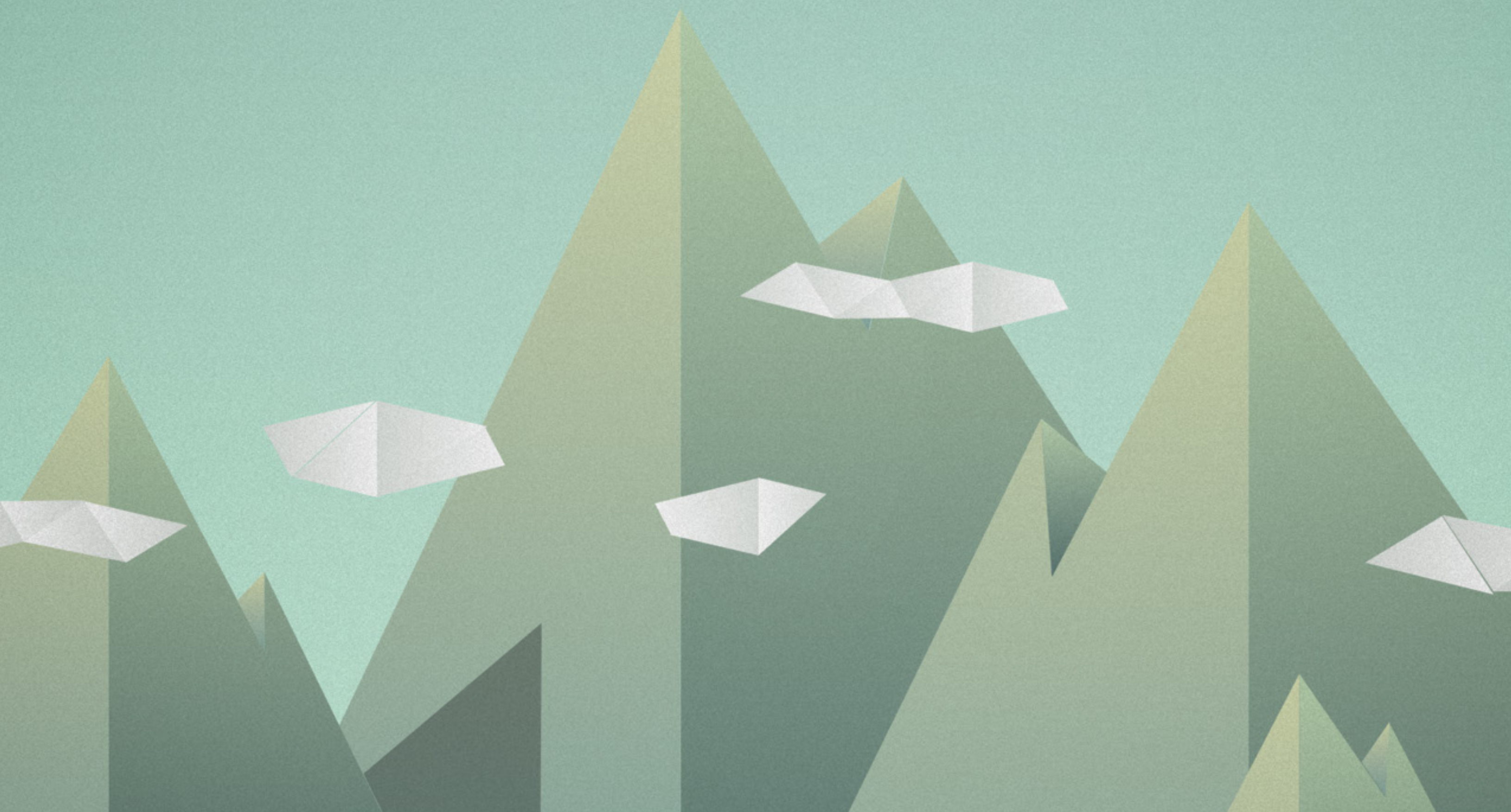
2016 ANNUAL REPORT

BLOOD DIAGNOSTICS • IMAGING DIAGNOSTICS • SOFTWARE • ALLERGY • VACCINES • PREVENTATIVES

2016 Heska Corporation Annual Report

This report was finalized on March 24, 2017 and speaks only as of such date or, with respect to historical information (including the financial data included herein), to such earlier date as may be expressly stated. Information contained herein has not been updated for the passage of time or otherwise from such dates.

This report also contains express or implied forward-looking information about the future plans, financial condition and operating performance of Heska Corporation ("Heska") that are not statements of historical fact. These are forward-looking statements within the meaning of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. These statements are based on current expectations, and factors that could cause our actual business and financial results to differ materially from those expressed in Heska's forward-looking statements include the following: risks related to relying on historical results to project future performance; uncertainties related to spending in the veterinary marketplace, including during times of economic difficulty; uncertainties related to Heska's ability to sell and market its products in an economically sustainable fashion; uncertainties related to the reputation of Heska and its offerings with Heska's customers and the reputation of third parties which sell Heska's products, Heska's ability to to benefit from such reputations; uncertainties related to the future technical performance of Heska's products; uncertainties related to product development and commercialization, including the risk that a planned product will not perform as anticipated or a new product will not gain the market acceptance anticipated; uncertainties related to Heska's reliance on third-parties to develop and supply certain of its products, which is substantial; uncertainties related to projects for which Heska is working with third-parties, which may or may not come to fruition and the risks and uncertainties set forth in Heska's filings and future filings with the Securities and Exchange Commission, including those articulated in Heska's Annual Report on Form 10-K for the twelve month period ended December 31, 2016. Heska does not undertake any obligation to update any forward-looking statement except as may be required by law.



March 24, 2017

Dear Shareholder,

I am grateful to report that Heska had a record year in 2016. Heska serves a broadly expanding veterinary market with excellent long-term demographics and trends. Heska's primary focus within this space is the highly coveted diagnostics area, which is a resilient "first spend" category for patient visits, is a key to positive healthcare outcomes for family members that cannot "speak", and is a core driver of veterinarian profits. We are fortunate to be a positive and major animator of this wonderful market.

More specifically, the Heska team solidly delivered in many key areas throughout 2016, including:

- Consolidated 2016 Heska revenues rose 24% to a record $130.1 million, resulting in net income that more than doubled. The price of Heska common stock responded in kind, beginning the year at $36.96 and finishing at $71.60.
- In blood diagnostics, our fully refreshed and expanded analyzer family is now often recognized as the newest and top performing portfolio available. Further, our multi-year transition to a sustainable "Reset" subscriptions model achieved critical mass, with over 72% of key blood diagnostics supplies now shipping under subscriptions that have initial terms of five to six years. These valuable subscriptions expanded and protected our gains through broad-based new sign-ups, excellent retention, early renewals and regular add-ons. This very difficult to reach true subscriptions milestone is unique to Heska and we are proud to have accomplished it while also improving revenues, profits, operations, and our balance sheet.
- Heska Imaging produced record revenues and profits in 2016, which has paved the way for us to complete our assembly of a world-class, wholly-owned global veterinary imaging enterprise in the first half of 2017. We began this effort in early 2013 and are excited to achieve this goal.
- Our Vaccines and Pharmaceuticals product areas in 2016 saw strong performances with our well-established partners, particularly in heartworm preventative and cattle vaccine sales, even as our Heska teams advanced in their goals for new projects and product approvals.

With record revenues, profits, and subscriptions, I am pleased with our results in 2016 and am thankful for the 325 dedicated Heska employees who worked hard to deliver them. I hope you are as well.

We enter the new year with a continued focus on building a healthy, ethical, highly respected, and more profitable company for our stakeholders. It is our intention in 2017 to optimize and expand our market share, geography, product bundles, multi-year subscriptions, and new product launches, while striving to be the best operator and value creator in a highly competitive space.

I appreciate your attention to our work, and I look forward to updating you on our progress in 2017.

Respectfully,

Kevin S. Wilson
Chief Executive Officer and President

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
Heska Corporation and Subsidiaries
Loveland, Colorado

We have audited the accompanying consolidated balance sheets of Heska Corporation and Subsidiaries (the "Company") as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2016. The Company's management is responsible for these financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Heska Corporation and Subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2016, based on criteria established in *Internal Control—Integrated Framework (1992)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 3, 2017, expressed an unqualified opinion.

EKS&H LLLP

March 3, 2017
Denver, Colorado

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

	December 31,	
	2016	**2015**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 10,794	$ 6,890
Accounts receivable, net of allowance for doubtful accounts of $237 and $189, respectively	20,857	15,935
Due from – related parties	100	308
Inventories, net	20,395	16,101
Other current assets	3,127	2,028
Total current assets	55,273	41,262
Property and equipment, net	16,581	17,020
Note receivable – related party	—	1,516
Goodwill	26,647	20,910
Other intangible assets, net	2,346	56
Deferred tax asset, net	21,122	25,883
Other long-term assets	8,875	3,072
Total assets	$ 130,844	$ 109,719
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 7,154	$ 7,624
Accrued liabilities	6,469	5,416
Current portion of deferred revenue	3,439	5,461
Obligation to purchase minority interest	14,602	—
Line of credit	672	143
Other short-term borrowings, including current portion of long-term note payable	78	159
Total current liabilities	32,414	18,803
Long-term note payable, net of current portion	—	69
Deferred revenue, net of current portion, and other	11,455	11,572
Total liabilities	43,869	30,444
Commitments and contingencies (Note 10)		
Non-Controlling Interest	—	15,747
Stockholders' equity:		
Preferred stock, $.01 par value, 2,500,000 shares authorized, none issued or outstanding	—	—
Common stock, $.01 par value, 9,000,000 shares authorized, none issued or outstanding	—	—
Public common stock, $.01 par value, 9,000,000 shares authorized, 7,026,051 and 6,625,287 shares issued and outstanding, respectively	70	66
Additional paid-in capital	238,635	227,267
Accumulated other comprehensive income	97	187
Accumulated deficit	(151,827)	(163,992)
Total stockholders' equity	86,975	63,528
Total liability and stockholders' equity	$ 130,844	$ 109,719

See accompanying notes to consolidated financial statements.

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

	Year Ended December 31,		
	2016	**2015**	**2014**
Revenue:			
Core companion animal health	$ 107,398	$ 84,249	$ 72,354
Other vaccines, pharmaceuticals and products	22,685	20,348	17,483
Total revenue, net	130,083	104,597	89,837
Cost of revenue	76,191	60,384	54,122
Gross profit	53,892	44,213	35,715
Operating expenses:			
Selling and marketing	22,092	21,339	19,159
Research and development	2,147	1,658	1,414
General and administrative	13,120	12,659	12,231
Total operating expenses	37,359	35,656	32,804
Operating income	16,533	8,557	2,911
Interest and other expense (income), net	29	130	(39)
Income before income taxes	16,504	8,427	2,950
Income tax expense:			
Current income tax expense	407	1,581	47
Deferred income tax expense	3,932	1,327	1,304
Total income tax expense	4,339	2,908	1,351
Net income	12,165	5,519	1,599
Net income (loss) attributable to non-controlling interest	1,657	280	(1,004)
Net income attributable to Heska Corporation	$ 10,508	$ 5,239	$ 2,603
Basic earnings per share attributable to Heska Corporation	$ 1.55	$ 0.80	$ 0.44
Diluted earnings per share attributable to Heska Corporation	$ 1.43	$ 0.74	$ 0.41
Weighted average outstanding shares used to compute basic earnings per share attributable to Heska Corporation	6,783	6,509	5,951
Weighted average outstanding shares used to compute diluted earnings per share attributable to Heska Corporation	7,361	7,074	6,409

See accompanying notes to consolidated financial statements.

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

	Year Ended December 31,		
	2016	**2015**	**2014**
Net income	$ 12,165	$ 5,519	$ 1,599
Other comprehensive income (expense):			
Minimum pension liability	75	(129)	—
Sale of equity investment	(90)	44	3
Foreign currency translation	(75)	(11)	(300)
Comprehensive income	12,075	5,423	1,302
Comprehensive income (loss) attributable to non-controlling interest	1,657	280	(1,004)
Comprehensive income attributable to Heska Corporation	$ 10,418	$ 5,143	$ 2,306

See accompanying notes to consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

	Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Income	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amount				
Balances January 1, 2014	5,846	$ 58	$ 217,588	$ 580	$ (171,110)	$ 47,116
Net loss	—	—	—	—	1,599	1,599
Issuance of common stock related to options, ESPP and other	496	5	1,443	—	—	1,448
Recognition of stock based compensation	—	—	1,653	—	—	1,653
Excess tax benefit from stock-based compensation	—	—	228	—	—	228
Stock issued for Heska Imaging	—	—	3,405	—	—	3,405
Stock issued for Heska Imaging Mark to Market	—	—	(2,020)	—	—	(2,020)
Unrealized gain on available for sale investments	—	—	—	3	—	3
Foreign currency translation adjustments	—	—	—	(300)	—	(300)
Balances, December 31, 2014	6,342	$ 63	$ 222,297	$ 283	$ (169,511)	$ 53,132
Net income	—	—	—	—	5,519	5,519
Issuance of common stock related to options, ESPP and other	283	3	1,255	—	—	1,258
Recognition of stock based compensation	—	—	2,269	—	—	2,269
Excess tax benefit from stock-based compensation	—	—	1,514	—	—	1,514
Unrealized gain on available for sale investments	—	—	—	44	—	44
Foreign currency translation adjustments	—	—	—	(11)	—	(11)
Balances, December 31, 2015	6,625	$ 66	$ 227,267	$ 187	$ (163,992)	$ 63,528
Net income	—	—	—	—	12,165	12,165
Issuance of common stock related to the acquisition of Cuattro Veterinary International, LLC	175	2	6,347	—	—	6,349
Issuance of common stock related to options, ESPP and other	226	2	1,616	—	—	1,618
Recognition of stock based compensation	—	—	2,260	—	—	2,260
Accretion of non-controlling interest	—	—	1,145	—	—	1,145
Minimum pension liability adjustments	—	—	—	75	—	75
Sale of equity investment	—	—	—	(90)	—	(90)
Foreign currency translation adjustments	—	—	—	(75)	—	(75)
Balances, December 31, 2016	7,026	$ 70	$ 238,635	$ 97	$ (151,827)	$ 86,975

See accompanying notes to consolidated financial statements.

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

	Year Ended December 31,		
	2016	**2015**	**2014**
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 12,165	$ 5,519	$ 1,599
Adjustments to reconcile net income to cash provided by operating activities:			
Depreciation and amortization	4,645	4,187	3,712
Deferred tax expense	3,932	1,327	1,304
Stock based compensation	2,260	2,269	1,653
Unrealized (gain) loss on foreign currency translation	(3)	36	(81)
Changes in operating assets and liabilities:			
Accounts receivable	(4,700)	(4,216)	(510)
Inventories	(4,731)	(7,240)	(5,592)
Other current assets	88	(238)	(73)
Accounts payable	(688)	3,059	900
Accrued liabilities and other	1,005	43	814
Other non-current assets	(5,818)	(2,430)	(263)
Deferred revenue and other	(2,300)	(191)	2,091
Net cash provided by operating activities	5,855	2,125	5,554
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from sale of equity investment	115	—	—
Purchases of property and equipment	(3,417)	(3,773)	(2,337)
Proceeds from disposition of property and equipment	—	—	6
Net cash used in investing activities	(3,302)	(3,773)	(2,331)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of common stock, net of distributions	1,620	1,258	1,430
Proceeds from (repayments of) line of credit borrowings, net	530	95	(4,751)
Repayments of other debt	(747)	(141)	(178)
Excess tax benefit from stock-based compensation	—	1,514	228
Net cash provided by (used in) financing activities	1,403	2,726	(3,271)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(52)	(43)	(113)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	3,904	1,035	(161)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	6,890	5,855	6,016
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 10,794	$ 6,890	$ 5,855
NON-CASH TRANSACTIONS:			
Common stock issued as partial consideration of acquisition of Cuattro Veterinary International, LLC	$ 6,349	$ —	$ —

See accompanying notes to consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Basis of Presentation

Our consolidated financial statements include our accounts and the accounts of our wholly-owned subsidiaries and majority-owned subsidiaries since their respective dates of acquisitions. All intercompany accounts and transactions have been eliminated in consolidation. Where our ownership of a subsidiary is less than 100%, the non-controlling interest is reported on our consolidated balance sheets. The non-controlling interest in our consolidated net income is reported as "Net income (loss) attributable to non-controlling interest" on our consolidated statements of income. Our consolidated financial statements are stated in United States dollars and have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP").

Use of Estimates

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

Concentration of Credit Risk

Financial instruments that potentially subject us to a concentration of credit risk consist of cash and cash equivalents and accounts receivable. We maintain the majority of our cash and cash equivalents with financial institutions that management believes are creditworthy in the form of demand deposits. We have no significant off-balance-sheet concentrations of credit risk such as foreign exchange contracts, options contracts or other foreign currency hedging arrangements. Our accounts receivable balances are due largely from distribution partners, domestic veterinary clinics and individual veterinarians and other animal health companies.

Henry Schein represented 16% of our consolidated accounts receivable at December 31, 2016. Merck entities represented approximately 11% and 13% of our consolidated accounts receivable at December 31, 2016 and 2015, respectively. Eli Lilly entities, including Elanco, represented approximately 15% and 20% of our consolidated accounts receivable at December 31, 2016 and 2015, respectively. No other customer accounted for more than 10% of our consolidated accounts receivable at December 31, 2016 or 2015.

We have established an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends, and other information.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable are recorded at net realizable value. From time to time, our customers are unable to meet their payment obligations. We continuously monitor our customers' credit worthiness and use our judgment in establishing a provision for estimated credit losses based upon our historical experience and any specific customer collection issues that we have identified. While such credit losses have historically been within our expectations and the provisions established, there is no assurance that we will continue to experience the same credit loss rates that we have in the past. A significant change in the liquidity or financial position of our customers could have a material adverse impact on the collectability of accounts receivable and our future operating results.

Changes in allowance for doubtful accounts are summarized as follows (in thousands):

	Years Ended December 31,		
	2016	2015	2014
Balances at beginning of period	$ 189	$ 216	$ 209
Additions - charged to expense	163	83	143
Deductions - write offs, net of recoveries	(115)	(110)	(136)
Balances at end of period	$ 237	$ 189	$ 216

Cash and Cash Equivalents

Cash and cash equivalents are stated at cost, which approximates market value, and include short-term, highly liquid investments with original maturities of less than three months. We valued our Euro and Japanese Yen cash accounts at the spot market foreign exchange rate as of each balance sheet date, with changes due to foreign exchange fluctuations recorded in current earnings. We held 2,778,614 and 1,779,910 Euros at December 31, 2016 and 2015, respectively. We held 1,252,221 and 1,252,221 Yen at December 31, 2016 and 2015, respectively. We held 172,743 and 127,507 Swiss Francs at December 31, 2016 and 2015, respectively. We held 26,477 and 26,477 Canadian Dollars at December 31, 2016 and 2015, respectively. The majority of our cash and cash equivalents are held at U.S.-based or Swiss-based financial institutions in accounts not insured by governmental entities.

Fair Value of Financial Instruments

Our financial instruments consist of cash and cash equivalents, short-term trade receivables and payables and the Company's revolving line of credit. The carrying values of cash and cash equivalents and short-term trade receivables and payables approximate fair value because of the short-term nature of the instruments. The fair value of our line of credit balance is estimated based on current rates available for similar debt with similar maturities and collateral, and at December 31, 2016 and 2015, approximates the carrying value due primarily to the floating rate of interest on such debt instruments.

Inventories

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

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

	December 31,	
	2016	2015
Raw materials	$ 10,807	$ 8,531
Work in process	3,820	2,839
Finished goods	7,087	6,122
Allowance for excess or obsolete inventory	(1,319)	(1,391)
	$ 20,395	$ 16,101

Property and Equipment

Property and equipment is stated at cost, net of accumulated depreciation. The costs of additions and improvements are capitalized, while maintenance and repairs are charged to expense as incurred. When an item is sold or retired, the cost and related accumulated depreciation is relieved, and the resulting gain or loss, if any, is recognized in the consolidated statements of income. We provide for depreciation primarily using the straight-line method by charges to income in amounts that allocate the cost of property and equipment over their estimated useful lives as follows:

Asset Classification	Estimated Useful Life
Building	10 to 20 years
Machinery and equipment	3 to 15 years
Leasehold and building improvements	7 to 15 years

We capitalize certain costs incurred in connection with developing or obtaining software designated for internal use based on three distinct stages of development. Qualifying costs incurred during the application development stage, which consist primarily of internal payroll and direct fringe benefits and external direct project costs, including labor and travel, are capitalized and amortized on a straight-line basis over the estimated useful life of the asset. Costs incurred during the preliminary project and post and post-implementation and operation phases are expensed as incurred. These costs are general and administrative in nature and related primarily to the determination of performance requirements, data conversion and training.

Goodwill, Intangible and Other Long-Lived Assets

We assess goodwill for impairment annually, at the reporting unit level, in the fourth quarter and whenever events or circumstances indicate impairment may exist. In evaluating goodwill for impairment, we have the option to first assess the qualitative factors to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. If, after assessing the totality of events or circumstances, we determine that is more likely than not that the fair value of a reporting is less than its carrying amount, we would then perform step one of the two-step impairment test; otherwise, no further impairment test would be required. In contrast, we can opt to bypass the qualitative assessment for any reporting unit in any period and proceed directly to step one of the two-step impairment test. Doing so does not preclude us from performing the qualitative assessment in any subsequent period.

In the fourth quarter of 2016, we performed a qualitative assessment of the goodwill residing within the assets of our CCA segment and determined that no indications of impairment existed.

Intangible assets are valued based on estimates of future cash flows and amortized over their estimated useful lives. We continually evaluate whether events and circumstances have occurred that indicate the remaining estimated useful life of intangible assets as well as other long-lived assets may warrant revision, or that the remaining balance of these assets may not be recoverable. When deemed necessary, we complete this evaluation by comparing the carrying amount of the assets with the estimated undiscounted future cash flows associated with them. If such evaluations indicate that the future undiscounted cash flows of amortizable long-lived assets are not sufficient to recover the carrying value of such assets, the assets are adjusted to their estimated fair values.

The estimation of useful lives and expected cash flows requires us to make significant judgments regarding future periods that are subject to some factors outside of our control. Changes in these estimates can result in significant revisions to our carrying value of these assets and may result in material charges to our results of operations.

Revenue Recognition

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

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

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

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

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

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

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

In addition to our direct sales force, we utilize 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.

Upfront payments we receive under arrangements for product, patent or technology rights in which we retain an interest in the underlying product, patent or technology are initially deferred, and revenue is subsequently recognized over the estimated life of the agreement, product, patent or technology. Similarly, upfront payments we receive under agreements where we are obligated to maintain a product or technology sold to a third party and/or transfer know-how or technology to a third party are initially deferred and revenue is subsequently recognized over the estimated life of the agreement. Milestone payments related to an improvement in a product in which we retain an interest in the product are initially deferred and recognized over the estimated life of the agreement or product. We received upfront and milestone payments totaling $3.0 million in 2014. We did not receive any such payments in 2016 or 2015. Revenue from royalties is recognized once we are informed of sales on which we are entitled to royalties.

Stock-Based Compensation

Accounting for stock-based compensation requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. We estimate the fair value of all stock options and awards on the date of grant using the Black-Scholes pricing model, which is affected by our stock price, as well as assumptions regarding a number of complex and subjective variables. These variables include our expected stock price volatility over the estimated term of the awards, the estimated term of the awards, which is dependent in part on employee option exercise behaviors, risk free interest rates and expected dividends. Our expected volatility assumption is based on the historical closing prices of our stock over a period equivalent to the expected life of the options.

Advertising Costs

Advertising costs are expensed as incurred and are included in sales and marketing expenses. Advertising expenses were $0.2 million for the year ended December 31, 2016 and $0.1 million for each of the years ended December 31, 2015 and 2014.

Income Taxes

The Company records a current provision for income taxes based on estimated amounts payable or refundable on tax returns filed or to be filed each year. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates, in each tax jurisdiction, expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in operations in the period that includes the enactment date. The overall change in deferred tax assets and liabilities for the period measures the deferred tax expense or benefit for the period. Deferred tax assets are reduced by a valuation allowance based on a judgmental assessment of available evidence if the Company is unable to conclude that it is more likely than not that some or all of the deferred tax assets will be realized.

Foreign Currency Translation

The functional currency of our Swiss subsidiary is the Swiss Franc. Assets and liabilities of our Swiss subsidiary are translated using the exchange rate in effect at the balance sheet date. Revenue and expense accounts and cash flows are translated using an average of exchange rates in effect during the period. Cumulative translation gains and losses are shown in the consolidated balance sheets as a separate component of stockholders' equity. Exchange gains and losses arising from transactions denominated in foreign currencies (i.e., transaction gains and losses) are recognized as a component of other income (expense) in current operations, as are exchange gains and losses on intercompany transactions expected to be settled in the near term.

Taxes Collected from Customers

In the course of doing business we collect various taxes from customers including, but not limited to, sales taxes. It is our policy to record revenue net of taxes collected from customers in our consolidated statements of income.

Shipping and Handling Costs

Amounts billed to customers for shipping and handling are recorded in sales. Shipping and handling costs incurred by us for the delivery of products to customers are included in cost of sales.

Recent Accounting Pronouncements

In March 2016, the Financial Accounting Standards Board ("FASB") issued guidance codified in Accounting Standards ASU, ("ASU") Topic 2016-09, "Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting". The update simplifies several aspects related to the accounting for share-based payment transactions, including the accounting for income taxes, statutory tax withholding requirements and classification on the statement of cash flows. The update is effective for annual and interim reporting periods beginning after December 15, 2016, with early adoption permitted. We early adopted the standard during the second quarter of 2016 and are therefore required to report the impacts

as though the standard had been adopted on January 1, 2016. Accordingly, we recognized additional income tax benefits as an increase to earnings of $0.8 million ($0.11 per diluted share) in the twelve months ended December 31, 2016.The update did not impact any periods prior to January 1, 2016, as we applied the changes to the standard on a prospective basis.

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

In July 2015, the FASB issued ASU 2015-11 "Inventory - Simplifying the Measurement of Inventory (Topic 330)". This update required an entity to measure inventory within the scope of the update at the lower of cost and net realizable value, and defines net realizable value as the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. ASU 2015-11 is effective for interim and annual periods beginning after December 15, 2016, with early adoption permitted, and is to be applied on a prospective basis. We early adopted this standard with no impact to our consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)". Upon the effective date, the ASU replaces almost all existing revenue recognition guidance, including industry specific guidance, in U.S. GAAP. In August 2015, the FASB issued ASU 2015-14, "Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date". The amendments in this update deferred the effective date for implementation of ASU 2014-09 by one year and are now effective for annual and interim reporting periods beginning after December 15, 2017. The new standard permits two methods of adoption: retrospectively to each prior reporting period presented (full retrospective method), or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application (the modified retrospective method). We currently anticipate adopting the standard using the modified retrospective method. We are still in the process of completing our analysis on the impact this guidance will have on our consolidated financial statements and related disclosures.

2. ACQUISITION AND RELATED PARTY ITEMS

On May 31, 2016, the Company closed a transaction (the "Merger") to acquire Cuattro Veterinary, LLC ("Cuattro International") from Kevin S. Wilson, and all of the members of Cuattro International (the "Members"). Pursuant to the Merger, the Company issued 175,000 shares of the Company's common stock, $0.01 par value per share (the "Common Stock"), to the Members on the Closing Date, at an aggregate value equal to approximately $6.3 million based on the adjusted closing price per share of the Common Stock as reported on the Nasdaq Stock Market on the Merger closing date. These shares were issued to the Members in a private placement in reliance upon an exemption from the registration requirements of the Securities Act of 1933, as amended, pursuant to Section 4(a)(2) thereof and the safe harbor provided by Rule 506 of Regulation D promulgated thereunder. Effective on the Merger closing date, each of the Members executed lock-up agreements with the Company that restricted their ability to sell any of the shares of Common Stock received in the Merger until 180 days after the Merger closing date. In addition, the Company assumed approximately $1.5 million in debt as part of the transaction.

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

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

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

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

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

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

Cuattro International is a provider to international markets of digital radiography technologies for veterinarians. As a leading provider of advanced veterinary diagnostic and specialty products, we made the acquisition in an effort to combine Cuattro International's international reach with our domestic success in the imaging and blood testing markets in the United States. International markets represent a significant portion of worldwide veterinary revenues for which we intend to compete.

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

On February 24, 2013, the Company acquired a 54.6% interest in Cuattro Veterinary USA, LLC (the "Acquisition"), which was subsequently renamed Heska Imaging US, LLC ("US Imaging). The remaining minority position (45.4)% in US Imaging is subject to purchase by Heska under performance-based puts and calls following the audit of either our 2016 and 2017 financial statements. Required performance criteria have been met in 2016 and we have been given notice that the put option is being exercised. We have 90 days from the receipt of notice to deliver payment (any applicable payment in aggregate to be defined as the "Put Payment") for the Imaging Minority's position, and we consider notice to have been received immediately prior to the filing of our Form 10-K with the SEC. We plan to deliver the Put Payment and obtain the Imaging Minority's position in US Imaging on May 31, 2017. Based on US Imaging's 2016 financial performance, the Put Payment is to be for a value of $13.8 million if we deliver all cash or up to $14.6 million if we deliver a combination of cash and the maximum contractually allowable value of stock. While we have the right to deliver up to 55% of the consideration in our Public Common Stock under certain circumstances, such stock is to be valued based on 90% of market value (the "Delivery Stock Value") and is limited to approximately 650 thousand shares in any case. If the Delivery Stock Value per share is less than the market value per share of our Public Common Stock at the time of the Acquisition, we do not have the right to deliver any Public Common Stock as consideration. While we have reported the Put Payment at $14.6 million for financial reporting purposes, which contemplates our delivery of 55% of the Put Payment consideration in Public Common Stock, no final decision by our Board of Directors as to the relative use of cash and stock has been made and we may not be able to deliver any stock based on the Delivery Stock Value at the time of closing, as discussed above. The estimated Put Payment value of $14.6 million, which had been listed as "Non-controlling interest" on our consolidated balance sheets and accreted to its estimated redemption value in accordance with US Imaging's Operating Agreement, is now listed as "Obligation to purchase minority interest" on the Company's consolidated balance sheets as of December 31, 2016.

The following is a reconciliation of the non-controlling interest balance (in thousands):

Balance December 31, 2015	$	15,747
Accretion of Put Value		(1,145)
Balance reclassification to current liabilities	$	(14,602)
Balance December 31, 2016	$	—

Shawna M. Wilson, Clint Roth, DVM, Steven M. Asakowicz, Rodney A. Lippincott, Kevin S. Wilson and Cuattro, LLC own approximately 29.75%, 8.39%, 4.09%, 3.07%, 0.05% and 0.05% of US Imaging, respectively. Kevin S. Wilson is the Chief Executive Officer and President of the Company and the spouse of Shawna M. Wilson. Steven M. Asakowicz serves as Executive Vice President, Companion Animal Health Sales for the Company. Rodney A. Lippincott serves as Executive Vice President, Companion Animal Health Sales for the Company.

Cuattro, LLC charged US Imaging $3.6 million from January 1, 2016 to May 31, 2016 and has charged Global Imaging $10.9 million since June 1, 2016, primarily related to digital imaging products, for which there is an underlying supply contract with minimum purchase obligations, software and services as well as other operating expenses; Heska Corporation charged US Imaging $5.3 million in 2016, primarily related to sales expenses; Heska Corporation has charged Cuattro, LLC $0.2 million, primarily related to facility usage and other services.

At December 31, 2016, US Imaging had a $1.6 million note receivable, including accrued interest, from International Imaging, which is due on June 15, 2019 and which eliminates in consolidation of the Company's financial statements. This note was previously listed as "Note receivable – related party" on the Company's consolidated balance sheets and, as discussed above, was assumed as part of the Company's acquisition of International Imaging. At December 31, 2016, Heska Corporation had accounts receivable from US Imaging of $5.6 million, including accrued interest, which eliminates in consolidation of the Company's financial statements; US Imaging had a net receivable due from Cuattro, LLC of $0.1 million, which is included in "Due from – related parties" on the Company's consolidated balance sheets; Global Imaging had net prepaid receivables from US Imaging of $1.2 million which eliminates in consolidation of the Company's financial statements; all monies owed accrue interest at the same interest rate Heska Corporation pays under its credit and security agreement with Wells Fargo once past due with the exception of the note receivable, which accrues at this rate to its maturity date.

3. INCOME TAXES

As of December 31, 2016, the Company had a domestic federal net operating loss carryforward ("NOL"), of approximately $96.0 million, a domestic alternative minimum tax credit of approximately $0.5 million and a domestic research and development tax credit carryforward of approximately $0.4 million for federal tax purposes. The Company's NOL is expected to expire as follows if unused: $90.0 million in 2018 through 2022, $5.5 million in 2024 and 2025 and $0.5 million in 2027 and later. The NOL and tax credit carryforwards are subject to alternative minimum tax limitations and to examination by the tax authorities. In addition, the Company had a "change of ownership" as defined under the provisions of Section 382 of the Internal Revenue Code of 1986, as amended (an "Ownership Change").

The Company does not believe this Ownership Change will place a significant restriction on its ability to utilize its NOL in the future. The Company has established a valuation allowance against those NOL's and credits for which it is estimated to be more likely than not that they will expire unutilized.

We are subject to income taxes in the U.S. federal jurisdiction, and various foreign, state and local jurisdictions. Tax regulations within each jurisdiction are subject to the interpretation of the related tax laws and regulations and require significant judgment to apply. The rate in the year ended December 31, 2016 benefited from additional tax benefits related to employee share-based payment awards which are now recorded as income tax benefit or expense in earnings effective with the adoption of ASU 2016-09. We early adopted the ASU during the second quarter of 2016 and are therefore required to report the impacts as though the accounting standard update had been adopted on January 1, 2016. Accordingly, we recognized additional income tax benefits as an increase to earnings of $0.8 million in the year ended December 31, 2016.

Cash paid for income taxes for the twelve months ended December 31, 2016, 2015, and 2014 was $357 thousand, $55 thousand and $272 thousand, respectively.

The components of income before income taxes were as follows (in thousands):

	Year Ended December 31,		
	2016	2015	2014
Domestic	$ 16,375	$ 8,325	$ 2,837
Foreign	129	102	113
	$ 16,504	$ 8,427	$ 2,950

Temporary differences that give rise to the components of net deferred tax assets are as follows (in thousands):

	December 31,	
	2016	2015
Inventory	$ 1,172	$ 954
Accrued compensation	114	267
Stock Options	811	344
Research and development	438	440
Alternative minimum tax credit	543	367
Deferred revenue	2,934	3,638
Property and equipment	2,750	1,967
Net operating loss carryforwards – domestic	34,706	37,845
Capital Lease	(2,833)	(384)
Other	34	(8)
	40,669	45,430
Valuation allowance	(19,547)	(19,547)
Total net deferred tax assets	$ 21,122	$ 25,883

The components of the income tax expense are as follows (in thousands):

	Year Ended December 31,		
	2016	2015	2014
Current income tax expense:			
Federal	$ 197	$ 1,492	$ 11
State	179	65	7
Foreign	31	24	29
Total current expense	$ 407	$ 1,581	$ 47
Deferred income tax expense:			
Federal	$ 3,545	$ 1,043	$ 1,181
State	387	284	123
Foreign	—	—	—
Total deferred expense	3,932	1,327	1,304
Total income tax expense	$ 4,339	$ 2,908	$ 1,351

The Company's income tax expense (benefit) relating to income (loss) for the periods presented differs from the amounts that would result from applying the federal statutory rate to that income (loss) as follows:

	Year Ended December 31,		
	2016	2015	2014
Statutory federal tax rate	34 %	34 %	34 %
State income taxes, net of federal benefit	2 %	3 %	5 %
Non-controlling interest in Heska Imaging US, LLC	(3)%	(1)%	12 %
Other permanent differences	(7)%	(1)%	(3)%
Change in tax rate	— %	(1)%	2 %
Change in valuation allowance	— %	(14)%	78 %
Other	— %	15 %	(82)%
Effective income tax rate	26 %	35 %	46 %

ASC 740 provides detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in the financial statements. Tax positions must meet a "more-likely-than-not" recognition threshold before a benefit is recognized in the financial statements. As of December 31, 2016, the Company has not recorded a liability for uncertain tax positions. The Company would recognize interest and penalties related to uncertain tax positions in income tax expense. No interest and penalties related to uncertain tax positions were accrued at December 31, 2016.

4. EARNINGS PER SHARE

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

The following is a reconciliation of the weighted-average shares outstanding used in the calculation of basic and diluted earnings per share for the years ended December 31, 2016, 2015, and 2014 (in thousands, except per share data):

	Years ended December 31,		
	2016	2015	2014
Net income attributable to Heska Corporation	$ 10,508	$ 5,239	$ 2,603
Basic weighted-average common shares outstanding	6,783	6,509	5,951
Assumed exercise of dilutive stock options and restricted stock units	578	565	458
Diluted weighted-average common shares outstanding	7,361	7,074	6,409
Basic earnings per share	$ 1.55	$ 0.80	$ 0.44
Diluted earnings per share	$ 1.43	$ 0.74	$ 0.41

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

	Years ended December 31,		
	2016	2015	2014
Stock options	234	144	367

5. GOODWILL AND OTHER INTANGIBLES

The following summarizes the changes in goodwill during the years ended December 31, 2016 and 2015 (in thousands):

	Year Ended December 31,	
	2016	2015
Carrying amount, December 31, 2015	$ 20,910	$ 20,903
Additions and adjustments	5,737	7
Carrying amount, December 31, 2016	$ 26,647	$ 20,910

Other intangibles assets, net consisted of the following as of December 31, 2016 and 2015 (in thousands):

	Year Ended December 31,	
	2016	2015
Gross carrying amount	$ 2,622	$ 788
Accumulated amortization	(276)	(732)
Net carrying amount	$ 2,346	$ 56

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

	Years Ended December 31,		
	2016	2015	2014
Amortization expense	$ 230	$ 246	$ 260

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

Year Ending December 31,	
2017	$ 388
2018	388
2019	388
2020	388
2021	384
Thereafter	410
	$ 2,346

6. PROPERTY AND EQUIPMENT

Detail of property and equipment is as follows (in thousands):

	December 31, 2016	December 31, 2015
Land	$ 377	$ 377
Building	2,868	2,868
Machinery and equipment	36,588	35,284
Leasehold and building improvements	7,662	6,673
Construction in progress	1,655	1,496
	49,150	46,698
Less accumulated depreciation	(32,569)	(29,678)
Total property and equipment, net	$ 16,581	$ 17,020

The Company has utilized marketing programs whereby its instruments in inventory may be placed in a customer's location on a rental basis. The cost of these instruments is transferred to machinery and equipment or other long-term assets and depreciated, typically over a five to seven-year period depending on the circumstance under which the instrument is placed with the customer. Total costs transferred from inventory were approximately $1.8 million, $4.1 million and $4.6 million for the years ended December 31, 2016, 2015 and 2014, respectively.

The Company has sold certain customer rental contracts and underlying assets to third parties under agreements that once the customer has met the customer obligations under the contract, ownership of the assets underlying the contract would be returned to the Company. The Company enters a debit to cash and a corresponding credit to deferred revenue at the time of these sales. Since the Company anticipates it will regain ownership of the assets underlying these sales, the Company reports these assets as part of property and equipment and depreciates these assets in accordance with its depreciation policies. The Company had $0.3 million and $2.2 million of net property and equipment related to these transactions as of December 31, 2016 and December 31, 2015, respectively, all related to the Company's 54.6%-owned subsidiary, US Imaging.

Depreciation expense for property and equipment was $4.4 million, $4.0 million and $3.4 million for the years ended December 31, 2016, 2015 and 2014, respectively.

The Company capitalizes third-party software costs, where appropriate, and reports such costs, net of accumulated amortization, on the "property and equipment, net" line of its consolidated balance sheets. We had $0.4 million of such capitalized costs, net of accumulated amortization, on the "property and equipment, net" line of each of our consolidated balance sheets as of December 31, 2016 and 2015, respectively. Capitalized software costs in a given year are reported on the "purchases of property and equipment" line item of the Company's consolidated statements of cash flows. We had $251 thousand, $51 thousand and $31 thousand of capitalized software costs reported on the "purchases of property and equipment" line item of our consolidated statements of cash flows for the years ended December 31, 2016, 2015 and 2014, respectively.

7. ACCRUED LIABILITIES

Accrued liabilities consisted of the following as of December 31, 2016 and 2015 (in thousands):

	2016	2015
Accrued payroll and employee benefits	$ 2,166	$ 1,626
Accrued property taxes	748	594
Other	3,555	3,196
Total accrued liabilities	$ 6,469	$ 5,416

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

8. CAPITAL STOCK

Stock Option Plans

We have two stock option plans which authorize granting of stock options and stock purchase rights to our employees, officers, directors and consultants to purchase shares of common stock. In 1997, the board of directors adopted the 1997 Stock Incentive Plan (the "1997 Plan") and terminated two prior option plans. All shares that remained available for grant under the terminated plans were incorporated into the 1997 Plan, including shares subsequently canceled under prior plans. In May 2012, the stockholders approved an amendment to the 1997 Plan allowing for an increase of 250,000 shares and an annual increase through 2016 based on the number of non-employee directors serving as of our Annual Meeting of Stockholders, subject to a maximum of 45,000 shares per year. In May 2016, the stockholders approved a further amendment to the 1997 Plan to authorize additional 500,000 shares to be available for issuance thereunder. In May 2003, the stockholders approved a new plan, the 2003 Equity Incentive Plan, which allows for the granting of options for up to 239,050 shares of the Company's common stock. The number of shares reserved for issuance under both plans as of December 31, 2016 was 407,339.

The stock options granted by the board of directors may be either incentive stock options ("ISOs") or non-qualified stock options ("NQs"). The exercise price for options under all of the plans may be no less than 100% of the fair value of the underlying common stock for ISOs or 85% of fair value for NQs. Options granted will expire no later than the tenth anniversary subsequent to the date of grant or three months following termination of employment, except in cases of death or disability, in which case the options will remain exercisable for up to twelve months. Under the terms of the 1997 Plan, in the event we are sold or merged, outstanding options will either be assumed by the surviving corporation or vest immediately.

There are four key inputs to the Black-Scholes model which we use to estimate the fair value for options which it issues: expected term, expected volatility, risk-free interest rate and expected dividends, all of which require us to make estimates. Our estimates for these inputs may not be indicative of actual future performance and changes to any of these inputs can have a material impact on the resulting estimated fair value calculated for the option. Our expected term input was estimated based on our historical experience for time from option grant to option exercise for all employees in 2016, 2015 and 2014. We treated all employees in one grouping in all three years. Our expected volatility input was estimated based on our historical stock price volatility in 2016, 2015 and 2014. Our risk-free interest rate input was determined based on the U.S. Treasury yield curve at the time of option issuance in 2016, 2015 and 2014. Our expected dividends inputs were zero in all periods as we did not anticipate paying dividends in the foreseeable future.

Weighted average assumptions used in 2016, 2015 and 2014 for each of these four key inputs are listed in the following table:

	2016	2015	2014
Risk-free interest rate	1.76%	1.41%	1.21%
Expected lives	4.5 years	3.4 years	3.4 years
Expected volatility	41%	41%	43%
Expected dividend yield	0%	0%	0%

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

	Year Ended December 31,					
	2016		2015		2014	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of period	940,610	$ 14.163	1,074,251	$ 10.110	1,321,232	$ 10.386
Granted at Market	129,855	$ 67.706	146,446	$ 36.904	134,800	$ 16.398
Canceled	(463)	$ 14.881	(28,440)	$ 10.080	(218,926)	$ 17.786
Exercised	(240,385)	$ 11.886	(251,647)	$ 10.559	(162,855)	$ 7.234
Outstanding at end of period	829,617	$ 23.203	940,610	$ 14.163	1,074,251	$ 10.110
Exercisable at end of period	532,703	$ 12.140	621,559	$ 10.269	729,175	$ 9.800

The total estimated fair value of stock options granted were computed to be approximately $3.2 million, $1.6 million and $0.7 million during the years ended December 31, 2016, 2015 and 2014, respectively. The amounts are amortized ratably over the vesting periods of the options. The weighted average estimated fair value of options granted was computed to be approximately $24.59, $11.35 and $5.28 during the years ended December 31, 2016, 2015 and 2014, respectively. The total intrinsic value of options exercised was $9.9 million, $4.7 million and $0.7 million during the years ended December 31, 2016, 2015 and 2014, respectively. The cash proceeds from options exercised was $1.9 million, $1.8 million and $1.2 million during the years ended December 31, 2016, 2015 and 2014, respectively.

The following table summarizes information about stock options outstanding and exercisable at December 31, 2016, excluding outstanding options to purchase an aggregate of 0.5 fractional shares resulting from our December 2010 1-for-10 reverse stock split with a weighted average remaining contractual life of 0.34 years at an exercise price of $22.50. We intend to issue whole shares only from option exercises.

	Options Outstanding				Options Exercisable		
Exercise Prices	Number of Options Outstanding at December 31, 2016	Weighted Average Remaining Contractual Life in Years		Weighted Average Exercise Price	Number of Options Exercisable at December 31, 2016		Weighted Average Exercise Price
$ 4.40 - $ 6.90	164,794	3.94	$	5.679	163,663	$	5.676
$ 6.91 - $ 7.36	157,323	6.89	$	7.360	114,670	$	7.360
$ 7.37 - $18.13	214,697	6.68	$	12.800	162,451	$	11.317
$18.14 - $39.76	182,303	7.93	$	34.954	91,878	$	31.057
$39.77 - $72.85	110,500	9.99	$	72.721	41	$	56.587
$ 4.40 - $72.85	829,617	6.89	$	23.203	532,703	$	12.140

As of December 31, 2016, there was approximately $4.5 million of total unrecognized compensation cost related to outstanding stock options. That cost is expected to be recognized over a weighted-average period of 1.9 years with all cost to be recognized by the end of December 2018, assuming all options vest according to the vesting schedules in place at December 31, 2016. As of December 31, 2016, the aggregate intrinsic value of outstanding options was approximately $40.3 million and the aggregate intrinsic value of exercisable options was approximately $31.7 million.

Employee Stock Purchase Plan (the "ESPP")

Under the 1997 Employee Stock Purchase Plan, we are authorized to issue up to 450,000 shares of common stock to our employees, of which 408,668 had been issued as of December 31, 2016. On May 5, 2015, our shareholders approved the amendment and restatement of the ESPP, including a 75,000 share increase to 450,000 total shares authorized under the ESPP as well as changes discussed below as compared to the ESPP prior to the amendment and restatement. Employees who are expected to work at least 20 hours per week and 5 months per year are eligible to participate and can choose to have up to 10% of their compensation withheld to purchase our stock under the ESPP when they choose to withhold a whole percentage of their compensation.

Beginning on July 1, 2013, our ESPP had a 27-month offering period and three-month accumulation periods ending on each March 31, June 30, September 30 and December 31. The purchase price of stock on March 31, June 30, September 30 and December 31 was the lesser of (1) 85% of the fair market value at the time of purchase and (2) the greater of (i) 95% of the fair market value at the beginning of the applicable offering period or (ii) 65% of the fair market value at the time of purchase. In addition, participating employees may purchase shares under the ESPP at the beginning of an applicable offering period for a purchase price of stock equal to 95% of the fair market value at such time or at 5 pm on a day other than March 31, June 30, September 30 and December 31 during the applicable offering period for a purchase price of stock equal to 95% of the fair market value at purchase.

Beginning April 1, 2015, employees may elect to withhold a positive fixed amount from each compensation payment in addition to the previous approach of withholding a whole percentage of such compensation payment, with all withholding for a given employee subject to a maximum monthly amount of $2,500 following the amendment and restatement as opposed to a $25,000 maximum annual amount prior to the amendment and restatement. For offering periods beginning on or after April 1, 2015, the purchase price of stock on March 31, June 30, September 30 and December 31 is to be the lesser of (1) 85% of the fair market value at the time of purchase and (2) the greater of (i) 85% of the fair market value at the beginning of the applicable offering period, (ii) the fair market value at the beginning of the applicable offering period less

1 cent and (iii) 65% of the fair market value at the time of purchase. In addition, participating employees may elect to purchase shares under the ESPP at the beginning of an applicable offering period for a purchase price of stock equal to the greater of (1) 85% of the fair market value at the beginning of the applicable offering period and (2) the fair market value at the beginning of the applicable offering period less 1 cent or at 5 pm on a day other than March 31, June 30, September 30 and December 31 during the applicable offering period for a purchase price of stock equal to the greater of (1) 85% of the fair market value at the time of purchase and (2) the fair market value at the time of purchase less 1 cent.

We issued 17,057, 16,673 and 29,847 shares under the ESPP for the years ended December 31, 2016, 2015 and 2014, respectively.

For the years ended December 31, 2016, 2015 and 2014, we estimated the fair values of stock purchase rights granted under the ESPP using the Black-Scholes pricing model and the following weighted average assumptions:

	2016	**2015**	**2014**
Risk-free interest rate	0.54%	0.27%	0.23%
Expected lives	1.2 years	1.2 years	1.3 years
Expected volatility	42%	36%	34%
Expected dividend yield	0%	0%	0%

The weighted-average fair value of the purchase rights granted was $8.23, $6.25 and $2.61 per share for the years ended December 31, 2016, 2015 and 2014, respectively.

Restricted Stock Issuance

On March 26, 2014, we issued 63,572 shares to Robert B. Grieve, Ph.D., who was our Executive Chair, pursuant to an employment agreement between Dr. Grieve and the Company effective as of March 26, 2014 (the "Grieve Employment Agreement"). The shares were issued in five tranches and are subject to time-based vesting and other provisions outlined in the Grieve Employment Agreement. All shares were to vest in full as of April 30, 2017. Effective on October 1, 2015, the Grieve Employment Agreement was terminated and, in connection therewith, the Company entered into a Separation and Release Agreement dated as of October 1, 2015 (the "Release Agreement") with Dr. Grieve. Pursuant to the Release Agreement, the Company agreed to treat the termination of the Grieve Employment Agreement as a termination without cause, entitling Dr. Grieve to the immediate vesting of 55,715 shares, 14,373 of which were withheld for tax purposes. As a result of the termination of the Grieve Employment Agreement, and as acknowledged in the Release Agreement, effective October 1, 2015, Dr. Grieve began serving as a consultant to the Company pursuant to the Consulting Agreement (Founder Emeritus) dated as of March 26, 2014 (the "Consulting Agreement"). The remaining 7,857 shares issued to Dr. Grieve on March 26, 2014 vested on April 30, 2016, of which 2,525 shares were withheld for tax purposes.

On March 26, 2014, we issued 110,000 shares to Mr. Wilson pursuant to an employment agreement between Mr. Wilson and the Company effective as of March 26, 2014 (the "Wilson Employment Agreement"). The shares were issued in four equal tranches and are subject to time-based vesting and other provisions outlined in the Wilson Employment Agreement. The first tranche vested on September 26, 2014, and each of the three remaining tranches is to vest on the succeeding March 26 until all shares are vested in full as of March 26, 2017. On May 6, 2014, we issued an additional 130,000 shares to Mr. Wilson following a vote of approval on the issuance by our stockholders. The shares were issued in ten equal tranches, five of which were subject to vesting based on the achievement of certain stock price targets as defined and further described in the Wilson Employment Agreement and five of which were subject to vesting based on certain

"Adjusted EBITDA" targets as defined and further described in the Wilson Employment Agreement. All shares subject to vesting based on "Adjusted EBITDA" vested based on our 2014 performance. Of the five tranches based on the achievement of certain stock price targets, one vested in 2014 and the remaining four vested in 2015.

On March 17, 2015, the Company issued unvested shares to certain Executive Officers related to performance-based restricted stock grants (the "Performance Grants") and performance-based restricted stock grants related to the Company's 2015 Management Incentive Plan (the "2015 MIP Grants"). The Company issued 52,956 shares under the Performance Grants and 24,649 shares under 2015 MIP Grants. The Performance Grants have met the underlying performance condition based on the Company's 2015 financial performance and are to cliff vest on March 17, 2018, subject to other vesting provisions in the underlying restricted stock grant agreement. The 2015 MIP Grants were subject to the Company's achievement of certain financial goals and other vesting provisions in the underlying restricted stock grant agreement. On March 2, 2016, the Company vested 14,364 shares related to the 2015 MIP Grants based on the respective performance criteria, including 4,788 shares withheld for tax, and canceled the remaining 10,285 shares.

On March 2, 2016, the Company issued 15,000 unvested shares to certain Executive Officers related to performance-based restricted stock grants as part of the Company's 2016 Management Incentive Plan (the "2016 MIP Grants"). The 2016 MIP Grants are scheduled to vest on the date MIP Payouts are to be made under the 2016 Management Incentive Plan and are subject to the Company's achievement of certain financial goals and other vesting provisions in the underlying restricted stock grant agreement.

Restrictions on the transfer of Company stock

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

9. ACCUMULATED OTHER COMPREHENSIVE INCOME

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

	Minimum pension liability	Foreign currency translation	Sale of equity investment	Total accumulated other comprehensive income
Balances at December 31, 2015	$ (576)	$ 673	$ 90	$ 187
Current period other comprehensive income (loss)	75	(75)	(90)	(90)
Balances at December 31, 2016	$ (501)	$ 598	$ —	$ 97

10. COMMITMENTS AND CONTINGENCIES

The Company holds certain rights to market and manufacture all products developed or created under certain research, development and licensing agreements with various entities. In connection with such agreements, the Company has agreed to pay the entities royalties on net product sales. Royalties of $0.4 million became payable under these agreements in each of the years ended December 31, 2016, 2015 and 2014.

The Company has contracts with suppliers for unconditional annual minimum inventory purchases and milestone obligations to third parties the Company believes are likely to be triggered currently totaling approximately $0.6 million in 2017 and $0.3 million in 2018.

The Company has entered into operating leases for its office and research facilities and certain equipment with future minimum payments as of December 31, 2016 as follows (in thousands):

Year Ending December 31,		
2017	$	2,090
2018		1,970
2019		1,810
2020		1,696
2021		1,677
Thereafter		3,202
	$	12,445

The Company had rent expense of $2.0 million in each of the years ended December 31, 2016 and 2015 and $1.9 million in the year ended December 31, 2014.

From time to time, the Company may be involved in litigation relating to claims arising out of its operations. On March 12, 2015, a complaint was filed against us by Shaun Fauley in the United States District Court Northern District of Illinois alleging our transmittal of unauthorized faxes in violation of the federal Telephone Consumer Protection Act of 1991, as amended by the Junk Fax Prevention Act of 2005, as a class action seeking stated damages of the greater of actual monetary loss or five hundred dollars per violation. We intend to defend ourselves vigorously in this matter. At December 31, 2016, the Company was not a party to any other legal proceedings that were expected, individually or in the aggregate, to have a material adverse effect on our business, financial condition or operating results.

The Company's current terms and conditions of sale include a limited warranty that its products and services will conform to published specifications at the time of shipment and a more extensive warranty related to certain of its products. The Company also sells a renewal warranty for certain of its products. The typical remedy for breach of warranty is to correct or replace any defective product, and if not possible or practical, the Company will accept the return of the defective product and refund the amount paid. Historically, the Company has incurred minimal warranty costs. The Company's warranty reserve was $0.4 million as of December 31, 2016 and 2015.

11. INTEREST AND OTHER EXPENSE (INCOME)

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

	Year Ended December 31,		
	2016	2015	2014
Interest income	$ (124)	$ (172)	$ (190)
Interest expense	160	200	206
Other expense (income), net	(7)	102	(55)
	$ 29	$ 130	$ (39)

Cash paid for interest was $78 thousand, $90 thousand and $92 thousand for the years ended December 31, 2016, 2015 and 2014, respectively.

12. CREDIT FACILITY AND LONG-TERM DEBT

At December 31, 2016, we had a $15.0 million asset-based revolving line of credit with Wells Fargo which has a maturity date of December 31, 2017 as part of our credit and security agreement with Wells Fargo. At December 31, 2016, we had $0.7 million of borrowings outstanding on this line of credit. Our ability to borrow under this line of credit varies based upon available cash, eligible accounts receivable and eligible inventory. Any interest on borrowings due is to be charged at a stated rate of three month LIBOR plus 2.25% and payable monthly. There is an annual minimum interest charge of $75 thousand under the agreement. We are required to comply with various financial and non-financial covenants, and we have made various representations and warranties under our agreement with Wells Fargo. A key financial covenant is based on a fixed charge coverage ratio, as defined in our agreement with Wells Fargo. We were in compliance with all financial covenants as of December 31, 2016 and our available borrowing capacity based upon eligible accounts receivable and eligible inventory under our revolving line of credit was approximately $12.9 million.

Long-term debt consists of the following (in thousands):

	December 31,	
	2016	2015
Term loan with a financial entity due in monthly installments beginning July 2012 with the balance to be paid in full in June 2017 and a stated interest rate of 6.0%.	$ 78	$ 228
Less current maturities	78	159
Long-term debt, net of current portion	$ —	$ 69

13. SEGMENT REPORTING

The Company is comprised of two reportable segments, Core Companion Animal Health ("CCA") and Other Vaccines, Pharmaceuticals and Products ("OVP"). The CCA segment includes diagnostic instruments and supplies, as well as single use diagnostic and other tests, pharmaceuticals and vaccines, primarily for canine and feline use. The CCA segment also includes digital radiography and ultrasound products along with embedded software and support, data hosting and other services from Heska Imaging. These products are sold directly by the Company as well as through independent third-party distributors and through other distribution relationships. CCA segment products manufactured at the Des Moines, Iowa production facility included in the OVP segment's assets are transferred at cost and are not recorded as revenue for the OVP segment. The OVP segment includes private label vaccine and pharmaceutical production, primarily for cattle, but also for other species including equine, porcine, avian, feline and canine. All OVP products are sold by third parties under third-party labels.

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

Year Ended December 31, 2016	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 107,398	$ 22,685	$ 130,083
Operating Income	13,015	3,518	16,533
Income before income taxes	12,938	3,566	16,504
Total assets	110,995	19,849	130,844
Net assets	68,072	18,903	86,975
Capital expenditures	1,135	2,282	3,417
Depreciation and amortization	3,800	845	4,645

Year Ended December 31, 2015	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 84,249	$ 20,348	$ 104,597
Operating Income	4,911	3,646	8,557
Income before income taxes	4,836	3,591	8,427
Total assets	92,567	17,152	109,719
Net assets	48,175	15,353	63,528
Capital expenditures	1,177	2,596	3,773
Depreciation and amortization	3,478	709	4,187

Year Ended December 31, 2014	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 72,354	$ 17,483	$ 89,837
Operating Income	1,198	1,713	2,911
Income before income taxes	1,290	1,660	2,950
Total assets	85,361	11,483	96,844
Net assets	41,286	11,846	53,132
Capital expenditures	1,864	473	2,337
Depreciation and amortization	2,954	758	3,712

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

	For the Years Ended December 31,		
	2016	2015	2014
United States	$ 120,082	$ 97,164	$ 83,584
Canada	2,378	1,833	1,123
Europe	4,781	2,086	2,264
Other International	2,842	3,514	2,866
Total	$ 130,083	$ 104,597	$ 89,837

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

	For the Years Ended December 31,		
	2016	2015	2014
United States	$ 127,827	$ 106,780	$ 93,977
Europe	3,017	2,939	2,867
Total	$ 130,844	$ 109,719	$ 96,844

14. SUPPLEMENTAL QUARTERLY FINANCIAL DATA (Unaudited)

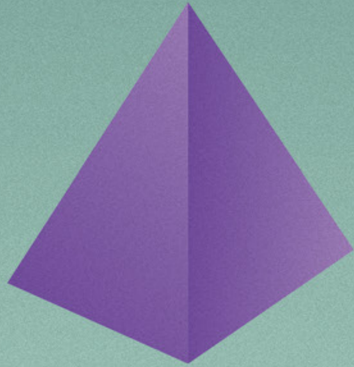
The following tables present quarterly unaudited results for each of the two years in the periods ended December 31, 2016 and 2015 (amounts in thousands, except per share data).

	Q1	Q2	Q3	Q4	Total
2016					
Total revenue	$ 27,146	$ 29,965	$ 33,430	$ 39,542	$ 130,083
Gross profit	11,442	12,682	13,718	16,050	53,892
Operating income	1,970	3,556	4,492	6,515	16,533
Net income	1,447	2,742	3,343	4,633	12,165
Net income attributable to Heska Corporation	1,186	2,522	3,347	3,453	10,508
Basic earnings per share attributable to Heska Corporation	0.18	0.38	0.49	0.50	1.55
Diluted earnings per share attributable to Heska Corporation	0.17	0.35	0.45	0.46	1.43
2015					
Total revenue	$ 22,894	$ 23,910	$ 28,034	$ 29,759	$ 104,597
Gross profit	10,084	10,297	11,597	12,235	44,213
Operating income	1,021	1,829	2,142	3,565	8,557
Net income	583	1,178	1,383	2,375	5,519
Net income attributable to Heska Corporation	598	1,197	1,415	2,029	5,239
Basic earnings per share attributable to Heska Corporation	0.10	0.19	0.22	0.29	0.80
Diluted earnings per share attributable to Heska Corporation	0.09	0.17	0.20	0.28	0.74

15. SUBSEQUENT EVENTS

As discussed in more detail above, the Imaging Minority has given us notice of exercise of the put option to sell to us all of the Imaging Minority's position in US Imaging granted to them under the Operating Agreement that was executed in connection with the Acquisition because the targeted US Imaging performance criteria has been met within the requisite period of time. Based on US Imaging’s 2016 financial performance, the Put Payment is to be for a value of $13.8 million if we deliver all cash or up to $14.6 million if we deliver a combination of cash and stock. We plan to deliver the Put Payment and obtain the Imaging Minority’s position in US Imaging on or about May 31, 2017.

Onward 2017



OFFICERS

Kevin S. Wilson, Chief Executive Officer and President
Jason A. Napolitano, Chief Operating Officer, Chief Strategist and Secretary
Michael J. McGinley, Ph.D., President, Biologicals and Pharmaceuticals
Nancy Wisnewski, Ph.D., Executive Vice President, Diagnostic Operations and Product Development
Steven M. Eyl, Executive Vice President, Global Sales and Marketing
Steven M. Asakowicz, Executive Vice President, Companion Animal Health Sales
Rodney A. Lippincott, Executive Vice President, Companion Animal Health Sales
John McMahon, Vice President, Chief Financial Officer
Gary W. Hampson, Vice President, Information Technology*
Laurie E. Peterson, Vice President, Heska Des Moines*
Daniel J. Pollack, Vice President, Imaging Operations*

BOARD OF DIRECTORS

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Bonnie J. Trowbridge, Retired Partner, PricewaterhouseCoopers LLP
Kevin S. Wilson, Chief Executive Officer and President, Heska Corporation
Carol A. Wrenn, Founder and former President, Sky River Helicopters, LLC

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