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HESKA CORP  
Form 10-Q/A  
August 27, 2002

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q/A

AMENDMENT NO. 1

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

For the quarterly period ended June 30, 2002  
OR

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

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

COMMISSION FILE NUMBER: 0-22427

HESKA CORPORATION

-----  
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)  
DELAWARE 77-0192527

-----  
(STATE OR OTHER JURISDICTION OF (I.R.S. EMPLOYER IDENTIFICATION NUMBER)  
INCORPORATION OR ORGANIZATION)

1613 PROSPECT PARKWAY  
FORT COLLINS, COLORADO 80525

-----  
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

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

The number of shares of the Registrant's Common Stock, \$.001 par value,  
outstanding at August 13, 2002 was 47,650,010

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This amendment to the Quarterly Report on Form 10-Q of Heska  
Corporation for the period ended June 30, 2002 is being filed solely for the  
purpose of correcting certain typographical errors on pages 2, 11 and 16

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of the original Form 10-Q filed on August 14, 2002.

HESKA CORPORATION

FORM 10-Q

QUARTERLY REPORT

TABLE OF CONTENTS

PAGE

## PART I. FINANCIAL INFORMATION

### Item 1. Financial Statements:

|  |   |
|--|---|
| Consolidated Balance Sheets (Unaudited) as of<br>December 31, 2001 and June 30, 2002                                     | 2 |
| Consolidated Statements of Operations (Unaudited)<br>for the three months and six months ended June<br>30, 2001 and 2002 | 3 |
| Consolidated Statements of Cash Flows (Unaudited)<br>for the six months ended June 30, 2001 and 2002                     | 4 |
| Notes to Consolidated Financial Statements (Unaudited)   | 5 |

|  |    |
|--|----|
| Item 2. Management's Discussion and Analysis of Financial<br>Condition and Results of Operations | 12 |
|--|----|

|   |    |
|---|----|
| Item 3. Quantitative and Qualitative Disclosures About<br>Market Risk | 27 |
|---|----|

## PART II. OTHER INFORMATION

|                           |    |
|---------------------------|----|
| Item 1. Legal Proceedings | 28 |
|---------------------------|----|

|   |    |
|---|----|
| Item 2. Changes in Securities and Use of Proceeds | 28 |
|---|----|

|   |                |
|---|----------------|
| Item 3. Defaults Upon Senior Securities | Not Applicable |
|---|----------------|

|   |    |
|---|----|
| Item 4. Submission of Matters to a Vote of Security Holders | 28 |
|---|----|

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|  |                |
|--|----------------|
| Item 5. Other Information                | Not Applicable |
| Item 6. Exhibits and Reports on Form 8-K | 29             |
| Signatures                               | 30             |

HESKA CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS  
(dollars in thousands except per share amounts)  
(unaudited)

ASSETS

|   | DECEMBER 31<br>2001 |
|---|---------------------|
| Current assets:   |                     |
| Cash and cash equivalents   | \$                  |
| Accounts receivable, net of allowance for doubtful accounts of<br>\$501 and \$230, respectively | 1                   |
| Inventories   |                     |
| Other current assets  |                     |
|   | -----               |
| Total current assets  | 2                   |
| Property and equipment, net   | 1                   |
| Goodwill and intangible assets, net   |                     |
| Other assets  |                     |
|   | -----               |
| Total assets  | \$ 3<br>=====       |

LIABILITIES AND STOCKHOLDERS' EQUITY

|   |            |
|---|------------|
| Current Liabilities:                              |            |
| Accounts payable                                  | \$         |
| Accrued liabilities                               |            |
| Deferred revenue                                  |            |
| Line of credit                                    |            |
| Current portion of capital lease obligations      |            |
| Current portion of long-term debt                 |            |
|   | -----      |
| Total current liabilities                         | 1          |
| Capital lease obligations, net of current portion |            |
| Long-term debt, net of current portion            |            |
| Deferred revenue and other long-term liabilities  |            |
|   | -----      |
| Total liabilities                                 | 2<br>----- |
| Commitments and contingencies                     |            |

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|   |    |       |
|---|----|-------|
| Stockholders' equity:   |    |       |
| Preferred stock, \$.001 par value, 25,000,000 shares authorized; none issued or outstanding   |    | 21    |
| Common stock, \$.001 par value, 75,000,000 shares authorized; 47,842,198 and 47,647,948 shares issued and outstanding, respectively |    |       |
| Additional paid-in capital  |    |       |
| Deferred compensation   |    |       |
| Accumulated other comprehensive loss  |    |       |
| Accumulated deficit   |    | (19)  |
|   |    | ----- |
| Total stockholders' equity  |    | 1     |
|   |    | ----- |
| Total liabilities and stockholders' equity  | \$ | 3     |
|   |    | ===== |

See accompanying notes to consolidated financial statements

2

HESKA CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS  
(in thousands, except per share amounts)  
(unaudited)

|  | THREE MONTHS ENDED<br>JUNE 30, |          |
|--|--------------------------------|----------|
|  | 2001                           | 2002     |
|  | -----                          | -----    |
| Revenue:                                     |                                |          |
| Products, net of sales returns and allowance | \$ 10,700                      | \$ 11,96 |
| Research, development and other              | 238                            | 26       |
|  | -----                          | -----    |
| Total revenue                                | 10,938                         | 12,22    |
| Cost of products sold                        | 6,990                          | 7,15     |
|  | -----                          | -----    |
|  | 3,948                          | 5,06     |
|  | -----                          | -----    |
| Operating expenses:                          |                                |          |
| Selling and marketing                        | 3,584                          | 3,15     |
| Research and development                     | 3,118                          | 2,20     |
| General and administrative                   | 1,859                          | 1,81     |
| Restructuring and other expenses             | -                              | 62       |
|  | -----                          | -----    |
| Total operating expenses                     | 8,561                          | 7,79     |
|  | -----                          | -----    |
| Loss from operations                         | (4,613)                        | (2,73    |
| Other income (expense), net                  | (51)                           | (4       |

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|   |            |          |
|---|------------|----------|
| Net loss  | \$ (4,664) | \$ (2,77 |
|   | =====      | =====    |
| Basic and diluted net loss per share                        | \$ (0.12)  | \$ (0.0  |
|   | =====      | =====    |
| Shares used to compute basic and diluted net loss per share | 38,673     | 47,80    |
|   | =====      | =====    |

See accompanying notes to consolidated financial statements

3

HESKA CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(in thousands)  
(unaudited)

CASH FLOWS USED IN OPERATING ACTIVITIES:

Net loss

Adjustments to reconcile net loss to cash used in operating activities:

Depreciation and amortization

Amortization of intangible assets and deferred compensation

Changes in operating assets and liabilities:

Accounts receivable, net

Inventories

Other current assets

Other long-term assets

Accounts payable

Accrued liabilities

Deferred revenue and other long-term liabilities

Other

Net cash used in operating activities

CASH FLOWS FROM INVESTING ACTIVITIES:

Proceeds from sale of marketable securities

Proceeds from disposition of property and equipment

Purchase of property and equipment

Net cash provided by (used in) investing activities

CASH FLOWS FROM FINANCING ACTIVITIES:

Proceeds from issuance of common stock

Proceeds from borrowings

Repayments of debt and capital lease obligations

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Net cash provided by financing activities

EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS

INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS

CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD

CASH AND CASH EQUIVALENTS, END OF PERIOD

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

Cash paid for interest

See accompanying notes to consolidated financial statements

4

### HESKA CORPORATION AND SUBSIDIARIES

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2002

(UNAUDITED)

#### 1. ORGANIZATION AND BUSINESS

Heska Corporation ("Heska" or the "Company") is primarily focused on the discovery, development, manufacturing and marketing of companion animal health products and delivery of diagnostic services to veterinarians. The Company currently conducts its operations through two reportable segments. Through its Companion Animal Health segment, the Company sells diagnostic, vaccine and pharmaceutical products and veterinary diagnostic and patient monitoring instruments, offers diagnostic services, and performs a variety of research and development activities. The operations of this segment are carried out through the Company's facilities in Fort Collins, Colorado, and its wholly owned Swiss subsidiary, Heska AG. Through its Food Animal Health segment, the Company manufactures food animal vaccine and pharmaceutical products that are marketed and distributed by third parties. The operations of this segment are carried out through the Company's wholly owned subsidiary Diamond Animal Health, Inc. ("Diamond"), located in Des Moines, Iowa.

From the Company's inception in 1988 until early 1996, the Company's operating activities related primarily to research and development activities, entering into collaborative agreements, raising capital and recruiting personnel. Prior to 1996, the Company had not received any revenue from the sale of products. During 1996, Heska grew from being primarily a research and development concern to a fully integrated research, development, manufacturing and marketing company. The Company accomplished this by acquiring Diamond, a licensed pharmaceutical and biological manufacturing facility, hiring key employees and support staff, establishing marketing and sales operations to support new Heska products, and designing and implementing more sophisticated operating and information systems. The Company also expanded the scope and level of its scientific and business development activities, increasing the opportunities for new products. In 1997, the Company introduced additional products and expanded in the United States through the acquisition of Center, a

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Food and Drug Administration ("FDA") and United States Department of Agriculture ("USDA") licensed manufacturer of allergy immunotherapy products located in Port Washington, New York, and internationally through the acquisitions of Heska UK Limited ("Heska UK", formerly Bloxham Laboratories Limited), a veterinary diagnostic laboratory in Teignmouth, England and Heska AG (formerly Centre Medical des Grand'Places S.A.) in Fribourg, Switzerland, which manufactures and markets allergy diagnostic products primarily in Europe.

The Company has incurred net losses since its inception and anticipates that it will continue to incur additional net losses in the near term as it introduces new products, expands its sales and marketing capabilities and continues its research and development activities. Cumulative net losses from inception of the Company in 1988 through June 30, 2002 have totaled \$199.8 million. During the six months ended June 30, 2002, the Company incurred a loss of approximately \$6.7 million and used cash of approximately \$2.2 million for operations.

The Company's primary short-term needs for capital are its continuing research and development efforts, its sales, marketing and administrative activities, working capital associated with increased product sales and capital expenditures relating to maintaining and developing its manufacturing operations. The Company's ability to achieve profitable operations will depend primarily upon its ability to successfully market its products, commercialize products that are currently under development and develop new products. Many of the Company's products are subject to long development and regulatory approval cycles and there can be no guarantee that the Company will successfully develop, manufacture or market these products. There can also be no guarantee that

5

the Company will attain profitability or, if achieved, will remain profitable on a quarterly or annual basis in the future.

The Company believes that its available cash and cash equivalents, together with cash from operations, borrowings expected to be available under its revolving line of credit facility, cash from the license of the rights to its Flu AVERT I.N. product (see Note 10) and other sources discussed below, should be sufficient to satisfy its projected cash requirements through June 30, 2003. Other potential sources to raise additional funds include one or more of the following: (1) obtaining new loans secured by unencumbered assets; (2) sale of various products or marketing rights; (3) licensing of technology; (4) sale of various assets; and (5) sale of additional equity or debt securities.

Under the Company's revolving line of credit agreement with Wells Fargo Business Credit, it is required to comply with various financial and non-financial covenants, and the Company has made various representations and warranties. Among the financial covenants is a requirement to maintain \$2.5 million of minimum liquidity (cash plus excess borrowing base). Additional requirements include covenants for minimum capital monthly and minimum net income quarterly. The Company currently believes it is not likely to be able to meet its existing covenants for minimum net income and minimum book capital in future periods. The Company intends to negotiate modifications or a waiver of these covenants. The Company has obtained modifications and a waiver of covenants in the past, although there can be no assurance it can obtain similar modifications or waivers in the future.

Failure to comply with any of the covenants, representations or warranties could result in the Company being in default under the loan and could cause all outstanding amounts to become immediately due and payable or impact the Company's ability to borrow under the agreement. All amounts due under the credit facility mature on May 31, 2003. The Company intends to rely on available borrowings under the credit agreement to fund its operations through

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2002 and into 2003. If the Company is unable to borrow funds under this agreement, it will need to raise additional capital to fund its cash needs and continue its operations. If the Company is unable to extend or refinance the borrowings under the credit facility as of, or before, May 31, 2003, or complete other options to meet its cash needs created by maturing debt, it may be unable to continue as a going concern.

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. The balance sheet as of June 30, 2002, the statements of operations for the three months and six months ended June 30, 2002 and 2001 and the statements of cash flows for the six months ended June 30, 2002 and 2001 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 financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

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, 2001,

6

included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on April 1, 2002.

#### Basic and Diluted Net Loss Per Share

Basic net loss per common share is computed using the weighted average number of common shares outstanding during the period. Diluted net 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. Since inception, due to the Company's net losses, all potentially dilutive securities are anti-dilutive and as a result, basic and net loss per share is the same as diluted net loss per share for all periods presented. At June 30, 2001 and 2002, outstanding options and warrants to purchase 6,162,416 and 6,553,530 shares, respectively, of the Company's common stock have been excluded from diluted net loss per share because they are anti-dilutive.

### 3. MAJOR CUSTOMERS

One customer accounted for approximately 11% and 12% of total revenues for the Company for the three months ended June 30, 2001 and 2002, respectively. This same customer accounted for approximately 11% and 11% of total revenues for



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the six months ended June 30, 2001 and 2002, respectively. At June 30, 2002, this customer accounted for approximately 17% of total accounts receivable. No single customer accounted for 10% or more of total accounts receivable at June 30, 2001. This customer purchased vaccines from Diamond.

### 4. RESTRUCTURING AND OTHER EXPENSES

The Company recorded a one time charge to other operating expenses during the second quarter of 2002 totaling approximately \$621,000 related to personnel severance costs.

The Company recorded a restructuring charge in the first quarter of 2002. The charge to operations of approximately \$566,000 related primarily to personnel severance costs for 32 individuals and the costs associated with disposal of leased vehicles and other costs for certain of the employees.

In the fourth quarter of 2001, the Company recorded a \$1.5 million restructuring charge related to a strategic change in its distribution model and the consolidation of its European operations into one facility. This expense related to personnel severance costs, costs to adjust the Company's products to align with the new distribution model and the cost to close a leased facility in Europe. During the first quarter of 2002, the Company revised its cost estimates related to the restructuring charge recorded in the fourth quarter of 2001 as certain liabilities were favorably settled. This change in estimate was approximately \$330,000 and was offset against the restructuring charge recorded in the first quarter of 2002 as described above.

Shown below is a reconciliation of restructuring costs for the six months ended June 30, 2002 (in thousands):

|                               | BALANCE AT<br>DECEMBER 31,<br>2001 | ADDITIONS FOR THE<br>SIX MONTHS ENDED<br>JUNE 30, 2002 | PAYMENTS FOR THE<br>SIX<br>MONTHS ENDED<br>JUNE 30, 2002 |       |
|-------------------------------|------------------------------------|--|--|-------|
|                               | -----                              | -----  | -----  | ----- |
| Severance pay and benefits    | \$ 378                             | \$ 466   | \$ (543)   | \$    |
| Leased facility closure costs | 50                                 | -  | (50)   |       |
| Products and other            | 1,100                              | 100  | (583)  |       |
|                               | -----                              | -----  | -----  | ----- |
| Total                         | \$ 1,528                           | \$ 566   | \$ (1,176)   | \$    |
|                               | =====                              | =====  | =====  | ===== |

7

### 5. GOODWILL AND INTANGIBLES

The Company adopted SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets" effective as of January 1, 2002. SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for using the purchase accounting method. SFAS No. 142 states that goodwill is no longer subject to amortization over its useful life. Rather, goodwill will be subject to an annual assessment for impairment and be written down to its fair value only if the carrying amount is greater than the fair

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value. In addition, intangible assets will be separately recognized if the benefit of the intangible asset is obtained through contractual or other legal rights, or if the intangible asset can be sold, transferred, licensed, rented or exchanged, regardless of the acquirer's intent to do so. The amount and timing of non-cash charges related to intangibles acquired in business combinations will change significantly from prior practice.

The Company's recorded goodwill relates to the acquisition in 1997 of Heska AG, and beginning in fiscal 2002 it is no longer amortized on a periodic basis. The balance at June 30, 2002 is approximately \$643,000. No impairment was recognized and there were no other changes to the goodwill balance during the six months ended June 30, 2002. This goodwill is included in the assets of the Companion Animal Health segment.

The Company has net intangible assets related to capitalized patent costs totaling approximately \$698,000 as of June 30, 2002. These costs are being amortized over an average life of 15 years. Amortization expense for the six months ended June 30, 2002, was approximately \$34,000. There are no additional intangible assets not being amortized on a periodic basis. These intangible assets are included in the assets of the Companion Animal Health segment.

The following reflects the impact on the Company's financial results of amortization expense for goodwill and other intangible assets during the prior three fiscal years. There was no material impact for the six months ended June 30, 2002. (In thousands except per share amounts):

|                                       | FOR THE YEAR ENDED |             |
|---------------------------------------|--------------------|-------------|
|                                       | 1999               | 2000        |
| Reported net loss                     | \$ (35,836)        | \$ (40,000) |
| Add back: Goodwill amortization       | 241                | (1,000)     |
| Adjusted net loss                     | \$ (35,595)        | \$ (41,000) |
| Basic and diluted earnings per share: |                    |             |
| Reported net loss                     | \$ (1.31)          | \$ (1.33)   |
| Goodwill amortization                 | 0.01               | (0.01)      |
| Adjusted net loss                     | \$ (1.30)          | \$ (1.34)   |

### 6. SEGMENT REPORTING

The Company's business is comprised of two reportable segments, Companion Animal Health and Food Animal Health. Within the Companion Animal Health segment products include pharmaceuticals, vaccines and diagnostics and veterinary diagnostic and patient monitoring instruments. These products are sold through operations in Fort Collins, Colorado and Europe. Within the Food Animal Health segment, products include food animal vaccines and pharmaceuticals. Food Animal Health products are manufactured at, and sold by, the Company's Diamond Animal Health subsidiary in Des Moines, Iowa.

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Non-product revenues are generated from sponsored research and development projects for third parties, licensing of technology and royalties. These sponsored research and development projects are performed for both companion animal and food animal purposes.

8

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

|                               | COMPANION<br>ANIMAL<br>HEALTH | FOOD<br>ANIMAL<br>HEALTH | INTERCOMP |
|-------------------------------|-------------------------------|--------------------------|-----------|
|                               | -----                         | -----                    | -----     |
| THREE MONTHS ENDED            |                               |                          |           |
| JUNE 30, 2002:                |                               |                          |           |
| Revenue                       | \$ 9,300                      | \$ 3,149                 | \$ (2)    |
| Operating income (loss)       | (3,315)                       | 584                      |           |
| Total assets                  | 46,270                        | 24,347                   | (38,6)    |
| Capital expenditures          | -                             | 170                      |           |
| Depreciation and amortization | 319                           | 297                      |           |
| THREE MONTHS ENDED            |                               |                          |           |
| JUNE 30, 2001:                |                               |                          |           |
| Revenue                       | \$ 8,351                      | \$ 3,193                 | \$ (      |
| Operating income (loss)       | (4,710)                       | 97                       |           |
| Total assets                  | 49,106                        | 18,091                   | (31,      |
| Capital expenditures          | 101                           | 39                       |           |
| Depreciation and amortization | 564                           | 365                      |           |
|                               | COMPANION<br>ANIMAL<br>HEALTH | FOOD<br>ANIMAL<br>HEALTH | INTERCOMP |
|                               | -----                         | -----                    | -----     |
| SIX MONTHS ENDED              |                               |                          |           |
| JUNE 30, 2002:                |                               |                          |           |
| Revenue                       | \$ 17,132                     | \$ 6,070                 | \$ (      |
| Operating income (loss)       | (7,347)                       | 818                      |           |
| Total assets                  | 46,270                        | 24,347                   | (38,      |
| Capital expenditures          | 97                            | 170                      |           |
| Depreciation and amortization | 635                           | 608                      |           |
| SIX MONTHS ENDED              |                               |                          |           |
| JUNE 30, 2001:                |                               |                          |           |
| Revenue                       | \$ 16,463                     | \$ 6,555                 | \$ (1,    |
| Operating income (loss)       | (9,266)                       | 188                      |           |
| Total assets                  | 49,106                        | 18,091                   | (31,      |
| Capital expenditures          | 204                           | 236                      |           |
| Depreciation and amortization | 1,128                         | 763                      |           |

The Company manufactures and markets its products in two major geographic areas, North America and Europe. The Company's primary manufacturing facilities

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are located in North America. Revenues earned in North America are attributable to Heska and Diamond. Revenues earned in Europe are primarily attributable to Heska AG. There have been no significant exports from North America or Europe.

During each of the years presented, European subsidiaries purchased products from North America for sale to European customers. Transfer prices to international subsidiaries are intended to allow the North American companies to produce profit margins commensurate with their sales and marketing efforts. Certain information by geographic area is shown in the following table (in thousands).

9

|                               | NORTH AMERICA | EUROPE   | INTERCO |
|-------------------------------|---------------|----------|---------|
| THREE MONTHS ENDED            |               |          |         |
| JUNE 30, 2002:                |               |          |         |
| Revenue                       | \$ 11,832     | \$ 617   | \$ (2)  |
| Operating income (loss)       | (2,728)       | (3)      |         |
| Total assets                  | 68,509        | 2,108    | (38,6)  |
| Capital expenditures          | 99            | 71       | (       |
| Depreciation and amortization | 528           | 88       |         |
| THREE MONTHS ENDED            |               |          |         |
| JUNE 30, 2001:                |               |          |         |
| Revenue                       | \$ 11,089     | \$ 455   | \$ (    |
| Operating income (loss)       | (4,471)       | (142)    |         |
| Total assets                  | 65,152        | 2,045    | (31,    |
| Capital expenditures          | 140           | -        |         |
| Depreciation and amortization | 913           | 16       |         |
|                               | NORTH AMERICA | EUROPE   | INTERCO |
| SIX MONTHS ENDED              |               |          |         |
| JUNE 30, 2002:                |               |          |         |
| Revenue                       | \$ 21,978     | \$ 1,224 | \$ (    |
| Operating income (loss)       | (6,558)       | 29       |         |
| Total assets                  | 68,509        | 2,108    | (38,    |
| Capital expenditures          | 195           | 72       |         |
| Depreciation and amortization | 1,110         | 133      |         |
| SIX MONTHS ENDED              |               |          |         |
| JUNE 30, 2001:                |               |          |         |
| Revenue                       | \$ 21,974     | \$ 1,045 | \$ (1,  |
| Operating income (loss)       | (8,870)       | (208)    |         |
| Total assets                  | 65,152        | 2,045    | (31,    |
| Capital expenditures          | 440           | -        |         |
| Depreciation and amortization | 1,868         | 23       |         |

### 7. CREDIT FACILITY

In March 2002, the Company entered into an amendment to its revolving line

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of credit facility. The Company's ability to borrow under this agreement varies based upon available cash, eligible accounts receivable and eligible inventory. The minimum liquidity (cash plus excess borrowing base) required to be maintained has been reduced to \$2.5 million during 2002. The Company had borrowed approximately \$5.5 million under its revolving line of credit as of June 30, 2002. As of June 30, 2002, the Company's remaining available borrowing capacity was approximately \$500,000. The credit facility expires on May 31, 2003.

### 8. COMPREHENSIVE INCOME

Comprehensive income includes net income (loss) plus the results of certain stockholders' equity changes not reflected in the Consolidated Statements of Operations. Such changes include foreign currency items, unrealized gains and losses on certain investments in marketable securities and unrealized gains and losses on derivative instruments. Total comprehensive income and the components of comprehensive income follow (in thousands):

10

|   |    | THRE<br>-----<br>2001<br>----- |
|---|----|--------------------------------|
| Net loss per Consolidated Statements of Operations  | \$ | (4,664)                        |
| Foreign currency translation adjustments  |    | 14                             |
| Changes in unrealized gains (losses) on forward contracts, net of realized gains (losses) |    | (68)                           |
| Comprehensive loss  | \$ | (4,718)<br>=====               |
|   |    | SIX<br>-----<br>2001<br>-----  |
| Net loss per Consolidated Statements of Operations  | \$ | (9,236)                        |
| Foreign currency translation adjustments  |    | (143)                          |
| Changes in unrealized gains (losses) on forward contracts, net of realized gains (losses) |    | (68)                           |
| Changes in unrealized loss on marketable securities                                       |    | 44                             |
| Comprehensive loss  | \$ | (9,403)<br>=====               |

Accumulated gains and losses from derivative contracts are as follows:

|  |    | 2001<br>----- |
|--|----|---------------|
| Accumulated derivative gains (losses), December 31 | \$ |               |

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Unrealized losses on forward contracts  
Realized losses on forward contracts reclassified to current earnings  
  
Accumulated derivative gains (losses), June 30

-----  
\$  
=====

### 9. RELATED PARTY TRANSACTIONS

In December 1999, the Company approved a personal loan to Dr. Grieve, its Chairman and Chief Executive Officer, for \$100,000. This loan is evidenced by a promissory note that was originally due and payable on December 23, 2002. The terms of this loan were modified in May 2002 to permit the payment of all interest due on December 23, 2002 and to extend the term of the loan for an additional three years or until December 23, 2005. Interest on the outstanding principal balance accrues at the rate of 5.74% per annum. Payment of any unpaid principal balance together with all accrued and unpaid interest can be accelerated and become payable within ninety days after Dr. Grieve's relationship with us is terminated for any reason other than Dr. Grieve's death or permanent disability.

### 10. SUBSEQUENT EVENT

On July 30, 2002, the Company agreed to license rights to certain patents, trademarks and know-how for its Flu AVERT I.N. vaccine to Intervet. For these rights, the Company received an undisclosed upfront cash payment and may be entitled to future milestone and royalty payments.

11

### ITEM 2.

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

This discussion contains forward-looking statements that involve risks and uncertainties. Such statements, which include statements concerning future revenue sources and concentration, gross margins, research and development expenses, selling and marketing expenses, general and administrative expenses, capital resources, additional financings or borrowings and additional losses, are subject to risks and uncertainties, including, but not limited to, those discussed below and elsewhere in this Form 10-Q, particularly in "Factors that May Affect Results," 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 date of this filing, and we undertake no duty to update this information.

#### CORPORATE OVERVIEW

We discover, develop, manufacture and market companion animal health products, principally for dogs and cats. We employ approximately 60 scientists, of whom over one quarter hold doctoral degrees, with expertise in several disciplines including microbiology, immunology, genetics, biochemistry, molecular biology, parasitology and veterinary medicine. This scientific expertise is focused on the development of a broad range of diagnostic, vaccine and pharmaceutical products for companion animals. We also sell veterinary diagnostic and patient monitoring instruments and offer diagnostic services to

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veterinarians in the United States and Europe, principally for companion animals. In addition to manufacturing companion animal health products for marketing and sale by Heska, our Diamond Animal Health subsidiary manufactures food animal vaccines and other food animal products that are marketed and distributed by other animal health companies.

### OUR BUSINESS

We currently market our products in the United States to veterinarians through approximately 20 independent third-party distributors and through a direct sales force. Nearly one-half of these domestic distributors purchase the full line of our diagnostic, vaccine, pharmaceutical and instrumentation products. We have recently begun to rely on distributors for a greater portion of our sales.

Our business is comprised of two reportable segments, Companion Animal Health and Food Animal Health. Within the Companion Animal Health segment, our products include diagnostics, vaccines and pharmaceuticals and veterinary diagnostic and patient monitoring instruments. These products are sold through our operations in Fort Collins, Colorado and Europe. Within the Food Animal Health segment, we sell food animal vaccine and pharmaceutical products. We manufacture these food animal products at our Diamond Animal Health subsidiary, located in Des Moines, Iowa.

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

### CRITICAL ACCOUNTING POLICIES

The Company's discussion and analysis of its 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

12

disclosure of contingent assets and liabilities as of the date of the financial statements, and the reported amounts of revenue and expenses during the periods. These estimates are based on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ materially from these estimates under different assumptions or conditions. Our critical accounting policies include:

\* We generate our revenue through sale of products, licensing of technology and sponsored research and development. Revenue is accounted for in accordance with the guidelines provided by Staff Accounting Bulletin 101 "Revenue Recognition in Financial Statements" (SAB 101). Our policy is to recognize revenue when the applicable revenue recognition criteria have been met, which generally include the following:

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

Revenue from the sale of products is generally recognized after both the goods are shipped to the customer and acceptance has been received with an appropriate provision for returns and allowances. The terms of the

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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.

In addition to its direct sales force, we utilize third-party distributors to sell our products. Distributors purchase goods from us, take title to those goods and resell them to their customers in the distributors' territory.

License revenues under arrangements to sell product rights or technology rights are recognized upon the sale and completion by us of all obligations under the agreement. Royalties are recognized as products are sold to customers.

We recognize revenue from sponsored research and development over the life of the contract as research activities are performed. The revenue recognized is the lesser of revenue earned under a percentage of completion method based on total expected revenues or actual non-refundable cash received to date under the agreement.

- \* 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 is less than the recorded value.

### RESULTS OF OPERATIONS

#### Revenue

Total revenue, which includes product revenue as well as research, development and other revenue increased 12% to \$12.2 million in the second quarter of 2002 compared to \$10.9 million for the second quarter of 2001. Year-to-date, total revenue increased 2% to \$22.4 million from \$21.9 million for the six-month period ended June 30, 2001.

Product revenue for the three months ended June 30, 2002, increased by 12% to \$12.0 million compared to \$10.7 million in the same period of 2001. Product revenue in our Companion Animal Health segment grew by over 12% to \$9.2 million from \$8.2 million in the same period of 2001. Product revenue from this segment of our

13

business includes diagnostics, vaccines, pharmaceuticals and medical instrumentation. This growth was driven by increased sales of our medical instrument reagents and consumables, sales of our most recent product introduction, the E.R.D.-Screen (TM) urine test for early renal disease in dogs, increased export sales of our canine heartworm diagnostic for Japanese distribution and increased sales of our SpotChem EZ (TM) clinical chemistry system, offset somewhat by declines in sales of our heartworm diagnostic products in the United States.

Product revenue increased 4% to \$21.9 million for the first half of 2002 compared to \$21.0 million for the first half of 2001. Product revenue for the first six months of 2002 in our Companion Animal Health segment grew by nearly 7% to \$16.8 million from \$15.7 million in the same period of 2001. This growth was driven by increased sales of our medical instrument reagents and consumables, increased sales of our SpotChem (TM) EZ clinical chemistry system, sales of our most recent product introduction, the E.R.D.-Screen (TM) urine



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test for early renal disease in dogs, and increased export sales of our canine heartworm diagnostic for Japanese distribution, offset somewhat by declines in sales of our heartworm diagnostic products in the United States.

Product revenue in our Food Animal Health segment for the three months ended June 30, 2002, grew by nearly 10% to \$2.8 million compared to \$2.5 million in the second quarter of 2001. This increase was due to special orders for pharmaceuticals from an existing customer. Product revenue in the first half of 2002 from the Food Animal Health segment of the business decreased 4% to \$5.1 million from \$5.3 million in the first half of last year.

Revenue from research, development and other sources were up slightly in the second quarter of 2002 as compared to the second quarter of 2001. This same revenue for the first half of 2002 was down \$345,000 compared to the first half of 2001 due primarily to non-recurring revenue from a sponsored product development project in last year's first quarter.

### Cost of Products Sold

Cost of products sold totaled \$7.2 million in the second quarter of 2002 compared to \$7.0 million in the second quarter of 2001. Gross profit as a percentage of product sales increased to 40.2% in the second quarter of 2002 compared to 34.7% in the same quarter last year. Cost of products sold totaled \$13.1 million for the first half of 2002 compared to \$13.2 million for the first half of 2001. Gross profit as a percentage of product sales increased to 40.3% for the six months ended June 30, 2002, compared to 37.2% for the same period last year. These improvements in gross profit reflect the increase in sales of our proprietary PVD products, increased sales of instrument reagents and consumables and improved margins at Diamond. We expect gross profit as a percentage of product sales to continue to improve as we increase the sales of our higher margin proprietary PVD products and instrument reagents and consumables.

### Operating Expenses

Selling and marketing expenses decreased 12% to \$3.2 million in the second quarter of 2002 compared to \$3.6 million in the second quarter of 2001. Selling and marketing expenses decreased 11% to \$6.3 million for the first half of 2002 compared to \$7.1 million for the same period in 2001. Both decreases are due primarily to lower personnel and related costs. We expect selling and marketing expense as a percentage of total sales to decrease in the future as we continue to increase sales from our business.

Research and development expenses decreased 29% to \$2.2 million in the second quarter of 2002 from \$3.1 million in the second quarter of 2001. Research and development expenses decreased 22% to \$5.1 million for the first half of 2002 compared to \$6.6 million for the first half of 2001. These decreases are due primarily to lower personnel costs. We expect research and development expense as a percentage of total sales to decrease in the future as we continue to increase sales from our business.

14

General and administrative expenses decreased 2% to \$1.8 million in the second quarter of 2002 from \$1.9 million in the second quarter of 2001 due to lower depreciation costs. General and administrative expenses decreased 12% to \$3.5 million for the first half of 2002 compared to \$4.0 million for the same period in 2001 due to lower personnel and depreciation costs. We expect general and administrative expense as a percentage of total sales to decrease in the future as we continue to increase sales from our business and continue our disciplined management of operating expenses.

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### Restructuring Expenses and Other

During the second quarter of 2002, we recorded a one time charge to other operating expenses of \$621,000 related to personnel severance costs and other related expenses. In the first quarter of 2002, we recorded a restructuring charge of \$566,000 for personnel severance costs and other related expenses related to 32 individuals. We also reversed approximately \$330,000 of the restructuring charge recorded in the fourth quarter of 2001 due to the favorable settlement of certain liabilities. For the six months ended June 30, 2002, we recorded net restructuring and other expenses totaling \$857,000.

### Net Loss

For the quarter ended June 30, 2002, our net loss declined to \$2.8 million from \$4.7 million in the second quarter of the prior year. The net loss per common share in the second quarter of 2002 was \$0.06, compared with a net loss per common share of \$0.12 in the second quarter of the prior year. Our net loss for the first half of 2002 decreased to \$6.7 million compared to \$9.2 million in the same period of 2001. The net loss per common share decreased to \$0.14 for the first half of this year compared to \$0.24 for the first half of 2001.

### LIQUIDITY AND CAPITAL RESOURCES

We have incurred negative cash flow from operations since inception in 1988. Our negative operating cash flows have been funded primarily through the sale of common stock and borrowings. At June 30, 2002, we had cash and cash equivalents of \$3.7 million.

We amended our credit agreement with our lender in March 2002 to set the financial covenants for 2002 and extend the maturity date of the loans an additional year to May 31, 2003. If our lender imposes additional loan covenants or other credit requirements that would prevent us from accessing the full amount of our line of credit, we would need to raise additional capital to fund any shortfall from our borrowings expected to be available under the revolving line of credit. We anticipate that any additional capital would be raised through one or more of the following:

- \* obtaining new loans secured by unencumbered assets;
- \* sale of various products or marketing rights;
- \* licensing of technology;
- \* sale of various assets; and
- \* sale of additional equity or debt securities.

At June 30, 2002, we had outstanding obligations for long-term debt and capital leases totaling \$3.4 million primarily related to two term loans with Wells Fargo Business Credit and a promissory note from one of Diamond's customers. One of these two term loans is secured by real estate at Diamond and had an outstanding balance at June 30, 2002 of \$1.7 million due in monthly installments of \$17,658 plus interest, with a balloon payment of approximately \$1.5 million due on May 31, 2003. The other term loan is secured by machinery and equipment at Diamond and had an outstanding balance at June 30, 2002 of approximately \$576,000 payable in monthly installments of \$18,667 plus interest, with a balloon payment of approximately \$370,000 due on May 31, 2003. Both loans have a stated interest rate of prime plus 1.25%. The promissory note with Diamond's customer is payable in three annual installments beginning April 15, 2003 and bears interest at prime plus 0.25%. In addition, Diamond has promissory notes to the Iowa Department of Economic

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2002 of \$28,000 and \$43,000, respectively, due in annual and monthly installments through June 2004 and May 2004, respectively. Both promissory notes have a stated interest rate of 3.0% and an imputed interest rate of 9.5%. The notes are secured by first security interests in essentially all of Diamond's assets and both lenders have subordinated their first security interest to Wells Fargo. We also had \$240,000 of equipment financing which was paid in full in January 2002. Our capital lease obligations totaled \$86,000 at June 30, 2002.

We also have a \$10.0 million asset-based revolving line of credit with Wells Fargo Business Credit. Available borrowings under this line of credit are based upon percentages of our eligible domestic accounts receivable and domestic inventories. Interest is charged at a stated rate of prime plus 1% and is payable monthly. Our ability to borrow under this facility varies based upon available cash, eligible accounts receivable and eligible inventory. The line of credit has a maturity date of May 31, 2003. At June 30, 2002, our outstanding borrowings under the line of credit were \$5.5 million and we had remaining available borrowing capacity of \$500,000.

Net cash used in operating activities was \$2.2 million for the first six months of 2002, compared to \$7.5 million for the same period in 2001. The improvement was primarily due to the lower net loss, increases in accounts receivable collections and higher accounts payable balances.

Net cash flows from investing activities used \$242,000 during the first half of 2002, compared to providing \$2.1 million in the same period of 2001. The higher cash provided in 2001 resulted from the sale of our marketable securities.

Net cash flows from financing activities provided \$209,000 during the first six months of 2002 compared to providing \$7.0 million for the same period last year. The cash provided in 2001 was the result of approximately \$5.3 million of net proceeds from a private placement of our common stock plus \$2.7 million of borrowings against our line of credit, offset by debt repayments.

Our primary short-term needs for capital are our continuing research and development efforts, our sales, marketing and administrative activities, 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 present and future products gain market acceptance, the extent to which products or technologies under research or development are successfully developed, the timing of regulatory actions regarding our products, the costs and timing of expansion of sales, marketing and manufacturing activities, the cost, timing and business management of current and potential acquisitions and contingent liabilities associated with such acquisitions, the procurement and enforcement of patents important to our business and the results of competition.

We believe that our available cash and cash equivalents, together with cash from operations, borrowings expected to be available under our revolving line of credit facility, cash from the license of the rights to our Flu AVERT I.N. product (see Note 10) and other sources discussed below, should be sufficient to satisfy our projected cash requirements through June 30, 2003. Other potential sources to raise additional funds include one or more of the following: (1) obtaining new loans secured by unencumbered assets; (2) sale of various products or marketing rights; (3) licensing of technology; (4) sale of various assets; and (5) sale of additional equity or debt securities.

Under our revolving line of credit agreement with Wells Fargo Business Credit, we are required to comply with various financial and non-financial covenants, and we have made various representations and warranties. Among the

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financial covenants is a requirement to maintain \$2.5 million of minimum liquidity (cash plus excess borrowing base). Additional requirements include covenants for minimum capital monthly and minimum net income quarterly. We currently believe we are not likely to be able to meet our existing covenants for minimum net income and minimum book capital in future periods. We intend to negotiate modifications or a

16

waiver of these covenants. We have obtained modifications and a waiver of covenants in the past, although there can be no assurance we can obtain similar modifications or waivers in the future.

Failure to comply with any of the covenants, representations or warranties could result in our being in default under the loan and could cause all outstanding amounts to become immediately due and payable or impact our ability to borrow under the agreement. All amounts due under the credit facility mature on May 31, 2003. We intend to rely on available borrowings under the credit agreement to fund our operations through 2002 and into 2003. If we are unable to borrow funds under this agreement, we will need to raise additional capital to fund our cash needs and continue our operations. If we are unable to extend or refinance the borrowings under the credit facility as of, or before, May 31, 2003, or complete other options to meet our cash needs created by maturing debt, we may be unable to continue as a going concern. See "Factors that May Affect Results."

A summary of our contractual obligations at June 30, 2002 is shown below (amounts in thousands).

|                                    | PAYMENTS DUE BY PERIOD |              |          |
|------------------------------------|------------------------|--------------|----------|
| TOTAL                              | LESS THAN<br>1 YEAR    | 1-3<br>YEARS |          |
| CONTRACTUAL OBLIGATIONS            |                        |              |          |
| Long-Term Debt                     | \$ 3,286               | \$ 2,600     | \$ 686   |
| Capital Lease Obligations          | 86                     | 62           | 24       |
| Line of Credit                     | 5,467                  | 5,467        | -        |
| Operating Leases                   | 2,298                  | 460          | 1,707    |
| Unconditional Purchase Obligations | 2,909                  | 102          | 2,007    |
| Other Long-Term Obligations        | 149                    | -            | -        |
| Total Contractual Cash Obligations | \$ 14,195              | \$ 8,691     | \$ 4,424 |

### RECENT ACCOUNTING PRONOUNCEMENTS

The Company adopted SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets" effective as of January 1, 2002. SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for using the purchase accounting method. SFAS No. 142 states that goodwill is no longer subject to amortization over its useful life. Rather, goodwill will be subject to an annual assessment for impairment and be written down to its fair value only if the carrying amount is greater than the fair value. In addition, intangible assets will be separately recognized if the benefit of the intangible asset is obtained through contractual or other legal

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rights, or if the intangible asset can be sold, transferred, licensed, rented or exchanged, regardless of the acquirer's intent to do so. The amount and timing of non-cash charges related to intangibles acquired in business combinations will change significantly from prior practice.

On January 1, 2002, the Company adopted SFAS No. 144, "Accounting for the Impairment or disposal of Long-Lived Assets" ("SFAS 144"). SFAS 144 supersedes SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" ("SFAS 121"). The primary objectives of SFAS 144 were to develop one accounting model based on the framework established in SFAS 121 for long-lived assets to be disposed of by sale, and to address significant implementation issues. The adoption of SFAS 144 did not have a material impact on the Company's financial position or results of operations.

In June 2002, the Financial Accounting Standards Board issued SFAS 146, "Accounting for Costs Associated with Exit or Disposal Activities" (SFAS 146). This statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The Company will adopt the provisions of this statement during the first quarter of 2003. The adoption of this statement will have an impact on the accounting for future exit or disposal activities, if any.

17

### FACTORS THAT MAY AFFECT RESULTS

Our future operating results may vary substantially from period to period due to a number of factors, many of which are beyond our control. The following discussion highlights these factors and the possible impact of these factors on future results of operations. If any of the following factors actually occur, our business, financial condition or results of operations could be harmed. In that case, the price of our common stock could decline, and you could experience losses on your investment.

### WE ANTICIPATE FUTURE LOSSES AND MAY NOT BE ABLE TO ACHIEVE PROFITABILITY.

We have incurred net losses since our inception in 1988 and, as of June 30, 2002, we had an accumulated deficit of \$199.8 million. We anticipate that we will continue to incur additional operating losses in the near term. These losses have resulted principally from expenses incurred in our research and development programs and from sales and marketing and general and administrative expenses. Even if we achieve profitability, we may not be able to sustain or increase profitability on a quarterly or annual basis. If we cannot achieve or sustain profitability, we may not be able to fund our expected cash needs or continue our operations.

### WE ARE NOT GENERATING POSITIVE CASH FLOW AND MAY NEED ADDITIONAL CAPITAL AND ANY REQUIRED CAPITAL MAY NOT BE AVAILABLE ON ACCEPTABLE TERMS OR AT ALL.

We have incurred negative cash flow from operations since inception in 1988. Our financial plan for 2002 indicates that our cash on hand, together with borrowings expected to be available under our revolving line of credit and other sources, should be sufficient to fund our operations through 2002 and into 2003. However, should our actual results achieved this year fall below those reflected in our forecast, or if we are unable to borrow the funds we expect to be available, we may need to raise additional capital.

We amended our credit agreement with our lender in March 2002 to set the

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financial covenants for 2002 and extend the maturity date of the loans an additional year to May 31, 2003. If our lender imposes additional loan covenants or other credit requirements that would prevent us from accessing the full amount of our line of credit, we would need to raise additional capital to fund any shortfall from our borrowings expected to be available under the revolving line of credit. We anticipate that any additional capital would be raised through one or more of the following:

- \* obtaining new loans secured by unencumbered assets;
- \* sale of various products or marketing rights;
- \* licensing of technology;
- \* sale of various assets; and
- \* sale of additional equity or debt securities.

Additional capital may not be available on acceptable terms, if at all. The public markets may remain unreceptive to equity financings, and we may not be able to obtain additional private equity financing. Furthermore, amounts we expect to be available under our existing revolving credit facility may not be available, and other lenders could refuse to provide us with additional debt financing. Furthermore, any additional equity financing would likely be dilutive to stockholders, and additional debt financing, if available, may include restrictive covenants which may limit our currently planned operations and strategies. If adequate funds are not available, we may be required to curtail our operations significantly and reduce discretionary spending to extend the currently available cash resources, or to obtain funds by entering into collaborative agreements or other arrangements on unfavorable terms, all of which would likely have a material adverse effect on our business, financial condition and our ability to continue as a going concern.

18

WE MUST MAINTAIN VARIOUS FINANCIAL AND OTHER COVENANTS UNDER OUR REVOLVING LINE OF CREDIT AGREEMENT.

Under our revolving line of credit agreement with Wells Fargo Business Credit, 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 \$2.5 million of minimum liquidity (cash plus excess borrowing base). Additional requirements include covenants for minimum capital monthly and minimum net income quarterly. We currently believe we are not likely to be able to meet our existing covenants for minimum net income and minimum book capital in future periods. We intend to negotiate modifications or a waiver of these covenants. We have obtained modifications and a waiver of covenants in the past, although there can be no assurance we can obtain similar modifications or waivers in the future.

Failure to comply with any of the covenants, representations or warranties could result in our being in default under the loan and could cause all outstanding amounts to become immediately due and payable or impact our ability to borrow under the agreement. All amounts due under the credit facility mature on May 31, 2003. We intend to rely on available borrowings under the credit agreement to fund our operations through 2002 and into 2003. If we are unable to borrow funds under this agreement, we will need to raise additional capital to fund our cash needs and continue our operations. If we are unable to extend or refinance the borrowings under the credit facility as of, or before, May 31, 2003, or complete other options to meet our cash needs created by maturing debt, we may be unable to continue as a going concern.

OUR COMMON STOCK COULD BE DELISTED FROM THE NASDAQ STOCK MARKET, WHICH MAY MAKE IT MORE DIFFICULT FOR YOU TO SELL YOUR SHARES.

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Our common stock is currently listed on the Nasdaq National Market. We are in the process of applying to transfer our listing to the Nasdaq SmallCap Market. Both the Nasdaq National Market and the Nasdaq SmallCap Market have requirements we must meet in order to remain listed, including a minimum bid price requirement of \$1.00. We are currently not in compliance with the minimum bid price requirement and have received notification from Nasdaq to that effect. If the transfer of our listing to the Nasdaq SmallCap Market is approved, we will have until November 18, 2002 to comply with the minimum \$1.00 bid price requirement which requires that our common stock close at \$1.00 per share or more for a minimum of 10 consecutive trading days. We may also be eligible for an additional 180-day grace period, or until May 16, 2003, provided that we have stockholders' equity of \$5 million or meet certain other initial listing criteria required by Nasdaq. We cannot assure you that our application to transfer to the Nasdaq SmallCap Market will be approved, nor can we assure you that we will be able to maintain such listing. If we are delisted from the Nasdaq stock market, our common stock will be considered a penny stock under the regulations of the Securities and Exchange Commission 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 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 to raise capital in the future.

WE MAY FACE COSTLY INTELLECTUAL PROPERTY DISPUTES.

Our ability to compete effectively will depend in part on our ability to develop and maintain proprietary aspects of our technology and either to operate without infringing the proprietary rights of others or to obtain rights to technology owned by third parties. We have United States and foreign-issued patents and are currently prosecuting patent applications in the United States and with various foreign countries. Our pending patent applications may not result in the issuance of any patents or any issued patents that will offer protection against competitors with similar technology. Patents we receive may be challenged, invalidated or circumvented in the future or the rights created by those patents may not provide a competitive advantage. We also rely on trade secrets, technical know-how and continuing invention to develop and maintain our competitive position. Others

19

may independently develop substantially equivalent proprietary information and techniques or otherwise gain access to our trade secrets.

The biotechnology and pharmaceutical industries have been characterized by extensive litigation relating to patents and other intellectual property rights. In 1998, Synbiotics Corporation filed a lawsuit against us alleging infringement of a Synbiotics patent relating to heartworm diagnostic technology, and this litigation remains ongoing. The sole remaining claim in the lawsuit is expected to be scheduled for trial in 2003.

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 costly, time-consuming and distracting. 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

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will result in substantial expense to us and significant diversion of the efforts of our technical and management personnel. Any adverse determination in litigation or interference proceedings could subject us to significant liabilities to third parties. Further, as a result of litigation or other proceedings, we may be required to seek licenses from third parties which may not be available on commercially reasonable terms, if at all.

WE HAVE LIMITED RESOURCES TO DEVOTE TO PRODUCT DEVELOPMENT AND COMMERCIALIZATION. IF WE ARE NOT ABLE TO DEVOTE ADEQUATE RESOURCES TO PRODUCT DEVELOPMENT AND COMMERCIALIZATION, WE MAY NOT BE ABLE TO DEVELOP OUR PRODUCTS.

Our strategy is to develop a broad range of products addressing companion animal healthcare. We believe that our revenue growth and profitability, if any, will substantially depend upon our ability to:

- \* improve market acceptance of our current products;
- \* complete development of new products; and
- \* successfully introduce and commercialize new products.

We have introduced some of our products only recently and many of our products are still under development. Among our recently introduced products E.R.D.-SCREEN Urine Test for detecting albumin in canine urine, ALLERCEPT E-SCREEN Test for assessing allergies in dogs, and SPOTCHEM (TM) EZ, a compact system for measuring animal blood chemistry. We currently have under development or in preliminary clinical trials a number of products, including a gene based therapy for canine cancer. 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 our other product candidates. If we fail to develop new products and bring them to market, our ability to generate revenues will decrease.

In addition, our products may not achieve satisfactory market acceptance, and we may not successfully commercialize them on a timely basis, or at all. If our products do not achieve a significant level of market acceptance, demand for our products will not develop as expected and it is unlikely that we ever will become profitable.

WE MAY BE UNABLE TO SUCCESSFULLY MARKET AND DISTRIBUTE OUR PRODUCTS AND HAVE RECENTLY MODIFIED OUR DISTRIBUTION STRATEGY.

The market for companion animal healthcare products is highly fragmented. Because our proprietary products are available only by prescription and our medical instruments require technical training, we sell our companion animal health products only to veterinarians. Therefore, we may fail to reach a substantial segment of the potential market.

20

We currently market our products in the United States to veterinarians through approximately 20 independent third-party distributors and through a direct sales force. Nearly one-half of these domestic distributors carry the full line of our pharmaceutical, vaccine, diagnostic and instrumentation products. We have recently begun to rely on distributors for a greater portion of our sales and therefore need to increase our training efforts directed at the sales personnel of our distributors. To be successful, we will have to continue to develop and train our direct sales force as well as sales personnel of our distributors and rely on other arrangements with third parties to market, distribute and sell our products. In addition, most of our distributor agreements can be terminated on 60 days' notice and we believe IDEXX, our largest competitor, prohibits its distributors from selling competitors'



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products, including ours. For example, one of our largest distributors recently informed us that they would no longer carry our heartworm diagnostic products or our chemistry or hematology instruments because they wish to carry products from one of our competitors, IDEXX, who required exclusivity of its comparable products.

We may not successfully develop and maintain marketing, distribution 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 distribution strategy is unsuccessful, our ability to sell our products will be negatively impacted and our revenues will decrease. Furthermore, the recent change in our distribution strategy and our expected increase in sales from distributors and decrease in direct sales may have a negative impact on our gross margins.

WE MUST OBTAIN AND MAINTAIN COSTLY REGULATORY APPROVALS IN ORDER TO MARKET OUR PRODUCTS.

Many of the products we develop and market are subject to extensive regulation by one or more of the USDA, the FDA, the EPA and foreign regulatory authorities. These regulations govern, among other things, the development, testing, manufacturing, labeling, storage, pre-market approval, advertising, promotion, sale and distribution 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.

Our Flu AVERT I.N. Vaccine, SOLO STEP CH, SOLO STEP FH, and SOLO STEP Batch Test Strips and Trivalent Intranasal/Intraocular Vaccine each have received regulatory approval in the United States by the USDA. In addition, the Flu AVERT I.N. Vaccine has been approved in Canada by the CFIA. SOLO STEP CH and SOLO STEP Batch Test Strips are pending approval by the CFIA. SOLO STEP CH has also been approved by the Japanese Ministry of Agriculture, Forestry and Fisheries. U.S. regulatory approval by the USDA is currently pending for our Feline ImmuCheck Assay, Canine Cancer Gene Therapy and Feline Mucosal Vaccine.

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. For example, the Flu AVERT I.N. vaccine for equine influenza was not approved until six months after the date on which we expected approval. This delay caused us to miss the initial primary selling season for equine influenza vaccines, and we believe it delayed the initial market acceptance of this product. 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 the facilities of our third party manufacturers conform to current Good Manufacturing Practices. Our manufacturing facilities and those of our third party manufacturers must also conform to certain other manufacturing regulations, which include requirements relating to quality control and quality assurance as well as maintenance of records and documentation. The USDA, FDA and foreign regulatory authorities strictly enforce manufacturing regulatory requirements through periodic inspections. 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 warning letters, product recalls or seizures, injunctions, refusal to permit products to be imported into or exported out of the United States, refusals

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21

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.

FACTORS BEYOND OUR CONTROL MAY CAUSE OUR OPERATING RESULTS TO FLUCTUATE, AND SINCE MANY OF OUR EXPENSES ARE FIXED, THIS FLUCTUATION COULD CAUSE OUR STOCK PRICE TO DECLINE.

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

- \* results from Diamond;
- \* the introduction of new products by us or by our competitors;
- \* our recent change in distribution strategy;
- \* market acceptance of our current or new products;
- \* regulatory and other delays in product development;
- \* product recalls;
- \* competition and pricing pressures from competitive products;
- \* manufacturing delays;
- \* shipment problems;
- \* product seasonality; and
- \* changes in the mix of products sold.

We have high operating expenses for personnel, new product development and marketing. Many of these expenses are fixed in the short term. If any of the factors listed above cause our revenues to decline, our operating results could be substantially harmed.

Our operating results in some quarters may not meet the expectations of stock market analysts and investors. In that case, our stock price probably would decline.

OUR LARGEST CUSTOMER ACCOUNTED FOR OVER 15% OF OUR REVENUES FOR THE PREVIOUS TWO YEARS, AND THE LOSS OF THAT CUSTOMER OR OTHER CUSTOMERS COULD HARM OUR OPERATING RESULTS.

We currently derive a substantial portion of our revenues from sales by our subsidiary, Diamond, which manufactures several of our products and products for other companies in the animal health industry. Revenues from one contract between Diamond and Agri Laboratories, Ltd., comprised approximately 11% and 11% of our total revenues for the six months ended June 30, 2001 and 2002, respectively. In May 2002, Diamond signed a seven-year contract extension with Agri Laboratories. However, if Agri Laboratories does not continue to purchase from Diamond and if we fail to replace the lost revenue with revenues from other customers, our business could be substantially harmed. In addition, sales from our next three largest customers accounted for an aggregate of approximately 12% of our revenues in 2001. If we are unable to maintain our relationships with one or more of these customers, our sales may decline.

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 ACHIEVE PROFITABILITY.

We compete with independent animal health companies and major pharmaceutical companies that have animal health divisions. Companies with a significant presence in the animal health market, such as Wyeth, Bayer, IDEXX, Intervet, Merial, Novartis, Pfizer, Pharmacia and Schering Plough, have developed or are developing products that compete with our products or would compete with them if developed. These competitors may have substantially greater financial, technical, research and other resources and larger, better-

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established marketing, sales, distribution and service organizations than us. In addition, we believe that IDEXX prohibits its distributors from selling competitors' products, including our SOLO STEP heartworm diagnostic products and medical diagnostic instruments. Our competitors frequently offer broader product lines and have greater name recognition than we do. Our competitors may develop or market technologies or products that are

22

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 healthcare market. Moreover, we may not have the financial resources, technical expertise or marketing, distribution or support capabilities to compete successfully. If we fail to compete successfully, our ability to achieve profitability will be limited.

OUR TECHNOLOGY AND THAT OF OUR COLLABORATORS MAY BECOME THE SUBJECT OF LEGAL ACTION.

We license technology from a number of third parties, including Quidel Corporation, Genzyme Corporation, Diagnostic Chemicals, Ltd., Valantis, Inc., Corixa Corporation, Roche, New England Biolabs, Inc. and Hybritech Inc., as well as a number of research institutions and universities. The majority of these license agreements impose due diligence or milestone obligations on us, and in some cases impose minimum royalty and/or sales obligations on us, in order for us to maintain our rights under these agreements. Our products may incorporate technologies that are the subject of patents issued to, and patent applications filed by, others. As is typical in our industry, from time to time we and our collaborators have received, and may in the future receive, notices from third parties claiming infringement and invitations to take licenses under third party patents. It is our policy that when we receive such notices, we conduct investigations of the claims they assert. With respect to the notices we have received to date, we believe, after due investigation, that we have meritorious defenses to the infringement claims asserted. Any legal action against us or our collaborators may require us or our collaborators to obtain one or more licenses in order to market or manufacture affected products or services. However, we or our collaborators may not be able to obtain licenses for technology patented by others on commercially reasonable terms, we may not be able to develop alternative approaches if unable to obtain licenses, or current and future licenses may not be adequate for the operation of our businesses. Failure to obtain necessary licenses or to identify and implement alternative approaches could prevent us and our collaborators from commercializing our products under development and could substantially harm our business.

WE RELY SUBSTANTIALLY ON THIRD-PARTY MANUFACTURERS. THE LOSS OF ANY THIRD-PARTY MANUFACTURERS COULD LIMIT OUR ABILITY TO LAUNCH OUR PRODUCTS IN A TIMELY MANNER, OR AT ALL.

To be successful, we must manufacture, or contract for the manufacture of, our current and future products in compliance with regulatory requirements, in sufficient quantities and on a timely basis, while maintaining product quality and acceptable manufacturing costs. In order to increase our manufacturing capacity, we acquired Diamond in April 1996.

We currently rely on third parties to manufacture those products we do not manufacture at our Diamond facility. We currently have supply agreements with Quidel Corporation for various manufacturing services relating to our point-of-care diagnostic tests, with Centaq, Inc. for the manufacture of our own allergy immunotherapy treatment products and with various manufacturers for the supply of our veterinary diagnostic and patient monitoring instruments. Our manufacturing strategy presents the following risks:

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- \* Delays in the scale-up to quantities needed for product development could delay regulatory submissions and commercialization of our products in development;
- \* Our manufacturing facilities and those of some of our third party manufacturers are subject to ongoing periodic unannounced inspection by regulatory authorities, including the FDA, USDA and other federal and state agencies for compliance with strictly enforced Good Manufacturing Practices regulations and similar foreign standards, and we do not have control over our third party manufacturers' compliance with these regulations and standards;
- \* If we need to change to other commercial manufacturing contractors for certain of our products, additional regulatory licenses or approvals must be obtained for these contractors prior to our use. This would require new testing and compliance inspections. Any new manufacturer would have to

23

be educated in, or develop substantially equivalent processes necessary for the production of our products;

- \* If market demand for our products increases suddenly, our current manufacturers 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; and
- \* We may not have intellectual property rights, or may have to share intellectual property rights, to any improvements in the manufacturing processes or new manufacturing processes for our products.

Any of these factors could delay commercialization of our products under development, interfere with current sales, entail higher costs and result in our being unable to effectively sell our products.

Our agreements with various suppliers of the veterinary medical instruments require us to meet minimum annual sales levels to maintain our position as the exclusive distributor of these instruments. We may not meet these minimum sales levels in the future, and maintain exclusivity over the distribution and sale of these products. If we are not the exclusive distributor of these products, competition may increase.

WE HAVE GRANTED THIRD PARTIES SUBSTANTIAL MARKETING RIGHTS TO CERTAIN OF OUR EXISTING PRODUCTS AS WELL AS PRODUCTS UNDER DEVELOPMENT. IF THE THIRD PARTIES ARE NOT SUCCESSFUL IN MARKETING OUR PRODUCTS OUR SALES MAY NOT INCREASE.

Our agreements with our corporate marketing partners generally contain no minimum purchase requirements in order for them to maintain their exclusive or co-exclusive marketing rights. Currently, Novartis Agro K.K. markets and distributes SOLO STEP CH in Japan, and Novartis Animal Health Canada, Inc. distributes our FLU AVERT I.N. vaccine in Canada. In addition, we have entered into agreements with Novartis and Eisai Inc. to market or co-market certain of the products that we are currently developing. Also, Nestle Purina Petcare has exclusive rights to license our technology for nutritional applications for dogs and cats. One or more of these marketing partners may not devote sufficient resources to marketing our products. Furthermore, there is nothing to prevent these partners from pursuing alternative technologies or products that may compete with our products. In the future, third-party marketing assistance may not be available on reasonable terms, if at all. If any of these events occur, we may not be able to commercialize our products and our sales will decline.

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WE DEPEND ON PARTNERS IN OUR RESEARCH AND DEVELOPMENT ACTIVITIES. IF OUR CURRENT PARTNERSHIPS AND COLLABORATIONS ARE NOT SUCCESSFUL, WE MAY NOT BE ABLE TO DEVELOP OUR TECHNOLOGIES OR PRODUCTS.

For several of our proposed products, we are dependent on collaborative partners to successfully and timely perform research and development activities on our behalf. For example, we jointly developed several point-of-care diagnostic products with Quidel Corporation, and Quidel manufactures these products. We license DNA delivery and manufacturing technology from Valentis Inc. and distribute chemistry analyzers for Arkray, Inc. We also have worked with i-STAT Corporation to develop portable clinical analyzers for dogs and Diagnostic Chemicals, Ltd. to develop the E.R.D.-SCREEN Urine Test. One or more of our collaborative partners may not complete research and development activities on our behalf in a timely fashion, or at all. If our collaborative partners fail to complete research and development activities, or fail to complete them in a timely fashion, our ability to develop technologies and products will be impacted negatively and our revenues will decline.

IF RECENT CHANGES IN OUR SENIOR MANAGEMENT ARE NOT SUCCESSFUL, WE WILL NOT BE ABLE TO ACHIEVE OUR GOALS.

Our President and Chief Operating Officer and Chief Financial Officer retired in May 2002. We have appointed a new Chief Financial Officer and Dr. Grieve, our Chief Executive Officer, assumed the duties of the President and Chief Operating Officer. These changes may place a strain on our resources and planning and management processes during this transition period. If these changes are not successful, we will not be able to

24

implement our business strategy. In addition, we will not be able to increase revenues or control costs unless we continue to improve our operational, financial and managerial controls and reporting systems and procedures.

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 scientific team, particularly Dr. Robert B. Grieve, our Chairman and Chief Executive Officer. The loss of the services of members of our senior management or scientific staff may significantly delay or prevent the achievement of product development and other business objectives. Because of the specialized scientific nature of our business, we depend substantially on our ability to attract and retain qualified scientific and technical personnel. There is intense competition among major pharmaceutical and chemical companies, specialized biotechnology firms and universities and other research institutions for qualified personnel in the areas of our activities. Although we have an employment agreement with Dr. Grieve, he is an at-will employee, which means that either party may terminate his employment at any time without prior notice. If we lose the services of, or fail to recruit, key scientific and technical personnel, the growth of our business could be substantially impaired. We do not maintain key person life insurance for any of our key personnel.

WE MAY FACE PRODUCT RETURNS AND PRODUCT LIABILITY LITIGATION AND THE EXTENT OF OUR INSURANCE COVERAGE IS LIMITED. 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 DECLINE.

The testing, manufacturing and marketing of our current products as well as those currently under development entail an inherent risk of product liability

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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 and 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.

Our products and development programs involve the controlled use of hazardous and biohazardous materials, including chemicals, infectious disease agents and various radioactive compounds. 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. In addition, we may incur substantial costs to comply with environmental regulations as we expand our manufacturing capacity.

WE EXPECT TO EXPERIENCE VOLATILITY IN OUR STOCK PRICE, WHICH MAY AFFECT OUR ABILITY TO RAISE CAPITAL IN THE FUTURE OR MAKE IT DIFFICULT FOR INVESTORS TO SELL THEIR SHARES.

The securities markets have experienced significant price and volume fluctuations and the market prices of securities of many public biotechnology companies have in the past been, and can in the future be expected to be, especially volatile. For example, in the last twelve months our closing stock price has ranged from a low of \$0.27 to a high of \$1.47. Fluctuations in the trading price or liquidity of our common stock may adversely affect

25

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:

- \* announcements of technological innovations or new products by us or by our competitors;
- \* our quarterly operating results;
- \* releases of reports by securities analysts;
- \* developments or disputes concerning patents or proprietary rights;
- \* regulatory developments;
- \* developments in our relationships with collaborative partners;
- \* changes in regulatory policies;
- \* litigation;
- \* 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, we would

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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.

26

### ITEM 3.

#### QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk represents the risk of loss that may impact the financial position, results of operations or cash flows due to adverse changes in financial and commodity market prices and rates. We are exposed to market risk in the areas of changes in United States and foreign interest rates and changes in foreign currency exchange rates as measured against the United States dollar. These exposures are directly related to our normal operating and funding activities. During 2002, we sold products to a Japanese distributor and the yen-based consideration we received is being held for the purchase of inventory during fiscal 2002. As of December 31, 2001, all of these forward contracts had been settled.

#### INTEREST RATE RISK

The interest payable on certain of our lines of credit and other borrowings is variable based on the United States prime rate and, therefore, is affected by changes in market interest rates. At June 30, 2002, approximately \$8.7 million was outstanding on these lines of credit and other borrowings with a weighted average interest rate of 5.73%. We manage interest rate risk by investing excess funds principally in cash equivalents or marketable securities, which bear interest rates that reflect current market yields. We completed an interest rate risk sensitivity analysis of these borrowings based on an assumed one percentage point increase in interest rates. Based on our outstanding balances as of June 30, 2002, a one percentage point increase in market interest rates would cause an annual increase in our interest expense of approximately \$87,000. We also had approximately \$3.7 million of cash and cash equivalents at June 30, 2002, the majority of which is invested in liquid interest bearing accounts. Based on our outstanding balances, a one percentage point increase in market interest rates would cause an annual increase in our interest income of approximately \$37,000.

#### FOREIGN CURRENCY RISK

We have a wholly owned subsidiary located in Switzerland. Sales from this operation are denominated in Swiss Francs or Euros, thereby creating exposures to changes in exchange rates. The changes in the Swiss/U.S. exchange rate or Euro/U.S. exchange rate may positively or negatively affect our sales, gross margins and retained earnings. We completed a foreign currency exchange risk sensitivity analysis on an assumed 1% increase in foreign currency exchange rates. If foreign currency exchange rates increase/decrease by 1% during the three months ended September 30, 2002, we would experience an increase/decrease in our foreign currency gain/loss of approximately \$100,000 based on the investment in foreign subsidiaries as of June 30, 2002. We purchase inventory for sale from one foreign vendor and sell our products to two foreign customers in transactions which are denominated in non-U.S. currency, primarily Japanese yen and Canadian dollars. If the exchange rate of the U.S. dollar increases/decreases by 1%, the net impact on our operating results would be approximately \$14,000 based upon our purchases and sales in these foreign currencies over the past 12 months.

27

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## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

In November 1998, Synbiotics Corporation filed a lawsuit against us in the United States District Court for the Southern District of California in which it alleges that we infringe a patent owned by Synbiotics relating to heartworm diagnostic technology. We have obtained legal opinions from our outside patent counsel that our heartworm diagnostic products do not infringe the Synbiotics patent and that the patent is invalid. The opinions of non-infringement are consistent with the results of our internal evaluations related to the one remaining claim. In September 2000, the U.S. District Court hearing the case granted our request for a partial summary judgment, holding two of the Synbiotics patent claims to be invalid, leaving only the one remaining claim in the lawsuit. The one remaining claim is currently scheduled for trial in 2003.

While we believe that we have valid defenses to Synbiotics' allegations and intend to defend the action vigorously, there can be no assurance that an adverse result or settlement would not have a material adverse effect on our financial position, results of operations or cash flow.

### ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Company's 2002 annual meeting of stockholders (the "2002 Annual Meeting") was held on May 16, 2002 in Fort Collins, Colorado. Three proposals, as described in the Company's Proxy Statement dated April 11, 2002, were voted on at the meeting. Following is a brief description of the matters voted upon and the results of the voting:

#### 1. Election of Directors:

| Nominee            |          | Number of Shares |
|--------------------|----------|------------------|
| -----              |          | -----            |
| A. Barr Dolan      | For      | 35,611,498       |
|                    | Withheld | 349,346          |
| Robert B. Grieve   | For      | 35,611,498       |
|                    | Withheld | 349,346          |
| John F. Sasen, Sr. | For      | 35,611,548       |
|                    | Withheld | 349,296          |

#### 2. To approve an amendment to the Company's 1997 Employee Stock Purchase Plan to increase the number of shares reserved for issuance under the plan by 1,000,000 shares.

|            |         |         |
|------------|---------|---------|
| For        | Against | Abstain |
| 35,461,559 | 423,974 | 75,311  |



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3. To ratify and approve an amendment to Article 8 of the Company's bylaws.

|            |         |         |           |
|------------|---------|---------|-----------|
| For        | Against | Abstain | Not Voted |
| 28,730,767 | 483,979 | 176,749 | 6,569,349 |

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

| Number    | Notes | Description   |
|-----------|-------|---|
| 3(ii)     | (1)   | Bylaws of the Registrant.   |
| 10.3(a)H  | (1)   | Amendment No. 4 to Bovine Vaccine Distribution Agreement between Diamond Animal Health, Inc. and AGRI Laboratories, Ltd., dated as of April 15, 2002. |
| 10.28(a)* | (1)   | Resignation Agreement and General Release between Registrant and Ronald L. Hendrick, effective as of June 6, 2002.                                    |
| 10.29(a)* | (1)   | Resignation Agreement and General Release between Registrant and James H. Fuller effective as of June 20, 2002.                                       |
| 99.1      | (1)   | Certification Under Section 906 of Sarbanes-Oxley Act   |

Notes

H Confidential treatment has been requested with respect to certain portions of this agreement.

\* Indicates management contract or compensatory plan or arrangement.

(1) Filed with Registrant's Form 10-Q for the quarter ended June 30, 2002

(b) Reports on Form 8-K

The Company filed a report on Form 8-K dated May 7, 2002, related to the retirement of its President and Chief Operating Officer, the retirement of its Chief Financial Officer and the appointment of a new Chief Financial Officer.

29

HESKA CORPORATION

SIGNATURES

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

HESKA CORPORATION

Date: August 27, 2002 By /s/ Robert B. Grieve

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ROBERT B. GRIEVE  
Chief Executive Officer and  
Chairman of the Board  
(on behalf of the Registrant and  
as the Registrant's Principal  
Executive Officer)

August 27, 2002      By /s/ Jason A. Napolitano

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JASON A. NAPOLITANO  
Executive Vice President and Chief  
Financial Officer  
(on behalf of the Registrant and  
as the Registrant's Chief  
Financial Officer)