %	(0.2)%	(0.1)%
Income before income taxes	12.0 %	13.4 %	11.8 %	11.2 %
Income tax expense	2.2 %	3.4 %	0.8 %	2.8 %
Net income	9.8 %	10.0 %	10.9 %	8.3 %
Net income (loss) attributable to non-controlling interest	— %	— %	(0.5)%	0.5 %
Net income attributable to Heska	9.8 %	10.0 %	11.5 %	7.8 %

Revenue

Total revenue decreased 6% to $31.4 million in the three months ended September 30, 2017, compared to $33.4 million in the three months ended September 30, 2016 and increased 6% to $96.1 million in the nine months ended September 30, 2017, compared to $90.5 million in the nine months ended September 30, 2016.

CCA segment revenue increased 1% to $26.7 million in the three months ended September 30, 2017, compared to $26.4 million in the three months ended September 30, 2016. The increase was driven primarily by a 16% increase in revenue from core blood diagnostics subscriptions, equipment and consumables, partially offset by a 27% decrease in revenue from sales of our imaging products. CCA segment revenue increased 5% to $78.3 million in the nine months ended September 30, 2017, compared to $74.3 million in the nine months ended September 30, 2016. The increase in the year to date period was driven primarily by a

23% increase in revenue from core blood diagnostics subscriptions, equipment and consumables, partially offset by a 21% decrease in revenue from sales of our imaging products.

OVP segment revenue decreased 32% to $4.8 million in the three months ended September 30, 2017, compared to $7.0 million in the three months ended September 30, 2016. The decrease is due to timing of sales under our Elanco agreement as well as other customer contracts. OVP segment revenue increased 10% to $17.8 million in the nine months ended September 30, 2017, compared to $16.3 million in the nine months ended September 30, 2016. The increase was driven primarily by increased revenue from sales under our agreement with Elanco.

Gross Profit

Gross profit decreased 1% to $13.6 million in the three months ended September 30, 2017, compared to $13.7 million in the three months ended September 30, 2016. Gross margin, which is gross profit divided by total revenue, increased to 43.1% in the three months ended September 30, 2017 compared to 41.0% in the three months ended September 30, 2016. The decrease in gross profit was driven primarily by a 6% decrease in overall sales, while the increase in gross margin percentage was driven primarily by favorable product mix as a larger percentage of our overall sales was generated by blood testing instruments and consumables, which produce higher gross margins than other parts of our business. Gross profit increased 10% to $41.7 million in the nine months ended September 30, 2017, compared to $37.8 million in the nine months ended September 30, 2016. Gross margin increased to 43.4% in the nine months ended September 30, 2017, compared to 41.8% in the nine months ended September 30, 2016. The increase in gross profit for the year to date period was driven primarily by a 6% increase in overall sales, while the increase in gross margin percentage was driven primarily by favorable product mix in our OVP segment.

Operating Expenses

Selling and marketing expenses increased 6% to $5.8 million in the three months ended September 30, 2017, compared to $5.5 million in the three months ended September 30, 2016. The increase was driven primarily by a $0.3 million increase in compensation and benefits related to the expansion of our sales force to support our market share growth, as well as smaller increases in stock compensation expense and travel. Selling and marketing expenses increased 9% to $17.9 million in the nine months ended September 30, 2017 compared to $16.5 million in the nine months ended September 30, 2016. The increase was driven primarily by a $0.8 million increase in compensation and benefits and a $0.4 million increase in stock compensation.

Research and development expenses increased 19% to $0.6 million in the three months ended September 30, 2017, compared to $0.5 million in the three months ended September 30, 2016. The increase was driven primarily by an increase in the purchase of general supplies for development projects in the quarter. Research and development expenses were relatively flat at $1.6 million in both the nine months ended September 30, 2017 and 2016.

General and administrative expenses increased 4% to $3.4 million in the three months ended September 30, 2017, compared to $3.2 million in the three months ended September 30, 2016. The increase was driven primarily by a $0.3 million increase in general consulting and a $0.1 million increase in facility costs, offset by a decrease in compensation and benefits of $0.4 million. General and administrative expenses increased 14% to $11.1 million in the nine months ended September 30, 2017 compared to $9.7 million in the nine months ended September 30, 2016. The increase was driven primarily by a $0.8 million increase in general consulting services, $0.4 million increase in compensation and benefits, and a $0.2 million increase in intangible amortization due to the acquisition of Cuattro Veterinary, LLC, in the later part of the comparable period a year ago.

Interest and Other Expense (Income), net

Interest and other expense (income), net, was income of $6 thousand in the three months ended September 30, 2017, compared to expense of $14 thousand in the three months ended September 30, 2016. This increase in other income was driven primarily by a $36 thousand increase in net foreign currency gains offset by a $15 thousand increase in interest expense.

Interest and other expense (income), net, was income of $186 thousand in the nine months ended September 30, 2017, as compared to income of $85 thousand in the nine months ended September 30, 2016. The increase in other income was driven primarily by an increase in net foreign currency gains.

Income Tax Expense

In the three months ended September 30, 2017, we had total income tax expense of $0.7 million, which was primarily domestic deferred income tax expense, a non-cash item primarily related to our domestic NOL position. In the three months ended September 30, 2016, we had total income tax expense of $1.1 million, including $1.0 million of domestic deferred income tax expense and $0.1 million of current income tax expense. In the nine months ended September 30, 2017 we had total income tax of $787 thousand, which was primarily domestic deferred income tax expense. In the nine months ended September 30, 2016, we had total income tax expense of $2.6 million, including $2.3 million of domestic deferred income tax expense and $0.3 million of current income tax expense.

The decrease in tax expense in both periods was primarily attributable to an increase in stock-based compensation excess tax benefits, which are now recorded as income tax expense or benefit in accordance with our policy

As of September 30, 2017, the Company assessed whether the reduction of taxable income due to large benefits created by stock option exercises and vesting of restricted stock and the excess tax benefits would cause a larger portion of our deferred tax assets ("DTAs") to likely expire unrealized. The Company assessed its ability to realize the DTAs by evaluating all available positive and negative evidence, including (1) cumulative results of operations in recent years, (2) sources of recent pre-tax losses, (3) estimates of future taxable income, and (4) the length of Net Operating Loss ("NOL") carryforward periods. Additionally, the Company considered the length of NOL carryforward periods and an objectively verifiable estimate of future income based on operating results from the Company’s recent history, as well as an estimate of future income that incorporates the Company's forecasted operating results for fiscal 2017. Due to the significant amount of additional stock based compensation excess tax deduction generated, the Company determined that the negative evidence outweighed the positive evidence and that the threshold of more-likely-than-not was not met and that sufficient taxable income may not be generated to realize all of the DTAs as of September 30, 2017. As such, an additional $1.3 million and $3.1 million was recorded to the current partial valuation allowance against the Company’s DTAs during the three and nine months ended September 30, 2017, respectively, which was partially offset by other adjustments to the valuation allowance. The Company will continue to closely monitor the need for an additional valuation allowance against its DTAs in each subsequent reporting period which can be impacted by actual operating results compared to the Company's forecast.

Net Income attributable to Heska

Net income attributable to Heska was $3.1 million for the three months ended September 30, 2017, compared to net income attributable to Heska of $3.3 million in the prior year period. Net income attributable to Heska was $11.0 million for the nine months ended September 30, 2017, compared to net income attributable to Heska of $7.1 million in the prior year period. The difference between this line item and "Net Income" is the net income or loss attributable to our minority interest in US Imaging, which we purchased on May 31, 2017. As a result of the purchase, there was no difference between these line items in the three months ended September 30, 2017, compared to a gain of $4 thousand in the three months ended September 30, 2016. The difference between these line items was a gain of $0.5 million in the nine months ended September 30, 2017 compared to a loss of $0.5 million in the nine months ended September 30, 2016.

Impact of Inflation

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

Liquidity, Capital Resources and Financial Condition

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

For the nine months ended September 30, 2017, we had net income of $10.5 million and net cash provided by operations of $6.3 million. At September 30, 2017, we had $7.4 million of cash and cash equivalents and working capital of $32.2 million.

On July 27, 2017, we entered into a Credit Agreement (the "Credit Agreement") with JP Morgan Chase Bank, N.A. ("Chase"), which provides for a new revolving credit facility of up to $30.0 million (the "Credit Facility"). The Credit Facility provides us with the ability to borrow up to $30.0 million, although the amount of the Credit Facility may be increased by an additional $20.0 million up to a total of $50.0 million subject to receipt of additional lender commitments and other conditions. Any interest on borrowings due is to be charged at either the (i) rate of interest per annum publicly announced from time to time by Chase as its prime rate in effect at its principal offices in New York City, subject to a floor, minus .0165, or (ii) the interest rate per annum equal to (a) LIBOR for the interest period in effect multiplied by (b) Chase's Statutory Reserve Rate (as defined in the Credit Agreement), plus 1.10% and payable monthly. There is an annual minimum interest charge of $60 thousand under the Credit Agreement. Borrowings under the Credit Facility are subject to certain financial and non-financial covenants and are available for various corporate purposes, including general working capital, capital investments, and certain permitted acquisitions. The Credit Agreement also permits us to issue letters of credit. The maturity date of the Credit Facility is July 27, 2020. The foregoing discussion of the new Credit Facility is a summary only and is qualified in its entirety by reference to the full text of the Credit Agreement, a copy of which has been filed as an exhibit to the Company's Current Report on Form 8-K filed with the SEC on August 2, 2017. At September 30, 2017, we had $6.3 million borrowings outstanding on this line of credit and were in compliance with all financial covenants.

Concurrent with the Credit Agreement, we repaid all outstanding balances and closed our asset-based revolving line of credit with Wells Fargo, which had a maturity date of December 31, 2017. Our outstanding balance under this arrangement at December 31, 2016 was $0.7 million.

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

	Nine Months Ended September 30,	
	2017	2016
Net cash provided by operating activities	$6,278	$1,881
Net cash used in investing activities	(15,749)	(1,295)
Net cash provided by financing activities	6,027	1,699
Effect of currency translation on cash	73	39
Increase (Decrease) in cash and cash equivalents	(3,371)	2,324
Cash and cash equivalents, beginning of the period	10,794	6,890
Cash and cash equivalents, end of the period	$7,423	$9,214

Net cash provided by operating activities was $6.3 million in the nine months ended September 30, 2017, compared to net cash provided in operating activities of $1.9 million in the nine months ended September 30, 2016, an increase of approximately $4.4 million. The increase in cash provided by operations was driven primarily by a $7 million increase in cash provided by accounts receivable, a $5.0 million decrease in cash used for accounts payable, a $2.9 million increase in net income, a $1.0 million decrease in cash used in deferred revenue and other and a $0.4 million increase in stock-based compensation, partially offset by a $4.8 million increase in cash used for inventory, a $2.9 million increase in cash used in other current assets, a $2.3 million reduction of accrued liabilities and other, a $1.5 million decrease in deferred tax expense, and a $0.6 million increase in cash used in other non-current assets.

Net cash used in investing activities was $15.7 million in the nine months ended September 30, 2017, compared to net cash used in investing activities of $1.3 million in the nine months ended September 30, 2016, an increase of approximately $14.5 million. The increase was driven primarily by our purchase of the minority interest in US Imaging for $13.8 million and a $0.7 million decrease in proceeds from the disposition of property, plant and equipment, partially offset by a $0.1 million decrease in purchase of property, plant and equipment and $0.1 million of cash generated by the sale of an equity investment that occurred in the first quarter of 2016.

Net cash provided by financing activities was $6.0 million in the nine months ended September 30, 2017, compared to net cash provided by financing activities of $1.7 million in the nine months ended September 30, 2016, which represented a $4.3 million increase in cash provided by financing activities. The change was driven primarily by a $1.7 million increase in proceeds from issuance of common stock, a $4.2 million increase in borrowings, net of repayments, from our line of credit used to partially finance the purchase of the minority interest in US Imaging, offset by $0.9 million of stock repurchased to cover employee tax payments, $1.0 million of distributions to non-controlling interest members and the repayment of other debt.

Following and in connection with the closing of the purchase of the minority interest in US Imaging, on June 1, 2017, the Company consolidated its assets and liabilities in the US Imaging and International Imaging companies into Heska Imaging Global, LLC, which was re-named Heska Imaging, LLC ("Heska Imaging").

At September 30, 2017, Heska Corporation had receivables from Cuattro, LLC of $22 thousand, which is included in "Due from – related parties" on the Company's consolidated balance sheets.

Our financial plan for 2017 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 for the foreseeable future. Additionally, we would consider additional acquisitions if we felt they were consistent with our strategic direction. However, our actual results may differ from this plan and we may be required to consider alternative strategies. We may be required to raise additional capital in the future. If necessary, we expect to raise these additional funds through the increased sale of customer leases, the sale of equity securities or the issuance of new term debt. There is no guarantee that additional capital will be available from these sources on acceptable terms, if at all, and certain of these sources may require approval by existing lenders. See "Risk Factors" in Item 1A of this Form 10-Q for a discussion of some of the factors that affect our capital raising alternatives.

Effect of currency translation on cash

Net effect of foreign currency translations on cash changed $34 thousand to a $73 thousand positive impact in the nine months ended September 30, 2017, compared to a $39 thousand positive impact in the nine months ended September 30, 2016. These effects are related to changes in exchange rates between the United States dollar and the Swiss Franc, which is the functional currency of our Swiss subsidiary.

Off Balance Sheet Arrangements

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

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with U.S. GAAP requires us to make judgments, assumptions and estimates that affect the amounts reported in the unaudited Condensed Consolidated Financial Statements and accompanying notes. Note 1 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2016 describes the significant accounting policies and methods used in the preparation of these unaudited Condensed Consolidated Financial Statements. Our critical accounting estimates, discussed in the Management's Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2016, except as noted below, include estimates for revenue recognition, allowances for doubtful accounts, accounting for income taxes, and assessing excess and obsolete inventories. Such accounting policies and estimates require significant judgments and assumptions to be used in the preparation of the unaudited Condensed Consolidated Financial Statements and actual results could differ materially from the amounts reported based on variability in factors affecting these estimates.

Revenue Recognition

We generate our revenue through the sale of products, either by outright purchase by our customers or through a subscription agreement whereby our customers receive specified blood-testing equipment and pay us a monthly fee for the usage of the equipment as well as the consumables needed to conduct testing. Additionally, we may recognize rental revenue for certain of our equipment in our digital imaging product line in which we are paid a monthly rental fee for usage of the equipment. We also may recognize revenue 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 have been rendered;
•Price is fixed or determinable; and
•Collectability is reasonably assured.

Revenue from the outright sale of products to customers 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 our subscription agreements is recognized based on the length of the agreements that are signed by our customers. Among other factors, the length of the agreement determines whether a subscription is considered an operating lease or capital lease. For subscription agreements that are considered operating leases, we recognize revenue and the associated cost of the equipment portion of our subscriptions ratably over the term of the agreement. The equipment is transferred from inventory to property, plant and equipment and depreciated over the assets' useful life. Revenue from subscription agreements that are considered capital leases is recognized, along with the associated cost of the equipment, at the time of placement in our customer's location. The amount of revenue recognized at the time of lease inception is based on observable prior sales prices of similar equipment sold by us over the prior twelve months, which is the amount determined to be the fair value.

Revenue from our rentals of digital imaging equipment is recognized ratably over the term of the rental agreement, which is typically over a 24-month period. The equipment is transferred from inventory to property, plant and equipment and depreciated over the assets' useful life.

Recording revenue from the sale of products involves the use of estimates and management's 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 collectability is reasonably assured is ultimately a judgment decision that must be made by management. We must also make estimates regarding our future obligations 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.

We may enter into arrangements that include multiple elements. 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.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

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

Interest Rate Risk

At September 30, 2017, $6.3 million was outstanding on our line of credit with Chase. We had no interest rate hedge transactions in place on September 30, 2017. We completed an interest rate risk sensitivity analysis based on the above and an assumed one-percentage point increase in interest rates would have an approximate $63 thousand negative impact on our pre-tax earnings based on our outstanding balances as of September 30, 2017.

Foreign Currency Risk

Our investment in foreign assets consists primarily of our investment in our Swiss subsidiary. Foreign currency risk may impact our results of operations. In cases where we purchase inventory in one currency and sell corresponding products in another, our gross margin percentage is typically at risk based on foreign currency exchange rates. In addition, in cases where we may be generating operating income in foreign currencies, the magnitude of such operating income when translated into U.S. dollars will be at risk based on foreign currency exchange rates. Our agreements with suppliers and customers vary significantly in regard to the existence and extent of currency adjustment and other currency risk sharing provisions. We had no foreign currency hedge transactions in place on September 30, 2017.

Our subsidiary in Switzerland uses the Swiss Franc as its functional currency. We purchase inventory in foreign currencies, primarily Euros, and sell corresponding products in U.S. dollars. We also sell products in foreign currencies, primarily Euros and Japanese Yen, where our inventory costs are largely in U.S. dollars. We also have entered into contracts for which payments are adjusted for changes in foreign currency rates, including the Chinese Yuan. Based on our results of operations for the twelve months ending September 30, 2017, currency holdings and currency-related prepaid accounts, accounts receivable and accounts payable (all of which, including currency holdings, we will refer to as "Currency Accounts") and the functional currency of the accounting entity where such Currency Accounts are held, the expected impact on our consolidated statements of income, if foreign currency exchange rates were to strengthen/weaken by 25% against the U.S. dollar, would be a resulting gain/loss in operating income of approximately $622 thousand and a currency loss/gain of $214 thousand. If all other currencies were to strengthen/weaken by 25% against the Swiss Franc, there would be a resulting loss/gain in operating income of approximately $58 thousand and a currency

gain/loss of $431 thousand. If all other currencies were to strengthen/weaken by 25% against the Euro, there would be a resulting loss/gain in operating income of approximately $373 thousand and a currency loss/gain of $217 thousand. If all other currencies were to strengthen/weaken by 25% against the Yuan, the resulting loss/gain in operating income would be approximately $332 thousand, but no resulting currency loss/gain.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and our chief financial officer, evaluated the effectiveness of our disclosure controls and procedures, as defined by Rule 13a-15c 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 chief financial officer have concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time 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.

Changes in Internal Control over Financial Reporting

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

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

From time to time, we may be involved in litigation related to claims arising out of our operations. On March 12, 2015, a complaint was filed against us by Shaun Fauley in the United States District Court Northern District of Illinois alleging our transmittal of unauthorized faxes in violation of the federal Telephone Consumer Protection Act of 1991, as amended by the Junk Fax Prevention Act of 2005, as a class action seeking stated damages of the greater of actual monetary loss or five hundred dollars per violation. The Company intends to defend itself vigorously in this matter. Not withstanding the foregoing, at this time we are unable to estimate the possible loss or range of possible loss. As of September 30, 2017, we were not a party to any other legal proceedings that are expected, individually or in the aggregate, to have a material adverse effect on our business, financial condition or operating results. Information regarding reportable legal proceedings is contained in Note 11, Commitments and Contingencies, of the unaudited condensed consolidated financial statements in this Quarterly Report on Form 10-Q.

Item 1A. Risk Factors

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

We have significant related party transactions, including the recent purchase of the minority interest in Heska Imaging US, LLC .

Cuattro, LLC is a supplier to Heska Imaging, LLC under an Amended and Restated Master License Agreement and a Supply Agreement originally negotiated at arm's length as part of the acquisition by Heska Corporation of a majority interest in a predecessor entity to Heska Imaging, LLC. As discussed below, Mr. Wilson has an interest in these agreements and any time and resources devoted to monitoring and overseeing this relationship may prevent us from deploying such time and resources on more productive matters.

Mr. Wilson's employment agreement with us acknowledges that Mr. Wilson has business interests in Cuattro, LLC, Cuattro Software, LLC and Cuattro Medical, LLC which may require a portion of his time, resources and attention in his working hours. If Mr. Wilson is distracted by these or other business interests, he may not contribute as much as he otherwise would have to enhancing our business, to the detriment of our stockholder value. Mr. Wilson is the spouse of Shawna M. Wilson ("Mrs. Wilson"). Mr. Wilson, Mrs. Wilson and trusts for their children and family own a majority interest in Cuattro Medical, LLC. In addition, including shares held by Mrs. Wilson and by trusts for the benefit of Mr. and Mrs. Wilson's children and family, Mr. Wilson also owns a 100% interest in Cuattro, LLC, the largest supplier to Heska Imaging, our wholly-owned subsidiary. Cuattro, LLC owns a 100% interest in Cuattro Software, LLC.
Cuattro, LLC charged Heska Imaging $13.9 million during the nine months ended September 30, 2017, primarily related to digital imaging products, for which there is an underlying supply contract with minimum purchase obligations, software and services as well as other operating expenses; Heska Corporation charged Heska Imaging $2.9 million during the five months ended May 31, 2017, prior to the purchase of the minority interest on June 1, 2017, primarily related to sales expenses; and Heska Corporation charged Cuattro, LLC $99 thousand during the nine months ended September 30, 2017, primarily related to facility usage and other services.
Heska Corporation had receivables from Cuattro, LLC of $22 thousand, which is included in "Due from – related parties" on the Company's consolidated balance sheet.
We may face costly legal disputes, including related to our intellectual property or technology or that of our suppliers or collaborators.

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

We may become subject to patent infringement claims and litigation in the United States or other countries or interference proceedings conducted in the United States Patent and Trademark Office, or USPTO, to determine the priority of inventions. The defense and prosecution of intellectual property suits, USPTO interference proceedings and related legal and administrative proceedings are likely to be costly, time-

consuming and distracting. As is typical in our industry, from time to time we and our collaborators and suppliers have received, and may in the future receive, notices from third parties claiming infringement and invitations to take licenses under third-party patents. Any legal action against us or our collaborators or suppliers may require us or our collaborators or suppliers to obtain one or more licenses in order to market or manufacture effected products or services. However, we or our collaborators or suppliers may not be able to obtain licenses for technology patented by others on commercially reasonable terms, or at all, or to develop alternative approaches to access or replace such technology if unable to obtain licenses or current and future licenses may not be adequate, any of which could substantially harm our business.

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

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

We are party to an agreement with Merck Animal Health, which grants Merck Animal Health exclusive distribution and marketing rights for our canine heartworm preventive product, TRI-HEART Plus Chewable Tablets, ultimately sold to or through veterinarians in the United States and Canada. Historically, a significant portion of our OVP segment's revenue has been generated from the sale of certain bovine vaccines, which have been sold primarily under the Titanium® and MasterGuard® brands. We have a supply agreement with Eli Lilly and its affiliates operating through Elanco for the production of these vaccines. Either of these marketing partners may not devote sufficient resources to marketing our products and our sales and financial position could suffer significantly as a result. Revenue from Merck & Co., Inc. ("Merck") entities, including Merck Animal Health, represented 11% of our LTM revenue. Revenue from Eli Lilly entities, including Elanco, represented 12% of our LTM revenue. If Merck Animal Health personnel fail to market, sell and support our heartworm preventive sufficiently or if Elanco personnel fail to market, sell and support the bovine vaccines we produce and sell to Elanco sufficiently, our sales could decline significantly. Furthermore, there may be nothing to prevent these partners from pursuing alternative technologies, products or supply arrangements, including as part of mergers, acquisitions or divestitures. For example, we believe a unit of Merck has obtained FDA approval for a canine heartworm preventive product with additional claims compared with our TRI-HEART Plus Chewable Tablets, but which we believe is not currently being marketed actively. Should Merck decide to emphasize sales and marketing efforts of this product rather than our TRI-HEART Plus Chewable Tablets or cancel our agreement regarding canine heartworm preventive distribution and marketing, our sales could decline significantly. In another example, if Elanco were to emphasize sales and marketing efforts for bovine vaccines other than those we produce or cancel our supply agreement and produce the vaccines we supply to it by itself, our sales could decline significantly. Third-party marketing assistance may not be available in the future on reasonable terms, if at all. If the third parties with marketing rights for our products were to merge or go out of business, the sale and promotion of our products could be diminished.

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

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

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

The loss of access to products from one or more suppliers could have a significant, negative impact on our business. Major suppliers who sell us proprietary products who are responsible for more than 5% of our LTM revenue are FUJIFILM Corporation, Cuattro, LLC, and Shenzen Mindray Bio-Medical Electronics Co., Ltd. None of these suppliers sold us products which were responsible for more than 25% of our LTM revenue, although products purchased from one of these suppliers was responsible for more than 20% of our LTM revenue and products purchased from another was responsible for more than 10% of our LTM revenue. We often purchase products from our suppliers under agreements that are of limited duration or potentially can be terminated on an annual basis. In the case of our blood testing instruments and our digital radiography solutions, post-termination, we are typically entitled to non-exclusive access to consumable supplies, or ongoing non-exclusive access to products and services to meet the needs of an existing customer base, respectively, for a defined period upon expiration of exclusive rights, which could subject us to competitive pressures in the period of non-exclusive access. Although we believe we will be able to maintain a supply of our major product and service offerings in the near future, there can be no assurance that our suppliers will meet their obligations under any agreements we may have in place with them or that we will be able to compel them to do so. Risks of relying on suppliers include:

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

adverse effect on our business, particularly if we are unable to identify and implement an alternative source of supply in a timely manner.

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

and could expose us to legal action if we are unable to perform on contracts to our customers involving related products.

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

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

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

Revenue from Butler Animal Health Supply, LLC d/b/a Henry Schein Animal Health ("Henry Schein") represented approximately 16% and 17% of our consolidated revenue for the nine and three months ended September 30, 2017 as well as 13% and 12% of our consolidated revenue for the nine and three months ended September 30, 2016, respectively. Revenue from Merck entities, including Merck Animal Health, represented approximately 11% and 14% of our consolidated revenue for the nine and three months ended September 30, 2017 as well as 11% and 12% of our consolidated revenue for the nine and three months September 30, 2016, respectively. Revenue from Eli Lilly entities, including Elanco, represented approximately 12% and 11% of our consolidated revenue for the nine and three months ended September 30, 2017 as well as 13% and 15% of our consolidated revenue for the nine and three months ended September 30, 2016, respectively. No other customer accounted for more than 10% of our consolidated revenue for the nine and three months ended September 30, 2017 or 2016.

Henry Schein represented 15% and 16% of our consolidated accounts receivable at September 30, 2017 and December 31, 2016, respectively. Eli Lilly entities, including Elanco accounted for approximately 20% and 15% of our consolidated accounts receivable at September 30, 2017 and December 31, 2016, respectively. Merck entities accounted for 20% and 11% of our consolidated accounts receivable at September 30, 2017 and December 31, 2016, respectively. No other customer accounted for more than 10% of our consolidated accounts receivable at September 30, 2017 or December 31, 2016, respectively.

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

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

The market in which we compete is intensely competitive. Our competitors include independent animal health companies and major pharmaceutical companies that have animal health divisions. We also compete with independent, third-party distributors, including distributors who sell products under their own private labels. In the point-of-care diagnostic testing market, our major competitors include IDEXX Laboratories, Inc. ("IDEXX"), Abaxis Inc. ("Abaxis"), and Zoetis Inc. ("Zoetis"). The products manufactured by our OVP segment for sale by third parties compete with similar products offered by a number of other companies, some of which have substantially greater financial, technical, research and other resources than us and may have more established marketing, sales, distribution and service organizations than those of our OVP segment customers. Competitors may have facilities with similar capabilities to our OVP segment, which they may operate and sell at a lower unit price to customers than our OVP segment does, which could cause us to lose customers. Companies with a significant presence in the companion animal health market, such as Bayer AG, CEVA Santé Animale, Eli Lilly, Merck, Sanofi, Vétoquinol S.A. and Virbac S.A. may be marketing or developing products that compete with our products or would compete with them if developed. These and other competitors and potential competitors may have substantially greater financial, technical, research and other resources and larger, more established marketing, sales and service organizations than we do. For example, if Zoetis devotes its significant commercial and financial resources to growing its market share in the veterinary allergy market, our allergy-related sales could suffer significantly. Our competitors may offer broader product lines and have greater name recognition than we do. Our competitors may also develop or market technologies or products that are more effective or commercially attractive than our current or future products or that would render our technologies and products obsolete. Further, additional competition could come from new entrants to the animal health care market. Moreover, we may not have the financial resources, technical expertise or marketing, sales or support capabilities to compete successfully. One of our competitors, Abaxis, has announced agreements with units of VCA Inc. ("VCA") for the long-term supply of blood chemistry testing products to VCA-owned veterinary clinics and for the co-marketing of Abaxis' blood chemistry testing products with VCA's veterinary diagnostic laboratory offering, which may serve to intensify competition and lower our margins as well as limit our prospects to sell blood chemistry testing products to VCA-owned veterinary clinics.

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

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

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

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

We may not develop and maintain marketing and/or sales capabilities successfully, and we may not be able to make arrangements with third parties to perform these activities on satisfactory terms. If our

--39-

marketing and sales strategy is unsuccessful, our ability to sell our products will be negatively impacted and our revenues will decrease. This could result in the loss of distribution rights for products or failure to gain access to new products and could cause damage to our reputation and adversely affect our business and future prospects.

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

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

Our stock price has historically experienced high volatility, and could do so in the future, including experiencing a material price decline resulting from a large sale in a short period of time.
Should a relatively large stockholder decide to sell a large number of shares in a short period of time, it could lead to an excess supply of our shares available for sale and correspondingly result in a significant decline in our stock price.

The securities markets have experienced significant price and volume fluctuations and the market prices of securities of many small cap companies have in the past been, and can in the future be expected to be, especially volatile. During the twelve months ended September 30, 2017, the stock price of our Public Common Stock has ranged from a low of $46.51 to a high of $115.00. Fluctuations in the trading price or liquidity of our Public Common Stock may adversely affect our ability to raise capital through future equity financings. Factors that may have a significant impact on the market price and marketability of our Public Common Stock include:

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

--40-

- economic and other external factors; and
- general market conditions.

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

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

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

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

The effect of government regulation may be to delay or to prevent marketing of our products for a considerable period of time and to impose costly procedures upon our activities. We may not be able to estimate the time to obtain required regulatory approvals accurately and such approvals may require significantly more time than we anticipate. We have experienced in the past, and may experience in the future, difficulties that could delay or prevent us from obtaining the regulatory approval or license necessary to introduce or market our products. Such delays in approval may cause us to forego a significant portion of a

--41-

new product's sales in its first year due to seasonality and advanced booking periods associated with certain products. Regulatory approval of our products may also impose limitations on the indicated or intended uses for which our products may be marketed.

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

Any of these events, alone or in combination with others, could damage our business.

We intend to pursue acquisitions and other strategic development opportunities, which may not result as desired and could be detrimental to our financial position.

We intend to pursue acquisitions and other strategic development opportunities. The ultimate business and financial performance of these opportunities may not create, and may end up adversely affecting materially, the value we hope to enhance by pursuing them. Any acquisition may significantly underperform relative to our financial expectations and may serve to diminish rather than enhance stockholder value.

The success of any acquisition will depend on, among other things, our ability to integrate assets and personnel acquired in such a transaction and to apply our internal controls process to such an acquired business. The integration of acquisitions may require significant attention from our management, and the diversion of management's attention and resources could have a material adverse effect on our ability to manage our business. Furthermore, we may not realize the degree or timing of benefits we anticipated when we first entered into the transaction. If actual integration costs are higher than amounts originally anticipated, if we are unable to integrate the assets and personnel acquired in an acquisition as anticipated, or if we are unable to fully benefit from anticipated synergies, our business, financial condition, results of operations, and cash flows could be materially adversely affected. Furthermore, it is possible we will use management time and resources to pursue opportunities we ultimately are unable or decide not to consummate, in which case, we may not be able to utilize such management time and resources on what may have proved to be more productive matters in other areas of our business.

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

We are often dependent on third parties and collaborative partners to successfully and timely perform research and development activities to successfully develop new products. We routinely discuss Heska marketing in the veterinary market instruments being developed by third parties 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.

--42-

If these third parties or collaborative partners fail to complete research and development activities or 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.

Many of our expenses are fixed and if factors beyond our control cause our revenue to fluctuate, this fluctuation could cause greater than expected losses, cash flow and liquidity shortfalls.

We believe that our future operating results will fluctuate on a quarterly basis due to a variety of factors which are generally beyond our control, including:

- supply of products from third-party suppliers or termination, cancellation or expiration of such relationships;
- competition and pricing pressures from competitive products;
- the introduction of new products or services by our competitors or by us;
- large customers failing to purchase at historical levels;
- fundamental shifts in market demand;
- manufacturing delays;
- shipment problems;
- information technology problems, which may prevent us from conducting our business effectively, or at all, and may also raise our costs;
- regulatory and other delays in product development;
- product recalls or other issues which may raise our costs;
- changes in our reputation and/or market acceptance of our current or new products; and
- changes in the mix of products sold.

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

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

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

Even if we are successful in the development of a product or obtain rights to a product from a third-party supplier, we may experience delays or shortfalls in commercialization and/or market acceptance of the product. For example, veterinarians may be slow to adopt a product, a product may not achieve the anticipated technical performance in field use or there may be delays in producing large volumes of a product. The former is particularly likely where there is no comparable product available or historical precedent for such a product. The ultimate adoption of a new product by veterinarians, the rate of such adoption and the extent veterinarians choose to integrate such a product into their practice are all important factors in the economic success of any 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.

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

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

If our regulators and/or auditors adopt or interpret more stringent standards than we anticipate, we could experience unanticipated changes in our reported financial statements, including but not limited to restatements, which could adversely affect our business due to litigation and investor confidence in our financial statements. In addition, changes in the underlying circumstances to which we apply given accounting standards and principles may affect our results of operations and have a negative impact on us. For example, we review goodwill recognized on our consolidated balance sheets at least annually and if we were to conclude there was an impairment of goodwill, we would reduce the corresponding goodwill to its estimated fair value and recognize a corresponding expense in our statement of operations. This impairment and corresponding expense could be as large as the total amount of goodwill recognized on our consolidated balance sheets, which was $26.7 million at September 30, 2017. There can be no assurance that future goodwill impairments will not occur if projected financial results are not met, or otherwise.

In addition, future legislative, regulatory or rule-making action or more stringent interpretations of existing legislation, regulations and rules may increase our general and administrative costs or have other adverse effects on us.

We have less than 300 holders of record, which would allow us to terminate voluntarily the registration of our common stock with the SEC and after which we would no longer be eligible to maintain the listing of our Public Common Stock on the Nasdaq Capital Market. We may also be unable to otherwise maintain our listing on the Nasdaq Capital Market.

We have less than 300 holders of record as of our latest information, a fact which would make us eligible to terminate voluntarily the registration of our common stock with the SEC and therefore suspend our reporting obligations with the SEC under the Exchange Act and become a non-reporting company. If we were to cease reporting with the SEC, we would no longer be eligible to maintain the listing of our common stock on the Nasdaq Capital Market, which we would expect to materially adversely affect the liquidity and market price for our common stock. The Nasdaq Capital Market has several additional quantitative and qualitative requirements a company must comply with to maintain its listing. While we believe, we are currently in compliance with all Nasdaq requirements, there can be no assurance we will continue to meet Nasdaq listing requirements, that Nasdaq will interpret these requirements in the same manner we do if we believe we meet the requirements, or that Nasdaq will not change such requirements or add new requirements to include requirements we do not meet in the future.

If we are delisted from the Nasdaq Capital Market, our Public Common Stock may be considered a penny stock under the regulations of the SEC and would therefore be subject to rules that impose additional sales practice requirements on broker-dealers who sell our securities. The additional burdens imposed upon broker-dealers may discourage broker-dealers from effecting transactions in our Public Common Stock, which could severely limit market liquidity of the Public Common Stock and any stockholder's ability to sell our

--44-

securities in the secondary market. This lack of liquidity would also likely make it more difficult for us to raise capital in the future.

Our Credit Facility contains restrictions that may limit our flexibility in operating our business.

In July 2017, we entered into a Credit Facility with JPMorgan Chase Bank, N.A. The Credit Facility contains various financial and negative operating covenants that limit our ability to engage in specified types of transactions. The financial covenants require that we maintain a minimum fixed charge coverage ratio and a maximum funded debt to EBITDA ratio. The operating covenants limit our ability to, among other things:

- sell, transfer, lease or dispose of our assets;
- create, incur or assume additional indebtedness;
- encumber or permit lines on certain of our assets;
- make restricted payments, including paying dividends on, repurchasing or making distributions with respect to our common stock;
- make specified investments (including loans and advances);
- consolidate, merge, sell or otherwise dispose of all our substantially all of our assets; and
- enter into certain transactions.

A breach of any of these covenants or a material adverse change to our business could result in a default under the Credit Agreement. Upon the occurrence of an event of default under our Credit Agreement, our lenders could elect to declare all amounts outstanding to be immediately due and payable and terminate all commitments to extend further credit. If we were unable to repay those amounts, the lenders could proceed against the collateral granted to them to secure such indebtedness.

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 September 30, 2017, we had an accumulated deficit of $142.3 million. Relatively small differences in our performance metrics may cause us to generate an operating or net loss in future periods. Our ability to continue to be profitable in future periods will depend, in part, on our ability to increase sales in our CCA segment, including maintaining and growing our installed base of instruments and related consumables, to maintain or increase gross margins and to limit the increase in our operating expenses to a reasonable level as well as avoid or effectively manage any unanticipated issues. We may not be able to generate, sustain or increase profitability on a quarterly or annual basis. If we cannot achieve or sustain profitability for an extended period, we may not be able to fund our expected cash needs, including the repayment of debt as it comes due, or continue our operations.

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

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

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

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information.

On July 26, 2017, the Company's Board of Directors approved minor clarifying amendments to Section 3.15 of the Company's Amended and Restated Bylaws, as amended (the "Bylaws"), to make it more clear that the Chair of the Board of Directors is to meet appropriately with the Chief Executive Officer and to participate in decisions regarding his or her retention, as well as to act as spokesperson for the Board of Directors. A conformed copy of the Bylaws, as so amended, is filed as an exhibit with this quarterly report on Form 10-Q.

Item 6. Exhibits.

Exhibit Number	Notes	Description of Document
3.1		Bylaws, as amended (incorporated by reference to Exhibit 3.2 to the registrant's Quarterly Report on Form 10-Q filed for the quarter ended June 30, 2017).
31.1		Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
31.2		Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
32.1**		Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS		XBRL Instance Document.
101.SCH		XBRL Taxonomy Extension Schema Document.
101.CAL		XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF		XBRL Taxonomy Extension Definition Linkbase Document.
101.PRE		XBRL Taxonomy Extension Presentation Linkbase Document.
101.LAB		XBRL Taxonomy Extension Label Linkbase Document.

Notes

** Furnished with this report.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized on November 3, 2017.

HESKA CORPORATION

By: /s/ KEVIN S. WILSON
Kevin S. Wilson
Chief Executive Officer and President
By: /s/ JOHN MCMAHON
John McMahon
Vice President, Chief Financial Officer