HESKA CORP
Form 10-Q
July 21, 2010

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

FORM 10-Q

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

For the quarterly period ended June 30, 2010

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: 000-22427

HESKA CORPORATION
(Exact name of registrant as specified in its charter)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes 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 o No o

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

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

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

The number of shares of the Registrant's Common Stock outstanding at July 20, 2010 was 52,236,930.

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DRI-CHEM is a registered trademark of FUJIFILM Corporation. SPOTCHEM is a trademark of Arkray, Inc. TRI-HEART is a registered trademark of Schering-Plough Animal Health Corporation ("SPAH") in the United

States and is a trademark of Heska Corporation in other countries. HESKA, ALLERCEPT, AVERT, E.R.D.-HEALTHSCREEN, E-SCREEN, FELINE ULTRANASAL, HEMATRUE, SOLO STEP, THYROMED and VET/OX are registered trademarks and CBC-DIFF, G2 DIGITAL, VET/IV and VITALPATH are trademarks of Heska Corporation. This Form 10-Q also refers to trademarks and trade names of other organizations.

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

ASSETS	December 31, 2009	June 30, 2010
Current assets:		
Cash and cash equivalents	$ 5,400	$ 5,564
Accounts receivable, net of allowance for doubtful accounts of $177 and $131, respectively	9,222	7,585
Inventories, net	12,018	12,726
Deferred tax asset, current	940	842
Other current assets	913	778
Total current assets	28,493	27,495
Property and equipment, net	6,349	5,856
Goodwill	905	866
Deferred tax asset, net of current portion	28,387	29,044
Total assets	$ 64,134	$ 63,261
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 4,172	$ 3,126
Accrued liabilities	3,689	3,563
Current portion of deferred revenue	1,664	1,852
Line of credit	4,201	5,583
Current portion of long-term debt	381	—
Total current liabilities	14,107	14,124
Deferred revenue, net of current portion, and other	4,972	4,504
Total liabilities	19,079	18,628
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $.001 par value, 25,000,000 shares authorized; none issued or outstanding	—	—
Common stock, $.001 par value, 75,000,000 shares authorized; 52,159,738 and 52,231,742 shares issued and outstanding, respectively	52	52
Additional paid-in capital	216,829	217,029
Accumulated other comprehensive income	(30)	(157)
Accumulated deficit	(171,796)	(172,291)
Total stockholders' equity	45,055	44,633
Total liabilities and stockholders' equity	$ 64,134	$ 63,261

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2010	2009	2010
Revenue, net:				
Core companion animal health	$16,879	$13,731	$ 35,016	$ 29,523
Other vaccines, pharmaceuticals and products	1,750	1,376	3,754	3,278
Total revenue, net	18,629	15,107	38,770	32,801
Cost of revenue	11,598	9,260	24,366	20,749
Gross profit	7,031	5,847	14,404	12,052
Operating expenses:				
Selling and marketing	3,622	3,656	7,380	7,692
Research and development	405	388	851	845
General and administrative	1,994	2,010	4,146	4,210
Total operating expenses	6,021	6,054	12,377	12,747
Operating income (loss)	1,010	(207)	2,027	(695)
Interest and other expense, net	41	122	206	295
Income (loss) before income taxes	969	(329)	1,821	(990)
Income tax expense (benefit)	390	(164)	782	(495)
Net income (loss)	$ 579	$ (165)	$ 1,039	$ (495)
Basic net income (loss) per share	$ 0.01	$ 0.00	$ 0.02	$ (0.01)
Diluted net income (loss) per share	$ 0.01	$ 0.00	$ 0.02	$ (0.01)
Weighted average outstanding shares used to compute basic net income (loss) per share	52,012	52,166	52,012	52,163
Weighted average outstanding shares used to compute diluted net income (loss) per share	52,035	52,166	52,013	52,163

See accompanying notes to condensed consolidated financial statements.

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

	Six Months Ended June 30,	
	2009	2010
CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
Net income (loss)	$ 1,039	$ (495)
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Depreciation and amortization	1,324	1,158
Deferred tax expense (benefit)	727	(559)
Stock-based compensation	175	160
Unrealized loss on foreign currency translation	13	73
Changes in operating assets and liabilities:		
Accounts receivable	816	1,637
Inventories	2,169	(1,200)
Other current assets	131	135
Accounts payable	235	(1,046)
Accrued liabilities	(802)	(136)
Deferred revenue and other liabilities	(622)	(265)
Net cash provided by (used in) operating activities	5,205	(538)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(126)	(180)
Net cash provided by (used in) investing activities	(126)	(180)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	36	40
Proceeds from (repayments of) line of credit borrowings, net	(4,057)	1,382
Proceeds from (repayments of) debt, net	(386)	(381)
Net cash provided by (used in) financing activities	(4,407)	1,041
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(53)	(159)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	619	164
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	4,705	5,400
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 5,324	$ 5,564
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest	$ 267	$ 92
Non-cash transfer of inventory to property and equipment	$ 63	$ 492

See accompanying notes to condensed consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2010
(UNAUDITED)

1. ORGANIZATION AND BUSINESS

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements are the responsibility of the Company's management and have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the instructions to Form 10-Q and rules and regulations of the Securities and Exchange Commission (the "SEC"). The condensed consolidated balance sheet as of June 30, 2010, the condensed consolidated statements of operations for the three months and six months ended June 30, 2009 and 2010 and the condensed consolidated statements of cash flows for the six months ended June 30, 2009 and 2010 are unaudited, but include, in the opinion of management, all adjustments (consisting of normal recurring adjustments) which the Company considers necessary for a fair presentation of its financial position, operating results and cash flows for the periods presented. All material intercompany transactions and balances have been eliminated in consolidation. Although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information and footnote disclosures normally included in complete financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the SEC.

Results for any interim period are not necessarily indicative of results for any future interim period or for the entire year. The accompanying financial statements and related disclosures have been prepared with the presumption that users of the interim financial information have read or have access to the audited financial statements for the preceding fiscal year. Accordingly, these financial statements should be read in conjunction with the audited financial statements and the related notes thereto for the year ended December 31, 2009, included in the Company's Annual Report on Form 10-K/A filed with the SEC on February 25, 2010.

Use of Estimates

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

Inventories

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

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

	December 31, 2009	June 30, 2010
Raw materials	$ 4,969	$ 5,469
Work in process	3,371	3,575
Finished goods	4,782	4,996
Allowance for excess or obsolete inventory	(1,104)	(1,314)
	$ 12,018	$ 12,726

Basic and Diluted Net Income (Loss) Per Share

Basic net income (loss) per common share is computed using the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed using the sum of the weighted average number of shares of common stock outstanding, and, if not anti-dilutive, the effect of outstanding common stock equivalents (such as stock options and warrants) determined using the treasury stock method. For the three and six months ended June 30, 2009, the Company reported net income and therefore, dilutive common stock equivalent securities, as computed using the treasury stock method, were added to basic weighted average shares outstanding for the period to derive the weighted average shares for the diluted earnings per share calculation. Common stock equivalent securities that were anti-dilutive for the three and six months ended June 30, 2009, and therefore excluded, were outstanding options to purchase 12,012,753 and 12,249,156 shares of common stock, respectively. These securities are anti-dilutive primarily due to exercise prices greater than the average value of the Company's common stock during the three and six months ended June 30, 2009. All common stock equivalent securities were anti-dilutive for the three and six months ended June 30, 2010 because the Company reported a net loss for those periods.

3. CAPITAL STOCK

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model, with the following weighted average assumptions for options granted in the three and six months ended June 30, 2009 and 2010.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2010	2009	2010
Risk-free interest rate	1.42%	1.45%	1.41%	1.44%
Expected lives	2.8 years	2.8 years	2.8 years	2.9 years
Expected volatility	67%	68%	67%	68%
Expected dividend yield	0%	0%	0%	0%

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

	Year Ended December 31, 2009		Six Months Ended June 30, 2010	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of period	12,835,269	$1.2836	12,917,702	$ 1.1846
Granted at market	1,075,000	$0.4529	299,000	$ 0.8417
Cancelled	(992,567)	$1.6713	(392,334)	$ 2.5188
Exercised	—	$ —	(6,825)	$ 0.6987
Outstanding at end of period	12,917,702	$1.1846	12,817,543	$ 1.1361
Exercisable at end of period	10,987,092	$1.2648	11,188,043	$ 1.1483

The estimated fair value of stock options granted during the six months ended June 30, 2010 and 2009 was computed to be approximately $112 thousand and $56 thousand, respectively. The amount is amortized ratably over the vesting period of the options. The per share weighted average estimated fair value of options granted during the six months ended June 30, 2010 and 2009 was computed to be approximately $0.38 and $0.20, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2010 and 2009 was approximately $1 thousand and $0, respectively. The cash proceeds from options exercised during the six months ended June 30, 2010 and 2009 were approximately $5 thousand and $0, respectively.

The following table summarizes information about stock options outstanding and exercisable at June 30, 2010:

	Options Outstanding			Options Exercisable	
Exercise Prices	Number of Options Outstanding at June 30, 2010	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Number of Options Exercisable at June 30, 2010	Weighted Average Exercise Price
$0.27 - $0.69	2,582,484	7.53	$0.4479	1,278,701	$0.4461
$0.70 - $0.88	2,925,558	4.27	$0.8092	2,902,475	$0.8089
$0.89 - $1.24	2,100,749	2.28	$1.0856	2,089,499	$1.0865
$1.25 - $1.60	2,583,863	4.72	$1.3749	2,570,113	$1.3747
$1.61 - $4.12	2,624,889	5.51	$1.9827	2,347,255	$2.0008
$0.27 - $4.12	12,817,543	4.95	$1.1361	11,188,043	$1.1483

As of June 30, 2010, there was approximately $539 thousand of total unrecognized compensation expense related to outstanding stock options. That expense is expected to be recognized over a weighted average period of 1.8 years, with approximately $172 thousand to be recognized in the six months ending December 31, 2010 and all the cost to be recognized as of May 2014, assuming all options vest according to the vesting schedules in place at June 30, 2010. As of June 30, 2010, the aggregate intrinsic value of outstanding options was approximately $454 thousand and the aggregate intrinsic value of exercisable options was approximately $231 thousand.

4. SEGMENT REPORTING

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

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

	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Six Months Ended June 30, 2009:			
Total revenue	$ 35,016	$ 3,754	$ 38,770
Operating income (loss)	2,352	(325)	2,027
Interest expense	228	42	270
Total assets	56,155	9,819	65,974
Net assets	37,161	6,532	43,693
Capital expenditures	121	5	126
Depreciation and amortization	855	469	1,324
Six Months Ended June 30, 2010:			
Total revenue	$ 29,523	$ 3,278	$ 32,801
Operating income (loss)	1,164	(1,859)	(695)
Interest expense	86	30	116
Total assets	54,540	8,721	63,261
Net assets	37,938	6,695	44,633
Capital expenditures	110	70	180
Depreciation and amortization	695	463	1,158

	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Three Months Ended June 30, 2009:			
Total revenue	$ 16,879	$ 1,750	$ 18,629
Operating income (loss)	1,163	(153)	1,010
Interest expense	96	19	115
Total assets	56,155	9,819	65,974
Net assets	37,161	6,532	43,693
Capital expenditures	99	5	104
Depreciation and amortization	428	234	662
Three Months Ended June 30, 2010:			
Total revenue	$ 13,731	$ 1,376	$ 15,107
Operating income (loss)	582	(789)	(207)
Interest expense	54	11	65
Total assets	54,540	8,721	63,261
Net assets	37,938	6,695	44,633
Capital expenditures	22	58	80
Depreciation and amortization	339	230	569

5. COMPREHENSIVE INCOME (LOSS)

Comprehensive income includes net income plus the results of certain stockholders' equity changes not reflected in the Condensed Consolidated Statements of Operations. Such changes primarily include foreign currency translation items. Total comprehensive income (loss) for the six months ended June 30, 2010 and 2009 was $(622) thousand and $959 thousand, respectively. Total comprehensive income (loss) for the three months ended June 30, 2010 and 2009 was $(221) thousand and $714 thousand, respectively.

Item 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with "Selected Consolidated Financial Data" and the Unaudited Condensed Consolidated Financial Statements and related Notes included in Part I Item 1 of this Form 10-Q.

This discussion contains forward-looking statements that involve risks and uncertainties. Such statements, which include statements concerning future revenue sources and concentration, gross profit margins, selling and marketing expenses, general and administrative expenses, research and development expenses, capital resources, capital expenditures and additional financings or borrowings, are subject to risks and uncertainties, including, but not limited to, those discussed below and elsewhere in this Form 10-Q, particularly in Part II Item 1A. "Risk Factors," that could cause actual results to differ materially from those projected. The forward-looking statements set forth in this Form 10-Q are as of the close of business on July 20, 2010, and we do not intend to update this forward-looking information.

Overview

We develop, manufacture, market, sell and support veterinary products. Our business is comprised of two reportable segments, Core Companion Animal Health, which represented 87% of our revenue for the twelve months ended June 30, 2010 ("LTM") and Other Vaccines, Pharmaceuticals and Products, which represented 13% of LTM revenue.

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

Diagnostic instruments and supplies represented approximately 44% of our LTM revenue. Many products in this area involve placing an instrument in the field and generating future revenue from consumables, including items such as supplies and service, as that instrument is used. Approximately 30% of our LTM revenue resulted from the sale of such consumables to an installed base of instruments and approximately 14% of our revenue was from new hardware sales. A loss of or disruption in supply of consumables we are selling to an installed base of instruments could substantially harm our business. For example, the supplier of our handheld blood analysis instruments informed us in May 2009 of the cancellation of our contractual agreement as of November 2009 and that they will not supply us with any related instruments or consumables following cancellation. We had established a large installed base of handheld blood analysis instruments and sales of instruments and consumables in this area represented 6% of our LTM revenue. Accordingly, we anticipate a significant decline in revenue and gross margin related to our handheld blood analysis instruments in the last six months of 2010 as compared to the prior year period. All of our diagnostic instruments and supplies are supplied by third parties, who typically own the product rights and supply the product to us under marketing and/or distribution agreements. In many cases, we have collaborated with a third party to adapt a human instrument for veterinary use. Major products in this area include our chemistry instruments, our hematology instruments and our new blood gas instruments and their affiliated operating consumables. Revenue from products in these three areas, including revenues from consumables, represented approximately 34% of our LTM revenue.

Other CCA revenue, including single use diagnostic and other tests, pharmaceuticals and vaccines as well as research and development, licensing and royalty revenue, represented approximately 43% of our LTM revenue. Since items in this area are often single use by their nature, our typical aim is to build customer satisfaction and loyalty for each product, generate repeat annual sales from existing customers and expand our customer base in the future. Products in this area are both supplied by third parties and provided by us. Major products in this area include our heartworm

diagnostic tests, our heartworm preventive, our allergy test kits, our allergy immunotherapy and our allergy diagnostic tests. Combined revenue from heartworm-related products and allergy-related products represented approximately 38% of our LTM revenue.

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

All our CCA products are ultimately sold to or through veterinarians. In many cases, veterinarians will mark up their costs to the end user. The acceptance of our products by veterinarians is critical to our success. CCA products are sold directly by us as well as through independent third-party distributors and other relationships, such as corporate agreements. Revenue from direct sales, independent third-party distributors and other relationships represented approximately 58%, 16% and 26%, respectively, of CCA LTM revenue. In January 2010, we gave notice of contract termination to most domestic independent third-party distributors who carry our full product line and, accordingly, we anticipate the percent of our revenue from sale to independent third-party distributors to decline in 2010 as compared to 2009. We took this action because we expect it will enhance our profitability and allow further investment in our direct sales efforts, which we expect to yield a greater return than continuing in our agreements with our previous independent third-party distributors.

We intend to sustain profitability over the long term through a combination of revenue growth, gross margin improvement and expense control. Accordingly, we closely monitor revenue growth trends in our CCA segment. LTM revenue in this segment declined 11% for the twelve months ended June 30, 2010 as compared to the twelve months ended June 30, 2009. The largest factor in this decline was lower sales of consumables for our handheld blood analysis instruments which declined by $8.3 million in the twelve months ended June 30, 2010 as compared to the twelve months ended June 30, 2009, primarily due to the loss of supply discussed above. In addition, we believe poor economic conditions over the past year have impacted our revenue growth as, for example, veterinarians have delayed or deferred capital expenditures on new diagnostic instrumentation.

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

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

We have developed our own line of bovine vaccines that are licensed by the USDA. We have a long-term agreement with a distributor, Agri Laboratories, Ltd., ("AgriLabs"), for the marketing and sale of certain of these vaccines which are sold primarily under the Titanium→ and MasterGuard→ brands which are registered trademarks of AgriLabs. This agreement generates a significant portion of our OVP segment's revenue. Our OVP segment also produces vaccines and pharmaceuticals for other third parties.

Critical Accounting Policies and Estimates

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

Revenue Recognition

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

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

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

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

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

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

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

Allowance for Doubtful Accounts

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

Inventories

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

Deferred Tax Assets – Valuation Allowance

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

a reduction of our deferred tax asset. If there is a change regarding our tax position in the future, we will make a corresponding adjustment to the related valuation allowance.

Results of Operations

Revenue

Total revenue decreased 15% to $32.8 million for the six months ended June 30, 2010 as compared to $38.8 million for the corresponding period in 2009. Total revenue decreased 19% to $15.1 million for the three months ended June 30, 2010 as compared to $18.6 million for the corresponding period in 2009.

Revenue from our CCA segment was $29.5 million for the six months ended June 30, 2010, a decrease of 16% as compared to $35.0 million for the corresponding period in 2009. The largest factor in the decline was lower sales of consumables for our handheld blood analysis instruments which declined by $5.8 million in the six months ended June 30, 2010 as compared to the six months ended June 30, 2009. In addition, we experienced a decline in sales of our IV pumps and in international sales of our heartworm diagnostic tests in the six months ended June 30, 2010 as compared to the prior year period. These declines were somewhat offset by greater sales of our heartworm preventive. Revenue from our CCA segment was $13.7 million for the three months ended June 30, 2010, a decrease of 19% as compared to $16.9 million for the corresponding period in 2009. The largest factor in the decline was lower sales of consumables for our handheld blood analysis instruments which declined by $3.1 million in the three months ended June 30, 2010 as compared to the three months ended June 30, 2009.

Revenue from our Other Vaccines, Pharmaceuticals and Products segment ("OVP") was $3.3 million for the six months ended June 30, 2010, a decrease of 13% as compared to $3.8 million in the corresponding period in 2009. Lower sales of our cattle vaccines, including under our contract with AgriLabs and in international markets, were a key factor in the decline. This was offset by somewhat greater sales of bulk bovine biologicals. Revenue from our OVP segment was $1.4 million for the three months ended June 30, 2010, a decrease of 21% as compared to $1.8 million in the corresponding period in 2009. The primary reason for the decline in both periods relates to issues we have had producing certain cattle vaccine product to appropriate specifications for purity, and as a result, we did not ship any related cattle vaccine product in the three months ended June 30, 2010. This was somewhat offset by increased sales of bulk bovine biologicals in the six months ended June 30, 2010 and of small mammal products for both the six- and three-month periods ended June 30, 2010.

We expect 2010 total revenue to decline as compared with 2009.

Cost of Revenue

Cost of revenue totaled $20.7 million for the six months ended June 30, 2010, a decrease of $3.6 million as compared to $24.4 million for the corresponding period in 2009. Gross profit decreased by $2.4 million to $12.1 million for the six months ended June 30, 2010 as compared to $14.4 million in the prior year period. Gross Margin, i.e. gross profit divided by total revenue, decreased to 36.7% for the six months ended June 30, 2010 from 37.2% in the prior year period. The largest factor in the decline was an approximately $1.0 million reserve taken for product produced and currently under review for potential destruction and replacement in our OVP segment.

Cost of revenue totaled $9.3 million for the three months ended June 30, 2010, a decrease of $2.3 million as compared to $11.6 million for the corresponding period in 2009. Gross profit decreased by $1.2 million to $5.8 million for the three months ended June 30, 2010 as compared to $7.0 million in the prior year period. Gross Margin increased to 38.7% for the three months ended June 30, 2010 from 37.7% in the prior year period. Increased Gross Margin on the domestic sale of our instrument consumables, which we no longer sell through independent third-party distributors, was a factor in the increase. This was somewhat offset by lower Gross Margin in our OVP segment primarily due to increased idle plant expense related to the cattle vaccine production situation discussed above.

We expect Gross Margin to decrease slightly for 2010 as compared to 2009.

Operating Expenses

Total operating expenses increased 3% to $12.7 million in the six months ended June 30, 2010 from $12.4 million in the prior year period. Total operating expenses increased 1% to $6.1 million in the three months ended June 30, 2010 from $6.0 million in the prior year period.

Selling and marketing expenses increased 4% to $7.7 million in the six months ended June 30, 2010 as compared to $7.4 million in the corresponding period in 2009. Spending related to the full launch of our new blood gas analyzer in 2010 and greater advertising expenditures were factors in the increase. Selling and marketing expenses increased 1% to $3.7 million in the three months ended June 30, 2010 as compared to $3.6 million in the corresponding period in 2009. Spending related to the full launch of our new blood gas analyzer in 2010 was a factor in the increase.

Research and development expenses were $845 thousand for the six months ended June 30, 2010, a 1% decrease as compared to $851 thousand in the corresponding period in 2009. Research and development expenses were $388 thousand for the three months ended June 30, 2010, a 4% decrease as compared to $405 thousand in the corresponding period in 2009. Lower spending on research and development resources were a factor in the decline in both periods.

General and administrative expenses were $4.2 million in the six months ended June 30, 2010, up 2% from the prior year period. Greater patent expenses were a factor in the increase. General and administrative expenses were $2.0 million in the three months ended June 30, 2010, up 1% from the prior year period. Greater spending related to legal matters was a factor in the increase.

We expect 2010 operating expenses will be slightly higher than in 2009.

Interest and Other Expense, Net

Interest and other (income) expense, net was $295 thousand in the six months ended June 30, 2010, an increase of $89 thousand as compared to $206 thousand in the prior year period. Interest and other (income) expense, net was $122 thousand in the three months ended June 30, 2010, an increase of $81 thousand as compared to $41 thousand in the prior year period. This line item can be broken into two components: net interest expense and net foreign currency gains or losses. Net interest expense was $91 thousand in the six months ended June 30, 2010, a decrease of $151 thousand from $242 thousand in the prior year period. Net interest expense was $55 thousand in the three months ended June 30, 2010, a decrease of $47 thousand from $102 thousand in the prior year period. Lower loan balances and a negotiated decrease in our borrowing rate were factors in the decline in both cases. Net foreign currency loss was $204 thousand in the six months ended June 30, 2010, a $239 thousand change from a net foreign currency gain of $35 thousand in the prior year period. In the three months ended June 30, 2010, net foreign currency loss was $67 thousand, a change of $127 thousand from a net foreign currency gain of $60 thousand in the prior year period.

We expect interest and other expense, net to increase in 2010 as compared to 2009 due to currency losses experienced to date, somewhat offset by the effect of our borrowings with Wells Fargo Bank, National Association ("Wells Fargo") anticipated to be at lower rates than in 2009 due to changes in our interest rate with Wells Fargo negotiated in November 2009.

Income Tax Expense (Benefit)

We recognized an income tax benefit of $495 thousand in the six months ended June 30, 2010, a $1.3 million change as compared to a tax expense of $782 thousand in the prior year period. The tax benefit in the 2010 period was a result of a pre-tax loss and the expense in the 2009 period corresponded with pre-tax income. We recognized an income tax benefit of $164 thousand in the three months ended June 30, 2010, a $555 thousand change as compared to a tax expense of $390 thousand in the prior year period. The tax entry was primarily non-cash and corresponded to a change in our deferred tax assets in all cases. The tax benefit in the 2010 period was a result of a pre-tax loss and the expense in the 2009 period corresponded with pre-tax income.

In 2010, we expect lower income tax expense than in 2009 as we expect to generate lower pre-tax income than in 2009.

Net Income (Loss)

Net loss was $495 thousand in the six months ended June 30, 2010, a decrease of approximately $1.5 million compared to net income of $1.0 million in the prior year period. The decrease was primarily due to lower revenue, lower Gross Margin and higher operating expenses, as discussed above. Net loss was $165 thousand in the three months ended June 30, 2010, a decrease of approximately $744 thousand compared to net income of $579 thousand in the prior year period. The decrease was primarily due to lower revenue and higher operating expenses, somewhat offset by higher Gross Margin, as discussed above.

In 2010, we expect to generate lower net income than in 2009, primarily as a result of lower revenue.

Liquidity and Capital Resources

We have incurred net cumulative negative cash flow from operations since our inception in 1988. For the six months ended June 30, 2010, we had a net loss of $495 thousand. During the six months ended June 30, 2010, our operations used cash of approximately $538 thousand. At June 30, 2010, we had $5.6 million of cash and cash equivalents, $13.4 million of working capital, and $5.6 million of outstanding borrowings under our revolving line of credit, discussed below.

Net cash used by operating activities was approximately $538 thousand for the six months ended June 30, 2010 as compared to $5.2 million of cash provided by operating activities in the prior year period, a decrease of approximately $5.7 million. Major factors in the change were a $3.4 million increase in cash used by inventory as we increased inventory levels in the 2010 period and reduced them in the 2009 period, a $1.5 million change as a result of a net loss of $495 thousand in the 2010 period versus net income of $1.0 million in the 2009 period, a $1.3 million change as a result of deferred tax benefit in 2010 and expense in 2009 and a $615 thousand increase in cash used by accounts payable and accrued liabilities, which is primarily a function of the scheduled timing of payments. These changes were somewhat offset by an $821 thousand increase in cash provided by accounts receivable, which is partially a function of lower revenue.

Net cash flows from investing activities used cash of $180 thousand in the six months ended June 30, 2010, an increase of approximately $54 thousand compared to $126 thousand during the corresponding period in 2009. All expenditures were for the purchase of property and equipment. An increase in expenditures related to our facility in Des Moines, Iowa was a key factor in the increase.

Net cash flows provided by financing activities were $1.0 million during the six months ended June 30, 2010, a decrease as compared to $4.4 million used during the corresponding period in 2009. The primary reason for the change is a $5.4 million change in the usage of borrowings under our revolving line of credit. We also experienced a

slight decline in scheduled term debt repayments and a slight increase in cash received from the issuance of common stock related to employee stock options in the 2010 period as compared to the 2009 period.

At June 30, 2010, we had a $15.0 million asset-based revolving line of credit with Wells Fargo which has a maturity date of December 31, 2012 as part of our credit and security agreement with Wells Fargo. At June 30, 2010, $5.6 million was outstanding under this line of credit. Our ability to borrow under this facility varies based upon available cash, eligible accounts receivable and eligible inventory. On June 30, 2010, interest was charged at a stated rate of three month LIBOR plus 4% and was payable monthly. We are required to comply with various financial and non-financial covenants, and we have made various representations and warranties. Among the financial covenants is a requirement to maintain a minimum liquidity (cash plus excess borrowing base) of $1.5 million. Additional requirements include covenants for minimum capital monthly and minimum net income quarterly. Failure to comply with any of the covenants, representations or warranties could result in our being in default on the loan and could cause all outstanding amounts payable to Wells Fargo to become immediately due and payable or impact our ability to borrow under the agreement. We were in compliance with all financial covenants as of June 30, 2010. At June 30, 2010, we had $2.5 million of additional borrowing capacity based upon eligible accounts receivable and eligible inventory under our revolving line of credit.

At June 30, 2010, we had deferred revenue and other long-term liabilities, net of current portion, of approximately $4.5 million. Included in this total is approximately $2.7 million of deferred revenue related to up-front fees that have been received for certain product rights and technology rights out-licensed. These deferred amounts are being recognized on a straight-line basis over the remaining lives of the agreements, products, patents or technology.

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

Our financial plan for 2010 indicates that our available cash and cash equivalents, together with cash from operations and borrowings expected to be available under our revolving line of credit, will be sufficient to fund our operations through 2010 and into 2011. However, our actual results may differ from this plan, and we may be required to consider alternative strategies. We may be required to raise additional capital in the future. If necessary, we expect to raise these additional funds through the sale of equity or refinancing loans currently outstanding on assets with historical appraised values significantly in excess of related debt. There is no guarantee that additional capital will be available from these sources on acceptable terms, if at all, and certain of these sources may require approval by existing lenders. If we cannot raise the additional funds through these options on acceptable terms or with the necessary timing, management could also reduce discretionary spending to decrease our cash burn rate through actions such as delaying or canceling budgeted research activities or marketing plans. These actions would likely extend the then available cash and cash equivalents, and then available borrowings to some degree.

Recent Accounting Pronouncements

None.

Item 3.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Interest Rate Risk

The interest payable on certain of our lines of credit is variable based on the United States prime rate and, therefore, is affected by changes in market interest rates. At June 30, 2010, approximately $5.6 million was outstanding on these lines of credit with a weighted average interest rate of 4.53%. We also had approximately $5.6 million of cash and cash equivalents at June 30, 2010, the majority of which was invested in liquid interest bearing accounts. We had no interest rate hedge transactions in place on June 30, 2010. We completed an interest rate risk sensitivity analysis based on the above and an assumed one percentage point increase/decrease in interest rates. If market rates increase/decrease by one percentage point, we would experience a decrease/increase in annual net interest expense of approximately $1 thousand based on our outstanding balances as of June 30, 2010.

Foreign Currency Risk

Our investment in foreign assets consists primarily of our investment in our European subsidiary. Foreign currency risk may impact our results of operations. In cases where we purchase inventory in one currency and sell corresponding products in another, our gross margin percentage is typically at risk based on foreign currency exchange rates. In addition, in cases where we may be generating operating income in foreign currencies, the magnitude of such operating income when translated into U.S. dollars will be at risk based on foreign currency exchange rates. Our agreements with customers and suppliers vary significantly in regard to the existence and extent of currency adjustment and other currency risk sharing provisions. We had no foreign currency hedge transactions in place on June 30, 2010.

We have a wholly-owned subsidiary in Switzerland which uses the Swiss Franc as its functional currency. We purchase inventory in foreign currencies, primarily Japanese Yen and Euros, and sell corresponding products in U.S. dollars. We also sell products in foreign currencies, primarily Japanese Yen and Euros, where our inventory costs are in U.S. dollars. Based on our results of operations for the most recent twelve months, if foreign currency exchange rates were to strengthen/weaken by 25% against the dollar, we would expect a resulting pre-tax loss/gain of approximately $468 thousand.

Item 4.

CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures. Our management, with the participation of our chief executive officer and our chief financial officer, evaluated the effectiveness of our disclosure controls and procedures, as defined by Rule 13a-15 of the Exchange Act, as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our chief executive officer and our chief financial officer have concluded that our disclosure controls and procedures are 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.

(b) Changes in Internal Control over Financial Reporting. There was no change in our internal control over financial reporting that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we may be involved in litigation relating to claims arising out of our operations. As of June 30, 2010, we were not a party to any legal proceedings that are expected, individually or in the aggregate, to have a material effect on our business, financial condition or operating results.

Item 1A. Risk Factors

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

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

Our agreements with our corporate marketing partners generally contain no or small minimum purchase requirements in order for them to maintain their exclusive or co-exclusive marketing rights. We are party to an agreement with Schering-Plough Animal Health Corporation ("SPAH") which grants SPAH exclusive distribution and marketing rights in the U.S. for our canine heartworm preventive product, TRI-HEART Plus Chewable Tablets. AgriLabs has the non-exclusive right to sell certain of our bovine vaccines in the United States, Africa and Mexico and currently generates all of our sales of those vaccines in those territories. Novartis Japan markets and distributes our SOLO STEP CH heartworm test and our E.R.D.-HEALTHSCREEN urine test products in Japan under an exclusive arrangement. One or more of these marketing partners may not devote sufficient resources to marketing our products. For example, on March 9, 2009, Merck & Co., Inc. ("Merck") and Schering-Plough Corporation ("SGP") announced plans to merge. SGP was the parent company of SPAH. Merck and sanofi-aventis ("Sanofi") each owned 50% of Merial Limited ("Merial"), a company which sells a canine heartworm preventive (the "Existing Product") competitive with ours. On July 30, 2009, Merck and Sanofi announced that they had entered into an agreement under which Merck was to sell its interest in Merial to Sanofi and that Sanofi was to receive a call option exercisable after the merger of Merck and SGP to essentially combine Merial with the animal health business of SGP ("SAH"), including SPAH, in a new joint venture company ("Newco") equally owned by Sanofi and the company created from the merger of Merck and SGP. Merck subsequently completed its merger with SGP. On March 9, 2010, Sanofi announced that it had exercised its option to combine Merial with SAH, and Sanofi and Merck announced they expected the transaction, which was subject to execution of final agreements, antitrust review and other customary closing conditions, to close in the twelve months following the announcement. Revenue from Merck entities, including SPAH, represented 13% of our LTM revenue. If Merck, SGP, SAH, SPAH, Newco or any related entity is required to divest or cease operations related to our heartworm preventive in order to complete a merger or other combination, our sales could decline significantly and our business could be damaged. Similarly, if SPAH personnel are distracted or experience turmoil as a result of the merger between Merial and SAH, a future combination between SPAH and any other entity or for other reasons, our sales could decline significantly. Furthermore, there may be nothing to prevent these partners from pursuing alternative technologies or products that may compete with our products in current or future agreements. For example, we believe a unit of SAH has obtained FDA approval for a

canine heartworm preventive product with additional claims compared with our TRI-HEART Plus Chewable Tablets. Should Merck, SGP, SAH, SPAH and/or Newco decide to emphasize sales and marketing efforts of this product and/or the Existing Product rather than our TRI-HEART Plus Chewable Tablets or cancel our agreement regarding canine heartworm preventive distribution and marketing, our sales could decline significantly. In the future, third-party marketing assistance may not be available on reasonable terms, if at all. If any of these events occur, we may not be able to maintain our current market share or commercialize our products and our sales will decline accordingly.

We believe a significant level of product we have recently produced in our OVP segment does not conform to regulatory specifications. In addition, obtaining and maintaining regulatory approvals in order to market our regulated products may be costly and delay the marketing and sales of our products.

We believe we have recently produced a significant level of cattle vaccine product in our OVP segment which will conform to regulatory specifications for safety, potency and efficacy but not purity. In compliance with United States Department of Agriculture ("USDA") regulations we intend to destroy any such product, and we intend to then produce replacement product for any product so destroyed. We have taken a reserve of $1.0 million related to this situation. We did not ship any related cattle vaccine product in the three months ended June 30, 2010. There can be no assurance that the ultimate cost will not exceed the level of the current reserve significantly, that our current efforts at remediation to ensure this or similar problems will not recur in the future will be successful, or that the USDA will not suspend our ability to produce these or other products for an extended time at some point in the future.

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

The effect of government regulation may be to delay or to prevent marketing of our products for a considerable period of time and to impose costly procedures upon our activities. We have experienced in the past, and may experience in the future, difficulties that could delay or prevent us from obtaining the regulatory approval or license necessary to introduce or market our products. Such delays in approval may cause us to forego a significant portion of a new product's sales in its first year due to seasonality and advanced booking periods associated with certain products. Regulatory approval of our products may also impose limitations on the indicated or intended uses for which our products may be marketed.

Among the conditions for certain regulatory approvals is the requirement that our facilities and/or the facilities of our third-party manufacturers conform to current Good Manufacturing Practices and other requirements. If any regulatory authority determines that our manufacturing facilities or those of our third-party manufacturers do not conform to appropriate manufacturing requirements, we or the manufacturers of our products may be subject to sanctions, including, but not limited to, warning letters, manufacturing suspensions, product recalls or seizures, injunctions, refusal to permit products to be imported into or exported out of the United States, refusals of regulatory authorities to grant approval or to allow us to enter into government supply contracts, withdrawals of previously approved marketing applications, civil fines and criminal prosecutions. In addition, certain of our agreements require us to pay penalties if we are unable to supply products, including for failure to maintain regulatory approvals. Any of these events, alone or in unison, could damage our business.

The loss of significant customers could harm our operating results.

Revenue from Merck entities, including SPAH, represented 19% and 13% of our total revenue for the six months ended June 30, 2010 and 2009, respectively. Sales to no other single customer accounted for more than 10% of our consolidated revenue for the six months ended June 30, 2010 and 2009. No other single customer accounted for more than 10% of our consolidated accounts receivable at June 30, 2010 and 2009. Revenue from Merck entities, including SPAH, represented 14% and 13% of our total revenue for the three months ended June 30, 2010 and 2009, respectively. Sales to no other single customer accounted for more than 10% of our consolidated revenue for the three months ended June 30, 2010 and 2009. The loss of significant customers who, for example, are historically large purchasers or who are considered leaders in their field could damage our business and financial results.

Our common stock is listed on the Nasdaq Capital Market and we may not be able to maintain that listing, which may make it more difficult for you to sell your shares.

Our common stock is listed on the Nasdaq Capital Market. The Nasdaq has several quantitative and qualitative requirements companies must comply with to maintain this listing, including a $1.00 minimum bid price. We are currently not in compliance with the $1.00 minimum bid price and we have received communications from Nasdaq so advising us. On February 2, 2010, Nasdaq sent us a letter informing us that we had not regained compliance with the minimum bid price requirement, but that since we met all other initial inclusion criteria for the Nasdaq Capital Market, we were being granted an additional compliance period through July 28, 2010 to regain compliance, which requires our stock to have a minimum closing bid price of $1.00 for a minimum of 10 consecutive trading days. If we fail to regain compliance by July 28, 2010, Nasdaq has informed us they will then provide written notification that our stock will be delisted, which we may then appeal. Nasdaq has informed us that if we appeal we will be asked to provide a plan to regain compliance and that historically a near-term reverse stock split has been viewed as the only definitive plan acceptable to resolve a bid price deficiency. We anticipate that we will receive a delisting notice from Nasdaq which we intend to appeal and submit a near-term reverse stock split plan to Nasdaq. Our Board of Directors has authorized us to pursue a near-term reverse stock split, which will require the affirmative vote of a majority of our stockholders, to maintain our listing on the Nasdaq Capital Market. On February 5, 2010, we received a general communication from Nasdaq that a company who fails to meet a listing standard has 45 calendar days to submit a compliance plan to Nasdaq. There can be no assurance we will continue to meet Nasdaq listing requirements other than the minimum bid price, that Nasdaq will interpret these criteria in the same manner we do if we believe we meet the criteria, that Nasdaq will not change such criteria or add new criteria to include requirements we do not meet in the future, that we will regain or maintain future compliance with the minimum bid price requirement, that a majority of our stockholders will affirmatively approve a reverse stock split, or that Nasdaq will find any compliance plan to resolve a bid price deficiency acceptable, including a near-term reverse stock split plan. If we are delisted from the Nasdaq Capital Market, our common stock may be considered a penny stock under the regulations of the SEC and would therefore be subject to rules that impose additional sales practice requirements on broker-dealers who sell our securities. The additional burdens imposed upon broker-dealers may discourage broker-dealers from effecting transactions in our common stock, which could severely limit market liquidity of the common stock and your ability to sell our securities in the secondary market. This lack of liquidity would also make it more difficult for us to raise capital in the future.

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

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

We believe the recent worldwide economic weakness has had a negative effect on our business, and this may continue in the future. This is particularly notable in the sale of new instruments, which is a capital expenditure many, if not most, veterinarians may choose to defer in times of perceived economic weakness. Even if the overall economy begins to grow in the future, there may be a lag before veterinarians display confidence such growth will continue and return to historical capital expenditure purchasing patterns. As the vast majority of cash flow to veterinarians ultimately is funded by pet owners without private insurance or government support, our business may be more susceptible to severe economic downturns than other health care businesses which rely less on individual consumers.

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

to or through veterinarians. The acceptance of our products by veterinarians is critical to our success. Changes in our ability to obtain or maintain such acceptance or changes in veterinary medical practice could significantly decrease our anticipated sales.

We currently sell and market most of our Core Companion Animal Health products in the United States to veterinarians through an outside field organization of approximately 38 individuals, an inside sales force of approximately 27 individuals, independent third-party distributors, as well as through trade shows and print advertising. To be successful in these endeavors, we will have to effectively market our products and continue to develop and train our direct sales force as well as the sales personnel of our independent third-party distributors. In January 2010, we gave notice of contract termination to most domestic independent third-party distributors who carry our full product line and, accordingly, we anticipate the percent of our revenue from sale to independent third-party distributors to decline in 2010 as compared to 2009. Sales to distributors whose underlying contracts have been canceled since the beginning of 2009 represented 8% of our LTM revenue. We intend to compete with these distributors primarily through direct sales efforts going forward. There can be no assurance we will be successful in competing with these or other distributors, that these distributors will not damage our business, and/or that we will not lose sales and experience damage to our financial results as a result of the termination of these agreements. We believe that one of our largest competitors, IDEXX Laboratories, Inc. ("IDEXX") in effect prohibits its distributors from selling competitive products, including our diagnostic instruments and heartworm diagnostic tests, which may hinder our ability to sell and market our products if these distributors are increasingly successful.

We rely substantially on third-party suppliers. The loss of products or delays in product availability from one or more third-party supplier could substantially harm our business. One of our major third-party suppliers cancelled our contractual agreement in November 2009 and we no longer have access to or are selling the products underlying the agreement.

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

We rely on third-party suppliers to manufacture those products we do not manufacture ourselves. Proprietary products provided by these suppliers represent a majority of our revenue. We currently rely on these suppliers for our veterinary instruments and consumable supplies for these instruments, for our point-of-care diagnostic and other tests, for the manufacture of our allergy immunotherapy treatment products as well as for the manufacture of other products.

The largest of these suppliers (the "Canceling Supplier") in 2009 provided us with their proprietary handheld diagnostic instruments and affiliated proprietary cartridges and supplies. Approximately 6% of our revenue for the twelve months ended June 30, 2010 is related to the proprietary products manufactured by the Canceling Supplier (the "Canceled Products"). The Canceled Products generated slightly below average Gross Margin as compared to our overall business in 2009. On May 1, 2009, the Canceling Supplier informed us that they were canceling our contractual agreement as of November 1, 2009. Under our agreement with the Canceling Supplier, our rights became non-exclusive upon receipt of such notice. We subsequently learned through a Form 8-K filing with the Securities and Exchange Commission ("SEC") that Abaxis, Inc. ("Abaxis"), one of our major competitors, had signed an agreement with the Canceling Supplier to distribute certain Canceled Products into the animal health market and that such rights were to be exclusive outside of Japan on November 1, 2009. We no longer have access to the Canceled Products to sell to our installed base of customers and anticipate a significant decline in revenue and gross margin in 2010 as compared to 2009 related to Canceled Products as a result. There can be no assurance we will be able to find an acceptable alternative product to the Canceled Products, that any such product could compete effectively against the Canceled Products, directly or in a niche, or that any such product will be available in a timely or economic manner.

Other major suppliers who sell us proprietary products which are responsible for more than 5% of our LTM revenue are Arkray Global Business, Inc. ("Arkray"), Boule Medical AB, FUJIFILM Corporation and Quidel Corporation. None of these suppliers sold us proprietary products which were responsible for more than 20% of LTM revenue, although the proprietary products of two were each responsible for more than 15% of LTM revenue and the proprietary products of one other was responsible for more than 10% of 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 veterinary diagnostic instruments, we are typically entitled to non-exclusive access to consumable supplies for a defined period upon expiration of exclusive rights, which could subject us to competitive pressures in the period of non-exclusive access. Although we believe we have arrangements to ensure supply of our major product offerings other than the Canceled Products in the marketplace through at least the end of 2010, there can be no assurance that our suppliers will meet their obligations under any agreements we may have in place with them or that we will be able to compel them to do so. Risks of relying on suppliers include:

- The loss of product rights upon expiration or termination of an existing agreement. Unless we are able to find an alternate supply of a similar product, we would not be able to continue to offer our customers the same breadth of products and our sales and operating results would likely suffer. In the case of an instrument supplier, we could also potentially suffer the loss of sales of consumable supplies, which would be significant in cases where we have built a significant installed base, further harming our sales prospects and opportunities. The Canceling Supplier eliminating our access to the Canceled Products is an example of such a situation. Even if we were able to find an alternate supply for a product to which we lost rights, we would likely face increased competition from the product whose rights we lost being marketed by a third party or the former supplier and it may take us additional time and expense to gain the necessary approvals and launch an alternative product.

- Loss of exclusivity. In the case of our veterinary diagnostic instruments, if we are entitled to non-exclusive access to consumable supplies for a defined period upon expiration of exclusive rights, we may face increased competition from a third party with similar non-exclusive access or our former supplier, which could cause us to lose customers and/or significantly decrease our margins and could significantly affect our financial results. For example, a third-party has gained access to chemistry instrument test strips and supplies for our previous chemistry instrument which are manufactured by Arkray, has increased competition for these products with our customers and such competition may cause us to lose customers and/or significantly decrease our margins in the future. In addition, current agreements, or agreements we may negotiate in the future, with suppliers may require us to meet minimum annual sales levels to maintain our position as the exclusive distributor of these products. We may not meet these minimum sales levels and maintain exclusivity over the distribution and sale of these products. If we are not the exclusive distributor of these products, competition may increase significantly, reducing our revenues and/or decreasing our margins.

- High switching costs. In our diagnostic instrument products we could face significant competition and lose all or some of the consumable revenues from the installed base of those instruments if we were to switch to a competitive instrument. If we need to change to other commercial manufacturing contractors for certain of our regulated products, additional regulatory licenses or approvals must be obtained for these contractors prior to our use. This would require new testing and compliance inspections prior to sale thus resulting in potential delays. Any new manufacturer would have to be educated in, or develop substantially equivalent processes necessary for the production of our products. We likely would have to train our sales force, distribution network employees and customer support organization on the new product and spend significant funds marketing the new product to our customer base.

- Inability to meet minimum obligations. Current agreements, or agreements we may negotiate in the future, may commit us to certain minimum purchase or other spending obligations. It is possible we will not be able to create the market demand to meet such obligations, which could create a drain on our financial resources and liquidity. Some such agreements may require minimum purchases and/or sales to maintain product rights and we

may be significantly harmed if we are unable to meet such requirements and lose product rights.

- The involuntary or voluntary discontinuation of a product line. Unless we are able to find an alternate supply of a similar product in this or similar circumstances with any product, we would not be able to continue to offer our customers the same breadth of products and our sales would likely suffer. Even if we are able to identify an alternate supply, it may take us additional time and expense to gain the necessary approvals and launch an alternative product, especially if the product is discontinued unexpectedly. An example of such a situation arose in 2006 when Dolphin Medical Inc. (a majority-owned subsidiary of OSI Systems, Inc.) discontinued production of our VET/OX G2 DIGITAL Monitor as part of an agreement with Masimo Corporation to settle a patent dispute.

- Inconsistent or inadequate quality control. We may not be able to control or adequately monitor the quality of products we receive from our suppliers. Poor quality items could damage our reputation with our customers.

- Limited capacity or ability to scale capacity. If market demand for our products increases suddenly, our current suppliers might not be able to fulfill our commercial needs, which would require us to seek new manufacturing arrangements and may result in substantial delays in meeting market demand. If we consistently generate more demand for a product than a given supplier is capable of handling, it could lead to large backorders and potentially lost sales to competitive products that are readily available. This could require us to seek or fund new sources of supply, which may be difficult to find unless it is under terms that are less advantageous.

- Regulatory risk. Our manufacturing facility and those of some of our third-party suppliers are subject to ongoing periodic unannounced inspection by regulatory authorities, including the FDA, USDA and other federal, state and foreign agencies for compliance with strictly enforced Good Manufacturing Practices, regulations and similar foreign standards, and we do not have control over our suppliers' compliance with these regulations and standards. Violations could potentially lead to interruptions in supply that could cause us to lose sales to readily available competitive products.

- Developmental delays. We may experience delays in the scale-up quantities needed for product development that could delay regulatory submissions and commercialization of our products in development, causing us to miss key opportunities.

- Limited intellectual property rights. We typically do not have intellectual property rights, or may have to share intellectual property rights, to the products themselves and any improvements to the manufacturing processes or new manufacturing processes for our products.

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

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

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

Even if we are successful in the development of a product or obtain rights to a product from a third-party supplier, we may experience delays or shortfalls in commercialization and/or market acceptance of the product. For example, veterinarians may be slow to adopt a product or there may be delays in producing large volumes of a product. The former is particularly likely where there is no comparable product available or historical use of such a product. For example, while we believe our E.R.D.-HEALTHSCREEN urine tests for dogs and cats represent a significant scientific breakthrough in companion animal annual health examinations, these products have achieved significantly lower market acceptance than we anticipated. The ultimate adoption of a new product by veterinarians, the rate of such adoption and the extent veterinarians choose to integrate such a product into their practice are all important factors in the economic success of one of our new products and are factors that we do not control to a large extent. If our products do not achieve a significant level of market acceptance, demand for our products will not develop as expected and our revenues will be lower than we anticipate.

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

The market in which we compete is intensely competitive. Our competitors include independent animal health companies and major pharmaceutical companies that have animal health divisions. We also compete with independent, third-party distributors, including distributors who sell products under their own private labels. In the point-of-care diagnostic testing market, our major competitors include IDEXX, Abaxis and Synbiotics Corporation. The products manufactured by our OVP segment for sale by third parties compete with similar products offered by a number of other companies, some of which have substantially greater financial, technical, research and other resources than us and may have more established marketing, sales, distribution and service organizations than our OVP segment's customers. Competitors may have facilities with similar capabilities to our OVP segment, which they may operate and sell at a lower unit price to customers than our OVP segment does, which could cause us to lose customers. Companies with a significant presence in the companion animal health market, such as Bayer AG, CEVA Santé Animale, Eli Lilly and Company, Merck, Merial (a company owned by Sanofi), Novartis AG, Pfizer Inc., Vétoquinol S.A. and Virbac S.A., may be marketing or developing products that compete with our products or would compete with them if developed. These and other competitors and potential competitors may have substantially greater financial, technical, research and other resources and larger, more established marketing, sales and service organizations than we do. Our competitors may offer broader product lines and have greater name recognition than we do. Our competitors may develop or market technologies or products that are more effective or commercially attractive than our current or future products or that would render our technologies and products obsolete. Further, additional competition could come from new entrants to the animal health care market. Moreover, we may not have the financial resources, technical expertise or marketing, sales or support capabilities to compete successfully. We believe that one of our largest competitors, IDEXX, in effect prohibits its distributors from selling competitive products, including our diagnostic instruments and heartworm diagnostic tests. Another of our competitors, Abaxis, recently launched a stand-alone canine heartworm diagnostic test competitive with ours and a heartworm diagnostic test conducted as part of a chemistry profile on its chemistry analyzer. On May 1, 2009, the Canceling Supplier informed us that they were canceling our contractual agreement as of November 1, 2009. Under our agreement with the Canceling Supplier, our rights became non-exclusive upon receipt of such notice. We subsequently learned through a Form 8-K filing with the SEC that Abaxis had signed an agreement with the Canceling Supplier to distribute certain Canceled Products into the animal health market and that such rights are to be exclusive outside of Japan on November 1, 2009. We no longer have access to the Canceled Products to sell to our installed base of customers and anticipate a significant decline in revenue and gross margin related to Canceled Products as a result. We also anticipate that our competitors will be able to obtain increased access to our installed customers who may seek to find replacement distribution channels for the Canceled Products or substantially similar products, which will intensify competition for our customers with respect to other of our products. There can be no assurance we will be able to find an acceptable alternative product to the Canceled Products, that any such product could compete effectively against the Canceled Products, directly or in a niche, or that any such product will be available in a timely or economic manner.

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

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

Prior to 2005, we incurred net losses on an annual basis since our inception in 1988 and, as of June 30, 2010, we had an accumulated deficit of $172.3 million. We have achieved only one quarter with income before income taxes greater than $1.5 million. Accordingly, relatively small differences in our performance metrics may cause us to lose money in future periods. In addition, we anticipate the loss of access to the Canceled Products will put significant financial pressure on us in 2010. Our ability to continue to be profitable in future periods will depend, in part, on our ability to increase sales in our Core Companion Animal Health segment, including maintaining and growing our installed base of instruments and related consumables, to maintain or increase gross margins and to limit the increase in our operating expenses to a reasonable level as well as avoid or effectively manage any unanticipated issues. We may not be able to generate, sustain or increase profitability on a quarterly or annual basis. If we cannot achieve or sustain profitability for an extended period, we may not be able to fund our expected cash needs, including the repayment of debt as it comes due, or continue our operations.

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

We may face legal disputes related to our business. Even if meritless, these disputes may require significant expenditures on our part and could entail a significant distraction to members of our management team or other key employees. A legal dispute leading to an unfavorable ruling or settlement could have significant material adverse consequences on our business.

We may become subject to additional patent infringement claims and litigation in the United States or other countries or interference proceedings conducted in the United States Patent and Trademark Office, or USPTO, to determine the priority of inventions. The defense and prosecution of intellectual property suits, USPTO interference proceedings and related legal and administrative proceedings are likely to be costly, time-consuming and distracting. As is typical in our industry, from time to time we and our collaborators and suppliers have received, and may in the future receive, notices from third parties claiming infringement and invitations to take licenses under third-party patents. Any legal action against us or our collaborators or suppliers may require us or our collaborators or suppliers to obtain one or more licenses in order to market or manufacture affected products or services. However, we or our collaborators or suppliers may not be able to obtain licenses for technology patented by others on commercially reasonable terms, or at all, may not be able to develop alternative approaches if unable to obtain licenses or current and future licenses may not be adequate, any of which could substantially harm our business. An example of such a situation arose in 2006 when Dolphin Medical Inc. (a majority-owned subsidiary of OSI Systems, Inc.) discontinued production of our VET/OX G2 DIGITAL Monitor as part of an agreement with Masimo Corporation to settle a patent dispute.

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

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

Under our credit and security agreement with Wells Fargo we are required to comply with various financial and non-financial covenants in order to borrow under the agreement. The availability of borrowings under this agreement is essential to continue to fund our operations. Among the financial covenants is a requirement to maintain minimum liquidity (cash plus excess borrowing base) of $1.5 million. Additional requirements include covenants for minimum capital monthly and minimum net income quarterly. Although we believe we will be able to maintain compliance with all these covenants and any covenants we may negotiate in the future, there can be no assurance thereof. We have not always been able to maintain compliance with all covenants under our credit and security agreement in the past. Although Wells Fargo granted us a waiver of non-compliance in each case, there can be no assurance we will be able to obtain similar waivers or other modifications if needed in the future on economic terms, if at all. Failure to comply with any of the covenants, representations or warranties, or failure to modify them to allow future compliance, could result in our being in default and could cause all outstanding borrowings under our credit and security agreement to become immediately due and payable, or impact our ability to borrow under the agreement. In addition, Wells Fargo has discretion in setting the advance rates which we may borrow against eligible assets. We intend to rely on available borrowings under the credit and security agreement to fund our operations in the future. If we are unable to borrow funds under this agreement, we will need to raise additional capital from other sources to continue our operations, which capital may not be available on acceptable terms, or at all.

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, such as the recent decision by the Canceling Supplier to cancel our contractual agreement as of November 1, 2009;
- the introduction of new products by our competitors or by us;
- competition and pricing pressures from competitive products;
- 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. If any of the factors listed above cause our revenues to decline, our operating results could be substantially harmed.

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

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

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

If our actual performance deviates from our operating plan, we may be required to raise additional capital in the future. If necessary, we expect to raise these additional funds by the sale of equity securities or refinancing loans currently outstanding on assets with historical appraised values in excess of related debt. There is no guarantee that additional capital will be available from these sources on reasonable terms, if at all, and certain of these sources may require approval by existing lenders. The public markets may be unreceptive to equity financings and we may not be able to obtain additional private equity or debt financing. Any equity financing would likely be dilutive to stockholders and additional debt financing, if available, may include restrictive covenants and increased interest rates that would limit our currently planned operations and strategies. Additionally, funds we expect to be available under our existing revolving line of credit may not be available and other lenders could refuse to provide us with additional debt financing. We believe the credit markets are particularly restrictive and difficult to obtain funding in versus recent history. Furthermore, even if additional capital is available, it may not be of the magnitude required to meet our needs under these or other scenarios. If additional funds are required and are not available, it would likely have a material adverse effect on our business, financial condition and our ability to continue as a going concern.

We have recently adopted certain transfer restrictions on our stock which could reduce trading liquidity from what it otherwise would have been and have other undesired affects. In addition, our stock price has historically experienced high volatility, and could do so in the future.

On May 4, 2010, our shareholders approved an amendment (the "Amendment") to our Restated Certificate of Incorporation. The Amendment places restrictions on the transfer of our stock that could adversely affect our ability to use our domestic 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. This may cause certain individuals or entities who may have otherwise been willing and able to bid on Heska stock to not do so, reducing the class of potential acquirers and trading liquidity from what it otherwise might have been. The Amendment could also have an adverse impact on the value of our stock if certain buyers who would otherwise have purchased our stock, including buyers who may not be comfortable owning stock with transfer restrictions, do not 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 common 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.

The securities markets have experienced significant price and volume fluctuations and the market prices of securities of many microcap and smallcap companies have in the past been, and can in the future be expected to be, especially volatile. During the twelve months ended June 30, 2010, our closing stock price has ranged from a low of $0.32 to a high of $0.97. Fluctuations in the trading price or liquidity of our common stock may adversely affect our ability to raise capital through future equity financings. Factors that may have a significant impact on the market price and marketability of our common stock include:

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

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

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") has increased our required administrative actions and expenses as a public company since its enactment. The general and administrative costs of complying with Sarbanes-Oxley will depend on how it is interpreted over time. Of particular concern are the level of standards for internal control evaluation and reporting adopted under Section 404 of Sarbanes-Oxley. If our regulators and/or auditors adopt or interpret more stringent standards than we anticipate, we and/or our auditors may be unable to conclude that our internal controls over financial reporting are designed and operating effectively, which could adversely affect investor confidence in our financial statements. Even if we and our auditors are able to conclude that our internal controls over financial reporting are designed and operating effectively in such a circumstance, our general and administrative costs are likely to increase. In addition, actions by other entities, such as enhanced rules to maintain our listing on the Nasdaq Capital Market, could also increase our general and administrative costs or have other adverse effects on us, as could further legislative, regulatory or rule-making action or more stringent interpretations of existing legislation, regulations and rules.

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

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

Changes to financial accounting standards may affect our results of operations, cause us to change our business practices or have a negative impact on us if we fail to track such changes.

We prepare our financial statements in conformance with United States generally accepted accounting principles, or GAAP. These accounting principles are established by and are subject to interpretation by the SEC, the Financial Accounting Standards Board and others who interpret and create accounting policies. A change in those policies can have a significant effect on our reported results and may affect our reporting of transactions completed before a change is made effective. Such changes may adversely affect our reported financial results, the way we conduct our business or have a negative impact on us if we fail to track such changes. For example, we have found the Financial Standards Accounting Board's ("FASB") recent decision to codify the accounting standards has made it more difficult to research complex accounting matters, increasing the risk we will fail to account consistent with the FASB rules in the future.

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

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

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

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

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

None.

Item 3. Defaults upon Senior Securities

None.

Item 4. Removed and Reserved

None.

Item 5. Other Information

None.

Item 6. Exhibits

(a) Exhibits

Number	Notes	Description
31.1		Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.
31.2		Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.
32.1		Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

HESKA CORPORATION

SIGNATURES

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

HESKA CORPORATION

Date:	July 21, 2010	By	/s/ Robert B. Grieve ROBERT B. GRIEVE Chairman of the Board and Chief Executive Officer (on behalf of the Registrant and as the Registrant's Principal Executive Officer)
Date:	July 21, 2010	By	/s/ Jason A. Napolitano JASON A. NAPOLITANO Executive Vice President and Chief Financial Officer (on behalf of the Registrant and as the Registrant's Principal Financial Officer)