

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2005

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
(State or other jurisdiction of
incorporation or organization)

77-0192527
(I.R.S. Employer
Identification Number)

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

80538
(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, \$.001 par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes No

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 No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

The aggregate market value of voting common stock held by non-affiliates of the Registrant was approximately \$42,332,517 as of June 30, 2005 based upon the closing price on the Nasdaq Capital Market reported for such date. This calculation does not reflect a determination that certain persons are affiliates of the Registrant for any other purpose.

50,206,517 shares of the Registrant's Common Stock, \$.001 par value, were outstanding at March 29, 2006.

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i-STAT is a registered trademark of Abbott Laboratories. SPOTCHEM is a trademark of Arkray, Inc. TRI-HEART is a registered trademark of Schering-Plough Animal Health Corporation ("SPA") in the United States and is a trademark of Heska Corporation in other countries. HESKA, ALLERCEPT, AVERT, E.R.D.-HEALTHSCREEN, E-SCREEN, FELINE ULTRANASAL, SOLO STEP and VET/OX are registered trademarks and CBC-DIFF, ERD, G2 DIGITAL, THYROMED and VET/IV are trademarks of Heska Corporation in the United States and/or other countries. This 10-K also refers to trademarks and trade names of other organizations.

Statement Regarding Forward Looking Statements

This Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. For this purpose, any statements contained herein that are not statements of current or historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, words such as "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual results could differ materially from those expressed or forecasted in any such forward-looking statements as a result of certain factors, including those set forth in "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations," "Business" and elsewhere in this Form 10-K. Readers are cautioned not to place undue reliance on these forward-looking statements.

Although we believe that expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based. These forward-looking statements apply only as of the date of this Form 10-K or for statements incorporated by reference from the 2006 definitive proxy statement on Schedule 14A, as of the date of the Schedule 14A .

Internet Site

Our Internet address is www.heska.com. We make publicly available free of charge on our Internet website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. Information contained on our website is not a part of this annual report on Form 10-K.

Where You Can Find Additional Information

You may review a copy of this annual report on Form 10-K, including exhibits and any schedule filed therewith, and obtain copies of such materials at prescribed rates, at the Securities and Exchange Commission's Public Reference Room in Room 1580, 100 F Street, NE, Washington, D.C. 20549-0102. You may obtain information on the operation of the Public Reference Room by calling the Securities and Exchange Commission at 1-800-SEC-0330. The Securities and Exchange Commission maintains a website (<http://www.sec.gov>) that contains reports, proxy and information statements and other information regarding registrants, such as Heska, that file electronically with the Securities and Exchange Commission.

PART I

Item 1. Business.

We discover, develop, manufacture, market, sell, distribute and support veterinary products. Our core focus is on the canine and feline companion animal health markets. In the past, we have devoted substantial resources to the research and development of innovative products in these areas, where we strive to provide high value products for unmet needs and advance the state of veterinary medicine.

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Our business is comprised of two reportable segments, Core Companion Animal Health and Other Vaccines, Pharmaceuticals and Products. The Core Companion Animal Health segment ("CCA") includes diagnostic and monitoring instruments and supplies as well as single use diagnostic and other tests, vaccines and pharmaceuticals, primarily for canine and feline use. These products are sold directly by us as well as through independent third party distributors and other distribution relationships. The Other Vaccines, Pharmaceuticals and Products segment ("OVP"), previously reported as Diamond Animal Health, includes private label vaccine and pharmaceutical production, primarily for cattle but also for other animals including small mammals, horses and fish. All OVP products are sold by third parties under third party labels.

Our principal executive offices are located at 3760 Rocky Mountain Avenue, Loveland, Colorado 80538, our telephone number is (970) 493-7272 and our internet address is www.heska.com. We were incorporated in California in 1988, and we reincorporated in Delaware in 1997.

Background

We were incorporated as Paravax, Inc. in 1988 and conducted research on vaccines to prevent infections by parasites. In 1991, we moved our headquarters from California to northern Colorado in order to be located closer to the research facilities of the College of Veterinary Medicine and Biomedical Sciences of Colorado State University. In 1995, we changed our name to Heska Corporation. Between 1996 and 1998, we expanded our business, making several acquisitions. During 1999 and 2000, we restructured and refocused our business, making several divestitures.

We continued to pursue operating efficiencies and rationalize our business in 2001 and 2002. In late 2001, we modified our sales strategy to a distributor-focused model and entered into distribution agreements with over 20 third-party veterinary distributors. We eliminated several direct sales positions as a result. We also consolidated our European operations into one facility in the fourth quarter of 2001. In the first half of 2002, we eliminated several positions, primarily in research and development, to lower our expense base. In July 2002, we licensed to Intervet Inc. certain rights to patents, trademarks and know-how for our Flu AVERT I.N. equine influenza vaccine, the world's first intranasal influenza vaccine for horses. This was the result of a strategic decision to focus our resources on the canine and feline veterinary markets. In the years 2003 through 2005, we have continued to focus our efforts on operating improvements.

Core Companion Animal Health Segment

We presently sell a variety of companion animal health products and services, among the most significant of which are the following:

Veterinary Instruments

We offer a broad line of veterinary diagnostic, monitoring and other instruments which are described below. We also market and sell consumable supplies for these instruments.

Diagnostic Instruments. Our line of veterinary diagnostic instruments includes the following:

- *Electrolytes and Blood Gases:* The i-STAT Portable Clinical Analyzer is a handheld, portable clinical analyzer that provides quick, easy analysis of blood gases and other key analytes, such as sodium, potassium and glucose, in whole blood. We are supplied this instrument and affiliated cartridges and supplies under a contractual agreement with i-STAT Corporation (a unit of Abbott Laboratories).

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- *Blood Chemistry:* The SPOTCHEM EZ Automated Dry Chemistry System is a compact benchtop system used to measure common blood chemistry components that are vital to veterinary medical diagnosis. It provides veterinarians with an easy-to-use, flexible and economical in-clinic chemistry system. We are supplied this instrument and affiliated test strips under a contractual agreement with Arkray Global Business, Inc.
- *Hematology:* The HESKA CBC-DIFF Veterinary Hematology System is an easy-to-use blood analyzer that measures such key parameters as white blood cell count, red blood cell count, platelet count and hemoglobin levels in animals. We are supplied this instrument and affiliated reagents and supplies under a contractual agreement with Boule Medical AB.

Monitoring and Other Instruments. The use by veterinarians of the types of patient monitoring products that are taken for granted in human medicine is becoming the state of the art in companion animal health. Our line of veterinary monitoring instruments includes the following:

- The VET/OX G2 DIGITAL Monitor is a veterinary monitor with a “digital-at-the-source” sensor, providing a digital signal starting at the tip of the sensor where the signal is generated (pulse oximetry monitors typically use an analog sensor). It monitors heart rate, oxygen saturation, respiratory rate and body temperature in a portable, rugged, easy-to-use package.
- The VET/IV 2.2 infusion pump is a compact, affordable IV pump that allows veterinarians to easily provide regulated infusion of fluids, drugs or nutritional products for their patients.

Point-of-Care Diagnostic and Other Tests

Heartworm Diagnostic Products. Heartworm infections of dogs and cats are caused by the parasite *Dirofilaria immitis*. This parasitic worm is transmitted in larval form to dogs and cats through the bite of an infected mosquito. Larvae develop into adult worms that live in the pulmonary arteries and heart of the host, where they can cause serious cardiovascular, pulmonary, liver and kidney disease. Our canine and feline heartworm diagnostic tests use monoclonal antibodies or a recombinant heartworm antigen, respectively, to detect heartworm antigens or antibodies circulating in the blood of an infected animal.

We currently market and sell heartworm diagnostic tests for both dogs and cats. SOLO STEP CH for dogs and SOLO STEP FH for cats are available in point-of-care, single use formats that can be used by veterinarians on site. We also offer SOLO STEP CH Batch Test Strips, a rapid and simple point-of-care antigen detection test for dogs that allows veterinarians in larger practices to run multiple samples at the same time. We obtain SOLO STEP CH, SOLO STEP FH and SOLO STEP Batch Test Strips under a contractual agreement with Quidel Corporation (“Quidel”).

Early Renal Damage Detection Products. Renal damage is a leading cause of death in both dogs and cats. Several inflammatory, infectious or neoplastic diseases can damage an animal’s kidneys. It is estimated that 70% to 80% of kidney function is already destroyed before veterinarians can detect renal damage using traditional tests. Early detection is key to eliminate the causes and to mitigate the effects of kidney damage. Identification and treatment of the underlying cause of kidney damage can slow the progression of disease and add quality years to an animal’s life.

Our E.R.D.-HEALTHSCREEN Canine Urine Test and our E.R.D.-HEALTHSCREEN Feline Urine Test are rapid in-clinic immunoassay tests designed to detect microalbuminuria, the most sensitive indicator of renal damage.

Veterinary Diagnostic Laboratory Services and Products

Allergy Diagnostic Services. Allergy is common in companion animals, and it is estimated to affect approximately 10% to 15% of dogs. Clinical symptoms of allergy are variable, but are often manifested as persistent and serious skin disease in dogs and cats. Clinical management of allergic disease is problematic, as there are a large number of allergens that may give rise to these conditions. Although skin testing is often regarded as the most accurate diagnostic procedure, such tests can be painful, subjective and inconvenient. The effectiveness of the immunotherapy that is prescribed to treat allergic disease is inherently limited by inaccuracies in the diagnostic process.

We have veterinary diagnostic laboratories in Loveland, Colorado and Fribourg, Switzerland. Both diagnostic laboratories offer blood testing using our ALLERCEPT Definitive Allergen Panels, which provide the most accurate determination of the specific allergens to which an animal, such as a dog, cat or horse, is reacting. The panels use a highly specific recombinant version of the natural IgE receptor to test the serum of potentially allergic animals for IgE directed against a panel of known allergens. A typical test panel consists primarily of various pollen, grass, mold, insect and mite allergens. The test results serve as the basis for prescription ALLERCEPT Allergy Treatment Sets, discussed later in this document. In our Fribourg diagnostic laboratory we also offer blood testing using our ALLERCEPT E-SCREEN Test, which detects the presence of allergen-specific IgE. Animals testing positive for allergen-specific IgE are candidates for further evaluation using our ALLERCEPT Definitive Allergen Panels.

Other Products and Services. In 2005, we introduced and sold ERD Reagent Packs used to detect microalbuminuria, the most sensitive indicator of renal damage, to Antech Diagnostics, the laboratory division of VCA Antech, Inc., for use in its veterinary diagnostic laboratories. In Europe, we sell kits to conduct blood testing using our ALLERCEPT Definitive Allergen Panels and our ALLERCEPT E-SCREEN Test to third-party veterinary diagnostic laboratories.

Our Loveland veterinary diagnostic laboratory currently also offers testing using our canine and feline heartworm, renal damage, immune status and flea bite allergy assays as well as other diagnostic services including polymerase chain reaction, or PCR, based tests for certain infectious diseases. Our Loveland diagnostic laboratory is currently staffed by medical technologists experienced in animal disease and several additional technical staff.

We intend to continue to use our Loveland veterinary diagnostic laboratory both as a stand-alone service center for our customers and as an adjunct to our product development efforts. Many of the assays which we intend to develop in a point-of-care format are initially validated and made available in the veterinary diagnostic laboratory. The assay will remain available there following the introduction of the analogous point-of-care test.

Vaccines and other Biologicals

Allergy Treatment. Veterinarians who use our ALLERCEPT Definitive Allergen Panels often purchase ALLERCEPT Allergy Treatment Sets for those animals with positive test results. These prescription immunotherapy treatment sets are formulated specifically for each allergic animal and contain only the allergens to which the animal has significant levels of IgE antibodies. The prescription formulations are administered in a series of injections, with doses increasing over several months, to ameliorate the allergic condition of the animal. Immunotherapy is generally continued for an extended time. We offer both canine and feline immunotherapy treatment products.

Feline Respiratory Disease. The use of injectable vaccines in cats has become controversial due to the frequency of injection site-associated side effects. The most serious of these side effects are injection site

sarcomas, tumors which, if untreated, are nearly always fatal. While there is one competitive non-injectable two-way vaccine, all other competitive products are injectable formulations.

We sell the FELINE ULTRANASAL FVRCP Vaccine, a three-way modified live vaccine combination to prevent disease caused by the three most common respiratory viruses of cats: calicivirus, rhinotracheitis virus and panleukopenia virus. Our two-way modified live vaccine combination, FELINE ULTRANASAL FVRC, prevents disease caused by calicivirus and rhinotracheitis. These vaccines are administered without needle injection by dropping the liquid preparation into the nostrils of cats. Our vaccines avoid injection site side effects, and we believe they are very efficacious.

Pharmaceuticals and Supplements

Heartworm Prevention. We have an agreement with Schering-Plough Animal Health Corporation (“SPAH”), the worldwide animal health care business of Schering-Plough Corporation, granting SPAH the distribution and marketing rights in the United States for TRI-HEART Plus Chewable Tablets, our canine heartworm prevention product. TRI-HEART Plus Chewable Tablets (ivermectin/pyrantel) are indicated for use as a monthly preventive treatment of canine heartworm infection and for treatment and control of ascarid and hookworm infections. We manufacture TRI-HEART Plus Chewable Tablets at our Des Moines, Iowa production facility. We sell our canine heartworm prevention product in South Korea through an independent third-party distributor.

Nutritional Supplements. We sell a novel fatty acid supplement, HESKA F.A. Granules. The source of the fatty acids in this product, flaxseed oil, leads to high omega-3:omega-6 ratios of fatty acids. Diets high in omega-3 fatty acids are believed to lead to lower levels of inflammatory mediators. The HESKA F.A. Granules include vitamins and are formulated in a palatable flavor base that makes the product convenient and easy to administer.

Hypothyroid Treatment. We sell a chewable thyroid supplement, THYROMED Chewable Tablets, for treatment of hypothyroidism in dogs. Hypothyroidism is one of the most common endocrine disorders diagnosed in older dogs, treatment of which requires a daily hormone supplement for the lifetime of the animal. THYROMED Chewable Tablets contain the active ingredient *Levothyroxine Sodium*, which is a clinically proven replacement for the naturally occurring hormone secreted by the thyroid gland. The chewable formulation makes this daily supplement convenient and easy to administer.

Other Vaccines, Pharmaceuticals and Products Segment

We have developed our own line of bovine vaccines that are licensed by the United States Department of Agriculture (“USDA”). We have a long-term agreement with a distributor, Agri Laboratories, Ltd., (“AgriLabs”), for the marketing and sale of certain of these vaccines which are sold primarily under the Titanium® and MasterGuard® brands – registered trademarks of AgriLabs. AgriLabs has rights to sell these bovine vaccines in the United States, Africa, China, Mexico and Taiwan to December 2013. Subject to minimum purchase requirements, AgriLabs’ rights in these regions will be exclusive at least to December 2009 and could remain exclusive up to December 2013 based on other contractual arrangements. We have the right to sell these bovine vaccines to any party of our choosing in other regions of the world. AgriLabs has non-exclusive rights to these vaccines in Canada to December 2009. We also manufacture other bovine products not covered under the agreement with AgriLabs.

We manufacture biological and pharmaceutical products for a number of other animal health companies. We manufacture products for animals including small mammals, horses and fish. Our offerings range from providing complete turnkey services which include research, licensing, production, labeling and

packaging of products to providing any one of these services as needed by our customers as well as validation support and distribution services.

In July 2002, we made a strategic decision to focus on the canine and feline animal health markets. At that time, we licensed certain of our Flu AVERT I.N. vaccine rights to Intervet Inc., a unit of Akzo Nobel. We currently manufacture this product for Intervet Inc., although Intervet Inc. is free to manufacture the product itself. Intervet Inc. has global distribution rights to this product.

Marketing, Sales, Distribution and Customer Support

We estimate that there are approximately 40,000 veterinarians in the United States whose practices are devoted principally to small animal medicine. Those veterinarians practice in approximately 20,000 clinics in the United States. In 2005, our products were sold to approximately 13,500 such clinics in the United States. All our Core Companion Animal Health Products are ultimately sold to or through veterinarians. In many cases, veterinarians will markup their costs to the end user. The acceptance of our products by veterinarians is critical to our success.

We currently market our Core Companion Animal Health products in the United States to veterinarians through a direct sales force, a telephone sales force, independent third-party distributors, as well as through trade shows and print advertising and SPAH in the case of our heartworm preventive. Our direct sales force currently consists of 28 territory managers and 4 regional managers responsible for sales in various parts of the United States. Our inside sales force consists of 20 persons.

Our independent third-party distributors in the U.S. purchase and market our Core Companion Animal Health products utilizing their direct sales forces. We currently have agreements with 24 regional distributors with approximately 700 representatives. We believe that one of our largest competitors, IDEXX Laboratories, Inc. (“IDEXX”), effectively prohibits its distributors from selling competitive products, including our diagnostic instruments and heartworm diagnostic tests. As a result, 10 of these 24 regional distributors with approximately 225 representatives carry our full product line. We believe the IDEXX restrictions limit our ability to engage national distributors to sell our full line of products and significantly restrict our ability to market our products to veterinarians. To be successful, we will need to continue to attract and retain sufficient independent distributors and train the sales personnel of our distributors about our products.

We have a full staff dedicated to customer and product support in our Core Companion Animal Health segment including veterinarians, technical support specialists and service technicians. Individuals from our research and development group may also be used as a resource in responding to certain product inquiries.

Internationally, we market our products to veterinarians primarily through corporate agreements and independent third-party distributors. For example, Novartis Agro K.K. (Novartis Animal Health K.K. Tokyo) exclusively markets and distributes SOLO STEP CH in Japan.

All OVP products are marketed and sold by third parties under third party labels. AgriLabs currently has exclusive sales and marketing rights to certain of our bovine vaccines, which are sold primarily under the Titanium® and MasterGuard® labels, in the United States and certain international regions.

We grant third parties rights to certain of our existing products as well as to our intellectual property, with our compensation often taking the form of royalties and/or milestone payments. For example, we have an agreement with Nestlé Purina PetCare Company (“Purina”), a unit of Nestlé S.A., under which Purina pays royalties on certain pet food products it markets based on our patent-protected science.

Manufacturing

The majority of our product revenue is from products manufactured by third parties. Third parties manufacture our veterinary diagnostic and patient monitoring instruments, including our various instruments and affiliated consumable supplies, as well as other products including our allergy treatment products and our E.R.D.-HEALTHSCREEN Urine Tests. Our handheld analyzers and affiliated supplies are supplied under a contractual agreement with i-STAT Corporation (a unit of Abbott Laboratories), our chemistry analyzers and affiliated supplies are supplied under a contractual agreement with Arkray Global Business, Inc., our hematology analyzers and affiliated supplies are supplied under a contractual agreement with Boule Medical AB, and our digital monitor and affiliated supplies are supplied under a contractual agreement with Dolphin Medical Inc. (a majority-owned subsidiary of OSI Systems, Inc.). ALK-Abelló, Inc. and Greer Laboratories, Inc. manufacture our immunotherapy treatment products. Diagnostic Chemicals Limited manufactures our E.R.D.-HEALTHSCREEN Urine Tests and our ERD Reagent Packs used to detect microalbuminuria in veterinary diagnostic laboratories. Quidel and we, at our Des Moines facility, manufacture our heartworm point-of-care diagnostic tests.

Our facility in Des Moines, Iowa is a USDA, Food and Drug Administration (“FDA”), and Drug Enforcement Agency (“DEA”) licensed biological and pharmaceutical manufacturing facility. This facility currently has the capacity to manufacture more than 50 million doses of vaccine each year. We expect that we will manufacture most or all of our biological and pharmaceutical products at this facility, as well as most or all of our recombinant proteins and other proprietary reagents for our diagnostic tests. We currently manufacture our canine heartworm prevention product, our FELINE ULTRANASAL Vaccines and all our OVP segment products at this facility. Our OVP segment’s customers purchase products in both bulk and finished format, and we perform all phases of manufacturing, including growth of the active bacterial and viral agents, sterile filling, lyophilization and packaging at this facility. We manufacture our various allergy diagnostic products at our Des Moines facility, our Loveland facility and our Fribourg facility. We believe the raw materials for products we manufacture are available from several sources.

Product Development

We are committed to providing innovative products to address significant unmet health needs of companion animals. We may obtain such products from external sources, external collaboration or internal research and development.

We are committed to identifying external product opportunities and creating business and technical collaborations that lead to high value veterinary products. We believe that our active participation in scientific networks and our reputation for investing in research enhances our ability to acquire external product opportunities. We have collaborated, and intend to continue to do so, with a number of companies and universities. Examples of such collaborations include:

- Quidel for the development of SOLO STEP CH Cassettes, SOLO STEP CH Batch Test Strips and SOLO STEP FH Cassettes;
- Diagnostic Chemicals, Ltd., for the development of the canine and feline E.R.D.-HEALTHSCREEN Urine Tests and ERD Reagent Packs to detect microalbuminuria;
- Boule Medical AB for the development of veterinary applications for the HESKA CBC-DIFF Hematology System and associated reagents.

Internal research is managed by multidisciplinary product-associated project teams that consist of microbiologists, immunologists, geneticists, biochemists, molecular biologists, parasitologists and

veterinarians, as appropriate. We have historically been an R&D-focused company and currently employ approximately 37 scientists, of whom approximately 35% hold doctoral degrees. We incurred expenses of \$6.1 million, \$5.9 million and \$3.7 million in the years ended December 31, 2003, 2004 and 2005, respectively, in support of our research and development activities.

Intellectual Property

We believe that patents, trademarks, copyrights and other proprietary rights are important to our business. We also rely upon trade secrets, know-how, continuing technological innovations and licensing opportunities to develop and maintain our competitive position. The proprietary technologies of our OVP segment and Heska AG, our operating subsidiary in Switzerland, are primarily protected through trade secret protection of, for example, our manufacturing processes in these areas.

We actively seek patent protection both in the United States and abroad. Our issued and pending patent portfolios primarily relate to allergy, flea control, heartworm control, infectious disease vaccines, diagnostic and detection tests, immunomodulators, instrumentation, nutrition, pain control and vaccine delivery technologies. As of December 31, 2005, we owned, co-owned or had rights to 204 issued U.S. patents and 67 pending U.S. patent applications expiring at various dates from June 2008 to February 2022. Applications corresponding to pending U.S. applications have been or will be filed in other countries. Our foreign patent portfolio as of December 31, 2005 included 202 issued patents and 147 pending applications in various foreign countries.

We have entered into a number of out licensing agreements to realize additional value in certain of our intellectual property assets in fields outside of our core focus. For example, in 1998 we obtained rights from ImmuLogic Pharmaceutical Corporation to an intellectual property portfolio including a number of major allergens and the genes that encode them for use in veterinary as well as human allergy applications. In order to realize additional value from that portfolio, we have granted licenses and options for licenses to several companies, including ALK-Abello A/S, Circassia, Ltd., Indoor Biotechnologies, Ltd., Meiji Milk Products Company, Ltd. and Phadia AB (formerly Pharmacia Diagnostics AB), for the use of those allergens in the fields of diagnosis and treatment of human allergy.

We also have obtained exclusive and non-exclusive licenses for numerous other patents held by academic institutions and biotechnology and pharmaceutical companies.

Seasonality

Certain portions of our business are subject to seasonality. For example, in our CCA segment, sales of our veterinary instruments historically have tended to be highest in the fourth quarter. We expect to experience less seasonality than we have in the past due to factors including increased instrument consumable revenue, which does not tend to be seasonal, and changes in the timing of certain product promotions. We expect the last six months of the year will outperform the first half of the year, both in terms of revenue and profitability.

Government Regulation

Although the majority of our product revenue is from the sale of unregulated items, many of our products or products that we may develop are, or may be, subject to extensive regulation by governmental authorities in the United States, including the USDA and the FDA, and by similar agencies in other countries. 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 to achieve and the time needed to satisfy them may vary substantially,

based on the type, complexity and novelty of the product. Any product that we develop must receive all relevant regulatory approval or clearances, if required, before it may be marketed in a particular country. The following summarizes the U.S. government agencies that regulate animal health products:

- *USDA.* Vaccines and certain single use, point-of-care diagnostics are considered veterinary biologics and are therefore regulated by the Center for Veterinary Biologics, or CVB, of the USDA. Industry data indicate that it takes approximately four years and \$1.0 million to license a conventional vaccine for animals from basic research through licensing. In contrast to vaccines, single use, point-of-care diagnostics can typically be licensed by the USDA in about two years, at considerably less cost. However, vaccines or diagnostics that use innovative materials, such as those resulting from recombinant DNA technology, usually require additional time to license. The USDA licensing process involves the submission of several data packages. These packages include information on how the product will be manufactured, information on the efficacy and safety of the product in laboratory and target animal studies and information on performance of the product in field conditions.
- *FDA.* Pharmaceutical products, which generally include synthetic compounds, are approved and monitored by the Center for Veterinary Medicine of the FDA. Industry data indicate that developing a new drug for animals requires approximately 11 years from commencement of research to market introduction and costs approximately \$5.5 million. Of this time, approximately three years is spent in animal studies and the regulatory review process. However, unlike human drugs, neither preclinical studies nor a sequential phase system of studies are required. Rather, for animal drugs, studies for safety and efficacy may be conducted immediately in the species for which the drug is intended. Thus, there is no required phased evaluation of drug performance, and the Center for Veterinary Medicine will review data at appropriate times in the drug development process. In addition, the time and cost for developing companion animal drugs may be significantly less than for drugs for livestock animals, as food safety issues relating to tissue residue levels are not applicable.
- *EPA.* Products that are applied topically to animals or to premises to control external parasites are regulated by the Environmental Protection Agency, or EPA.

After we have received regulatory licensing or approval for our products, numerous regulatory requirements typically apply. Among the conditions for certain regulatory approvals is the requirement that our manufacturing facilities or those of our third-party manufacturers conform to current Good Manufacturing Practices or 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.

A number of our animal health products are not regulated. For example, certain products such as our E.R.D.-HEALTHSCREEN Urine Tests and our ALLERCEPT panels, as well as other reference lab tests, are not regulated by either the USDA or FDA. Similarly, none of our veterinary diagnostic instruments or patient monitoring instruments require regulatory approval to be marketed and sold. Additionally, various botanically derived products, various nutritional products and supportive care products are exempt from significant regulation as long as they do not bear a therapeutic claim that represents the product as a drug.

We have pursued regulatory approval outside the United States based on market demographics of foreign countries. For marketing outside the United States, we are subject to foreign regulatory requirements governing regulatory licensing and approval for many of our products. Licensing and approval by comparable regulatory authorities of foreign countries must be obtained before we can market products in those countries. Product licensing approval processes and requirements vary from country to country and the

time required for such approvals may differ substantially from that required in the United States. We cannot be certain that approval of any of our products in one country will result in approvals in any other country. To date, we or our distributors have sought regulatory approval for certain of our products in

Canada, which is governed by the Canadian Food Inspection Agency, or CFIA, in Japan, which is governed by the Japanese Ministry of Agriculture, Forestry and Fisheries, or MAFF, and in certain European and other Asian countries requiring such approval.

The status of regulatory approval for our major products and products in development both in the United States and elsewhere is summarized below.

Products	Country	Regulated	Agency	Status
Veterinary Medical Instrumentation	United States	No		
	EU	No		
ALLERCEPT Definitive Allergen Panels	United States	No		
	EU	No		
E.R.D.-HEALTHSCREEN Canine Urine Test	United States	No		
	EU	No-in most countries		
	Canada	No		
	Japan	Yes	MAFF	Pending
E.R.D.-HEALTHSCREEN Feline Urine Test	United States	No		
	EU	No-in most countries		
	Canada	No		
	Japan	Yes	MAFF	Pending
FELINE ULTRANASAL FVRC Vaccine	United States	Yes	USDA	Licensed
FELINE ULTRANASAL FVRCP Vaccine	United States	Yes	USDA	Licensed
HESKA F.A. Granules	United States	No		
SOLO STEP CH	United States	Yes	USDA	Licensed
	EU	No-in most countries		
	Canada	Yes	CFIA	Licensed
	Japan	Yes	MAFF	Licensed
SOLO STEP CH Batch Test Strips	United States	Yes	USDA	Licensed
	Canada	Yes	CFIA	Licensed
SOLO STEP FH	United States	Yes	USDA	Licensed
TRI-HEART Plus Heartworm Preventive	United States	Yes	FDA	Approved
	Korea	Yes	NVRQS	Approved

Competition

The market in which we compete is intensely competitive. Our competitors include independent animal health companies and major pharmaceutical companies that have animal health divisions. We also compete with independent, third party distributors, including distributors who sell products under their own private labels. In the point-of-care diagnostic testing market, our major competitors include IDEXX, Abaxis, Inc., AGEN Biomedical Limited and Synbiotics Corporation. The products manufactured by our OVP segment for sale by third parties compete with similar products offered by a number of other companies, some of which have substantially greater financial, technical, research and other resources than us and may have more established marketing, sales, distribution and service organizations than our OVP segment's customers. Companies with a significant presence in the animal health market such as Bayer AG, Intervet International bv (a unit of Akzo Nobel), Merial Limited, Novartis AG, Pfizer Inc., Schering-Plough Corporation, Virbac S.A. and Wyeth (formerly American Home Products) may be marketing or developing products that compete with our products or would compete with them if successfully developed. These and other competitors may have substantially greater financial, technical, research and other resources and larger, more established marketing, sales, distribution and service organizations than we do. Our competitors may offer broader product lines and have

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greater name recognition than we do. We believe that one of our largest competitors, IDEXX, effectively prohibits its distributors from selling competitive products, including our diagnostic instruments and heartworm diagnostic tests.

Environmental Regulation

In connection with our product development activities and manufacturing of our biological, pharmaceutical and diagnostic and detection products, we are subject to federal, state and local laws, rules, regulations and policies governing the use, generation, manufacture, storage, handling and disposal of certain materials, biological specimens and wastes. Although we believe that we have complied with these laws, regulations and policies in all material respects and have not been required to take any significant action to correct any noncompliance, we may be required to incur significant costs to comply with environmental and health and safety regulations in the future. Although we believe that our safety procedures for handling and disposing of such materials comply with the standards prescribed by state and federal regulations, the risk of accidental contamination or injury from these materials cannot be eliminated. In the event of such an accident, we could be held liable for any damages that result and any such liability could exceed our resources.

Employees

As of December 31, 2005, we and our subsidiaries employed 286 people, of whom 103 were in sales, marketing, distribution and customer support, 91 were in manufacturing, materials management and veterinary diagnostics laboratories, 55 were in management and administration and 37 were in research, development, and regulatory affairs. We believe that our ability to attract and retain skilled personnel is critical to our success. None of our employees is covered by a collective bargaining agreement, and we believe our employee relations are good.

Executive Officers of the Registrant

Our executive officers and their ages as of March 29, 2006 are as follows:

Name	Age	Position
Robert B. Grieve, Ph.D.	54	Chairman of the Board and Chief Executive Officer
Jason A. Napolitano	37	Executive Vice President, Chief Financial Officer and Secretary
Joseph H. Ritter, D.V.M.	57	Executive Vice President, Global Business Operations

Carol Talkington Verser, Ph.D.	53	Executive Vice President, Intellectual Property and Business Development
Michael A. Bent	51	Vice President, Principal Accounting Officer and Controller

Robert B. Grieve, Ph.D., one of our founders, currently serves as Chief Executive Officer and Chairman of the Board. Dr. Grieve was named Chief Executive Officer effective January 1, 1999, Vice Chairman effective March 1992 and Chairman of the Board effective May 2000. Dr. Grieve also served as Chief Scientific Officer from December 1994 to January 1999 and Vice President, Research and Development, from March 1992 to December 1994. He has been a member of our Board of Directors since 1990. He holds a Ph.D. degree from the University of Florida and M.S. and B.S. degrees from the University of Wyoming.

Jason A. Napolitano was appointed Executive Vice President, Chief Financial Officer and Secretary in May 2002. Prior to joining us formally, he was a financial consultant. From 1990 to 2001, Mr. Napolitano

held various positions at Credit Suisse First Boston, an investment bank, including Vice President in health care investment banking and Director in mergers and acquisitions. He holds a B.S. degree from Yale University.

Joseph H. Ritter, D.V.M. was appointed Executive Vice President, Global Business Operations in February 2006. Since February 2004, he was Vice President, Marketing and International Business. Also during part of 2004 Dr. Ritter was responsible for our sales force. From October 2002 until February 2004, he was Heska's Vice President of International Business. From 1995 until 2002 he was President and owner of Veterinary Specialties, Inc., a veterinary products distribution company. From 1984 to 1995, Dr. Ritter held various senior positions at Mallinckrodt Veterinary, Inc. including Group Vice President, America and Asia. He holds a Doctorate of Veterinary Medicine from the University of Illinois and a M.B.A. with an emphasis on international finance from the American Graduate School of International Management

Carol Talkington Verser, Ph.D., was appointed Executive Vice President, Intellectual Property and Business Development in February 2001. From June 2000 until January 2001 she was Vice President, Intellectual Property and Business Development. From July 1996 to May 2000, she served us as Vice President, Intellectual Property. From July 1995 to June 1996, Dr. Verser served us as Director, Intellectual Property. From July 1991 to June 1995, Dr. Verser was a Patent Agent and Technical Specialist at Sheridan, Ross and McIntosh, an intellectual property law firm. Dr. Verser holds a Ph.D. in cellular and developmental biology from Harvard University and a B.S. in biological sciences from the University of Southern California.

Michael A. Bent was appointed Vice President, Principal Accounting Officer and Controller in May 2002. From September 1999 until April 2002, he was Corporate Controller. From November 1993 until September 1999, Mr. Bent was Director, Accounting Operations at Coors Brewing Company. Mr. Bent holds a B.S. in accounting from the University of Wyoming. Mr. Bent is a CPA in Colorado and Wyoming.

Item 1A. Risk Factors

Our future operating results may vary substantially from period to period due to a number of factors, many of which are beyond our control. The following discussion highlights 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 may be unable to successfully market, sell and distribute our 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, sales and distribution strategy is unsuccessful, our ability to sell our products will be negatively impacted and our revenues will decrease.

The market for companion animal healthcare products is highly fragmented. Because our Core Companion Animal Health proprietary products are generally available only to veterinarians or by prescription and our medical instruments require technical training to operate, we ultimately sell our Core Companion Animal Health products only to or through veterinarians. The acceptance of our products by veterinarians is critical to our success. Changes in our ability to obtain or maintain such acceptance or changes in veterinary medical practice could significantly decrease our anticipated sales.

We currently market our Core Companion Animal Health products in the United States to veterinarians through approximately 10 independent third-party distributors who carry our full line of Core Companion Animal Health products, approximately 14 independent third-party distributors who carry

portions of our Core Companion Animal Health product line and through a direct sales force of approximately 28 individuals. To be successful, we will have to effectively market our products and 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 that IDEXX, one of our largest competitors, effectively prohibits its distributors from selling competitive products, including our diagnostic instruments and heartworm diagnostic tests. We believe this restriction significantly limits our ability to engage national distributors to sell our full line of products and significantly restricts our ability to market our products to veterinarians. In 2002, one of our largest distributors informed us that they were going to carry IDEXX products and that they no longer would carry our diagnostic instruments and heartworm diagnostic tests. In late 2004, this distributor acquired another of our distributors. We believe IDEXX effectively prohibits this distributor from carrying our diagnostic instruments and heartworm diagnostic tests as a condition for having access to buy the IDEXX product line.

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

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

business.

We currently rely on third party suppliers to manufacture those products we do not manufacture ourselves. Products provided by these suppliers represent a majority of our revenues. We currently rely on these suppliers for our veterinary diagnostic and patient monitoring instruments and consumable supplies for these instruments, for certain of our point-of-care diagnostic and other tests, for the manufacture of our allergy immunotherapy treatment products as well as for the manufacture of other products. Major suppliers who sell us products they manufacture which are responsible for more than 5% or more of our revenue are i-STAT Corporation (a unit of Abbott Laboratories), Arkray Global Business, Inc., Boule Medical AB and Quidel. We often purchase products from our suppliers under agreements that are of limited duration or potentially can be terminated on an annual basis. Although we believe we have agreements in place to ensure supply of our major product offerings through at least the end of 2006 and we believe we are in compliance with such agreements, there can be no assurance that our suppliers will be able to meet their obligations under these agreements or that we will be able to compel them to do so. Risks of relying on suppliers include:

- *The loss of product rights upon expiration or termination of an existing agreement.* Unless we are able to find an alternate supply of a similar product, we would not be able to continue to offer our customers the same breadth of products and our sales and operating results would likely suffer. In the case of an instrument supplier, we could also potentially suffer the loss of sales of consumable supplies, which would be significant in cases where we have built a significant installed base, further harming our sales prospects and opportunities. Even if we were able to find an alternate supply, we would likely face increased competition from the product whose rights we lost being marketed by a third party or the former supplier and it may take us additional time and expense to gain the necessary approvals and launch an alternative product.
- *High switching costs.* In certain of our medical products we would lose the consumable revenues from the installed base of those instruments if we were to switch to a competitive instrument. If we need to change to other commercial manufacturing contractors for certain of our regulated products, additional regulatory licenses or approvals must be obtained for these contractors prior to our use. This would require new testing and compliance inspections prior to sale thus resulting in potential delays. Any new manufacturer would have to be educated in, or develop substantially equivalent processes necessary for the production of our products. We likely would

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have to train our salesforce, distribution network employees and customer support organization on the new product and spend significant funds marketing the new product to our customer base.

- *The involuntary or voluntary discontinuation of a product line.* Unless we are able to find an alternate supply of a similar product in this or similar circumstances with any product, we would not be able to continue to offer our customers the same breadth of products and our sales would likely suffer. Even if we are able to identify an alternate supply, it may take us additional time and expense to gain the necessary approvals and launch an alternative product, especially if the product is discontinued unexpectedly.
- *Inability to meet minimum obligations.* Current agreements, or agreements we may negotiate in the future, may commit us to certain minimum purchase or other spending obligations. It is possible we will not be able to create the market demand to meet such obligations, which could create a drain on our financial resources and liquidity. Some such agreements may require minimum purchases and/or sales to maintain product rights and we may be significantly harmed if we are unable to meet such requirements and lose product rights.
- *Loss of exclusivity.* Current agreements, or agreements we may negotiate in the future, with suppliers may require us to meet minimum annual sales levels to maintain our position as the exclusive distributor of these products. We may not meet these minimum sales levels 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.
- *Limited capacity or ability to scale capacity.* If market demand for our products increases suddenly, our current suppliers might not be able to fulfill our commercial needs, which would require us to seek new manufacturing arrangements and may result in substantial delays in meeting market demand. If we consistently generate more demand for a product than a given supplier is capable of handling, it could lead to large backorders and potentially lost sales to competitive products that are readily available. This could require us to seek or fund new sources of supply, which may be difficult to find unless it is under terms that are less advantageous.
- *Inconsistent or inadequate quality control.* We may not be able to control or adequately monitor the quality of products we receive from our suppliers. Poor quality items could damage our reputation with our customers.
- *Regulatory risk.* Our manufacturing facility and those of some of our third party suppliers are subject to ongoing periodic unannounced inspection by regulatory authorities, including the FDA, USDA and other federal and state agencies for compliance with strictly enforced Good Manufacturing Practices, regulations and similar foreign standards, and we do not have control over our suppliers' compliance with these regulations and standards. Violations could potentially lead to interruptions in supply that could cause us to lose sales to readily available competitive products.
- *Developmental delays.* We may experience delays in the scale-up quantities needed for product development that could delay regulatory submissions and commercialization of our products in development, causing us to miss key opportunities.
- *Limited intellectual property rights.* We may not have intellectual property rights, or may have to share intellectual property rights, to the products themselves and any improvements to the manufacturing processes or new manufacturing processes for our products.

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

substantially harm our business.

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

Our agreements with our corporate marketing partners generally contain no or small minimum purchase requirements in order for them to maintain their exclusive or co-exclusive marketing rights. We are party to an agreement with SPAH which grants distribution and marketing rights in the U.S. for our canine heartworm preventive product, TRI-HEART Chewable Tablets. AgriLabs has the exclusive right to sell certain of our bovine vaccines in the United States, Africa, China, Mexico and Taiwan. Novartis Agro K.K. markets and distributes our SOLO STEP CH heartworm test in Japan. One or more of these marketing partners may not devote sufficient resources to marketing our products. Furthermore, there may be nothing to prevent these partners from pursuing alternative technologies or products that may compete with our products in current or future agreements. In the future, third-party marketing assistance may not be available on reasonable terms, if at all. If any of these events occur, we may not be able to commercialize our products and our sales will decline. In addition, both our agreements with SPAH and AgriLabs require us to potentially pay penalties if we are unable to supply product over an extended period of time.

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

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

- supply of products from third party suppliers or termination of such relationships;
- the introduction of new products by our competitors or by us;
- competition and pricing pressures from competitive products;
- our ability to maintain relationships with distributors;
- large customers failing to purchase at historical levels, including changes in distributor purchasing patterns and inventory levels;
- fundamental shifts in market demand;
- manufacturing delays;
- shipment problems;
- regulatory and other delays in product development;
- product recalls or other issues which may raise our costs;
- changes in our reputation and/or market acceptance of our current or new products; and
- changes in the mix of products sold.

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

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

If our actual performance deviates from our operating plan, which anticipates we will be profitable in fiscal 2006 as a whole, we may be required to raise additional capital in the future. If necessary, we expect to raise these additional funds through one or more of the following: (1) sale of equity or debt securities; (2) obtaining new loans secured by unencumbered assets, or refinancing loans currently outstanding on properties with historical appraised values significantly in excess of related debt; (3) sale of assets, products or marketing rights; and (4) licensing of technology. There is no guarantee that additional capital will be available from these sources on acceptable terms, if at all, and certain of these sources may require approval by existing lenders. The public markets may be unreceptive to equity financings and we may not be able to obtain additional private equity or debt financing. Any equity financing would likely be dilutive to stockholders and additional debt financing, if available, may include restrictive covenants and increased interest rates that would limit our currently planned operations and strategies. We may not find any third parties interested in licensing our intellectual property or purchasing any of our assets, products or marketing rights in a timely manner, or at all. If we relinquish rights to certain of our intellectual property, or sell certain of our assets, products or marketing rights it may limit our future prospects. Additionally, amounts we expect to be available under our existing revolving line of credit may not be available and other lenders could refuse to provide us with additional debt financing. Furthermore, even if additional capital is available, it may not be of the magnitude required to meet our needs under these or other scenarios. If additional funds are required and are not available, it would likely have a material adverse effect on our business, financial condition and our ability to continue as a going concern.

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

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") has increased our required administrative actions as a public company. The increase in general and administrative costs of complying with Sarbanes-Oxley will depend on how it is interpreted over time. Of particular concern are the level and timing of standards for internal control evaluation and reporting adopted under Section 404 of Sarbanes-Oxley. If our regulators and/or auditors adopt or interpret more stringent standards than we are anticipating, we and/or our auditors may be unable to conclude that our internal controls over financial reporting are designed and operating effectively, which could adversely affect investor confidence in our financial statements. Even if we and our auditors are able to conclude that our internal controls over financial reporting are designed and operating effectively in such a circumstance, our general and administrative costs are likely to increase. We may be required to obtain an audit of our internal controls for the year ending December 31, 2006 if we are an accelerated filer as defined by Rule 12b-2 of the Securities Exchange Act of 1934, as amended, on June 30, 2006, and, if so, our general and administrative costs are likely to increase in 2006. Actions by other entities, such as enhanced rules to maintain our listing on the Nasdaq Capital Market, could also increase our general and administrative costs, as could further legislative action.

We may not be able to achieve sustained profitability.

Prior to 2005, we have incurred net losses on an annual basis since our inception in 1988 and, as of December 31, 2005, we had an accumulated deficit of \$209.8 million. Notwithstanding our positive net income in 2005 and our expectation of profitability for 2006 as a whole, we have not consistently achieved profitability on an annual basis. Our ability to be profitable in future periods will depend, in part, on our ability to increase sales in our Core Companion Animal Health segment, including maintaining and growing our installed base of instruments and related consumables, to maintain or increase gross margins and to at least limit the increase in our operating expenses to a reasonable level. 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 for an extended period, we may not be able to fund our expected cash needs, including the repayment of debt as it comes due, or continue our operations.

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

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

We 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.

The market in which we compete is intensely competitive. Our competitors include independent animal health companies and major pharmaceutical companies that have animal health divisions. We also compete with independent, third party distributors, including distributors who sell products under their own private labels. In the point-of-care diagnostic testing market, our major competitors include IDEXX, Abaxis, Inc., Agenix Limited and Synbiotics Corporation. The products manufactured by our OVP segment for sale by third parties compete with similar products offered by a number of other companies, some of which have substantially greater financial, technical, research and other resources than us and may have more established marketing, sales, distribution and service organization's than our OVP segment's customers. Competitors may have facilities with similar capabilities to our OVP segment, which they may operate at a lower unit price to their customers, which could cause us to lose customers. Companies with a significant presence in the companion animal health market, such as Bayer AG, Intervet International bv (a unit of Akzo Nobel N.V.), Merial Limited, Novartis AG, Pfizer Inc., Schering-Plough Corporation, Virbac S.A. and Wyeth (formerly American Home Products), may be marketing or developing products that compete with our products or would compete with them if developed. These and other competitors may have substantially greater financial, technical, research and other resources and larger, more established marketing, sales, distribution and service organizations than we do. Our competitors may offer broader product lines and have greater name recognition than we do. Our competitors may develop or market technologies or products that are more effective or commercially attractive than our current or future products or that would render our technologies and products obsolete. Further, additional competition could come from new entrants to the animal health care market. Moreover, we may not have the financial resources, technical expertise or marketing, distribution or support capabilities to compete successfully. We believe that one of our largest competitors, IDEXX, effectively prohibits its distributors from selling competitive products, including our diagnostic instruments and heartworm diagnostic tests. If we fail to compete successfully, our ability to achieve sustained profitability will be limited and sustained profitability, or profitability at all, may not be possible.

The loss of significant customers could harm our operating results.

Although no single customer accounted for more than 10% of our consolidated revenue or accounts receivable for either of the twelve month periods ended December 31, 2004 and 2005, revenue from our contract with AgriLabs comprised approximately 15% of consolidated revenue in 2003. While we do not have any other customers who represented more than 10% of revenues over the last three years, the loss of significant customers who, for example, are historically large purchasers or who are considered leaders in their field could damage our business and financial results. For example, on March 8, 2006, Henry Schein, Inc. ("Henry Schein") announced a definitive agreement to acquire NLS Animal Health ("NLS"). Henry Schein is our largest independent third party distributor and NLS is a distributor of IDEXX products. We believe IDEXX effectively prohibits its distributors from selling competitive products, including our diagnostic instruments and heartworm diagnostic tests. If Henry Schein were to decide not to carry our full product line due to prohibitions IDEXX effectively places on its distributors or for other reasons, our sales would likely suffer as it is unlikely we would completely recover the corresponding lower sales to Henry Schein through direct sales and sales through other distributors.

We may face costly intellectual property or other legal disputes, or our technology or that of our suppliers or collaborators may become the subject of legal action.

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

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 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 license technology from a number of third parties, including New England Biolabs, Inc. and Roche Molecular Systems, 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. While we currently do not have any unresolved notices of infringement, there is no

assurance that there will be none in the future. 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, or at all, 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 may also face legal disputes relating to other areas of our business. These disputes may require significant expenditures on our part and could have material adverse consequences on our business in the case of an unfavorable ruling or settlement. For example, on September 9, 2005, United Vaccines, Inc. ("United"), a customer of our OVP segment, filed a lawsuit in Madison, Wisconsin against our Diamond Animal Health, Inc. subsidiary ("Diamond") and Heska Corporation alleging various claims, including breach of contract and breach of warranty, and demanding compensatory and punitive damages. On October 20, 2005, we filed a motion to dismiss certain claims against Diamond and all claims against Heska, as well as an answer to United's claims, affirmative defenses and counterclaims on behalf of Diamond. Both sides subsequently filed amended complaints and the matter is ongoing. While we intend to pursue the matter vigorously and believe we are entitled to damages from United and that United is not entitled to damages from Heska or Diamond, there can be no assurance the ultimate resolution of this case will reflect our current beliefs.

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

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

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

Our stock price has historically experienced high volatility, which may increase in the future, and which could affect our ability to raise capital in the future or make it difficult for investors to sell their shares.

The securities markets have experienced significant price and volume fluctuations and the market prices of securities of many microcap and smallcap companies have in the past been, and can in the future be

expected to be, especially volatile. During the past 12 months, our closing stock price has ranged from a low of \$0.56 to a high of \$1.71. Fluctuations in the trading price or liquidity of our common stock may adversely affect our ability to raise capital through future equity financings. Factors that may have a significant impact on the market price and marketability of our common stock include:

- stock sales by large stockholders or by insiders;
- our quarterly operating results, including as compared to our revenue, earnings or other guidance and in comparison to historical results;
- termination of our third party supplier relationships;
- announcements of technological innovations or new products by our competitors or by us;
- litigation;
- regulatory developments, including delays in product introductions;
- developments in our relationships with collaborative partners;
- developments or disputes concerning patents or proprietary rights;

- availability of our revolving line of credit and compliance with debt covenants;
- releases of reports by securities analysts;
- changes in regulatory policies;
- economic and other external factors; and
- general market conditions.

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

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

Our common stock is listed on the Nasdaq Capital Market. The Nasdaq has several quantitative and qualitative requirements companies must comply with to maintain this listing, including a \$1.00 minimum bid price. While we believe we are currently in compliance with all Nasdaq requirements, we have not always been able to maintain compliance in the past and there can be no assurance we will maintain compliance in the future. For example, in 2005 we received two communications from Nasdaq advising us we had failed to comply with the minimum \$1.00 per share bid price requirement and the \$35 million minimum value of listed securities requirement, respectively. While we subsequently received communications from Nasdaq advising us we have regained compliance in both matters and that both matters are now closed, there can be no assurance we will continue to meet these requirements or other requirements in the future. If we are delisted from the Nasdaq Capital Market, our common stock may be considered a penny stock under the regulations of the SEC and would therefore be subject to rules that impose additional sales practice requirements on broker-dealers who sell our securities. The additional burdens imposed upon broker-dealers may discourage broker-dealers from effecting transactions in our common stock, which could severely limit market liquidity of the common stock and your ability to sell our securities in the secondary market. This lack of liquidity would also make it more difficult for us to raise capital in the future.

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

Under our credit and security agreement with Wells Fargo, as amended and restated in December 2005 and under prior agreements, we are required to comply with various financial and non-financial covenants in order to borrow under the agreement. The availability of borrowings under this agreement is

essential to continue to fund our operations. Among the financial covenants is a requirement to maintain minimum liquidity (cash plus excess borrowing base) of \$1.5 million. Additional requirements include covenants for minimum capital monthly and minimum net income quarterly. Although we believe we will be able to maintain compliance with all these covenants and any covenants we may negotiate in the future, there can be no assurance thereof. We have not always been able to maintain compliance with all covenants in the past, including in the first four months of 2005 and on June 30, 2005. Wells Fargo granted us a waiver of non-compliance in each case. However, there can be no assurance we will be able to obtain similar waivers or other modifications if needed in the future.

Failure to comply with any of the covenants, representations or warranties, or failure to modify them to allow future compliance, could result in our being in default under the loan and could cause all outstanding amounts and loans with our other lenders to become immediately due and payable, or impact our ability to borrow under the agreement. We intend to rely on available borrowings under the credit and security agreement to fund our operations in the future. If we are unable to borrow funds under this agreement, we will need to raise additional capital from other sources to continue our operations, which capital may not be available on acceptable terms, or at all.

Obtaining and maintaining regulatory approvals in order to market our regulated products may be costly and delay the marketing and sales of our products.

Many of the products we develop, market or manufacture 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.

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

Among the conditions for certain regulatory approvals is the requirement that our facilities and/or the facilities of our third party manufacturers conform to current Good Manufacturing Practices. 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, manufacturing suspensions, product recalls or seizures, injunctions, refusal to permit products to be imported into or exported out of the United States, refusals of regulatory authorities to grant approval or to allow us to enter into government supply contracts, withdrawals of previously approved marketing applications, civil fines and criminal prosecutions. In addition, certain of our agreements require us to pay penalties if we are unable to supply products, including for failure to maintain regulatory approvals. Any of these events, alone or in unison, could damage our business.

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

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

Changes to financial accounting standards may affect our results of operations and cause us to change our business practices.

We prepare our financial statements in conformance with United States generally accepted accounting principles, or GAAP. These accounting principles are established by and are subject to interpretation by the Financial Accounting Standards Board, the American Institute of Certified Public Accountants, the SEC and various bodies formed to interpret and create appropriate accounting policies. A change in those policies can have a significant effect on our reported results and may affect our reporting of transactions completed before a change is made effective. Changes to those rules may adversely affect our reported financial results or the way we conduct our business.

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

The testing, manufacturing and marketing of our current products as well as those currently under development entail an inherent risk of product liability claims and associated adverse publicity. Following the introduction of a product, adverse side effects may be discovered. Adverse publicity regarding such effects could affect sales of our other products for an indeterminate time period. To date, we have not experienced any material product liability claims, but any claim arising in the future could substantially harm our business. Potential product liability claims may exceed the amount of our insurance coverage or may be excluded from coverage under the terms of the policy. We may not be able to continue to obtain adequate insurance at a reasonable cost, if at all. In the event that we are held liable for a claim against which we are not indemnified or for damages exceeding the \$10 million limit of our insurance coverage or which results in significant adverse publicity against us, we may lose revenue, be required to make substantial payments which could exceed our financial capacity and/or lose or fail to achieve market acceptance. Furthermore, our agreements with some suppliers of our instruments contain limited warranty provisions, which may subject us to liability if a supplier fails to meet its warranty obligations if a defect is traced to our instrument or if we cannot correct errors reported during the warranty period. If our contractual limitations are unenforceable in a particular jurisdiction, a successful claim could require us to pay substantial damages.

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

Certain of our products and development programs produced at the Iowa facility 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, significant remediation costs and potential legal liability. In addition, we may incur substantial costs to comply with environmental regulations if we choose to expand our manufacturing capacity.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties.

Our principal administrative and research and development activities are located in Loveland, Colorado. We currently lease approximately 60,000 square feet at a facility in Loveland, Colorado under an 18-year lease agreement which expires in 2023. Our principal production facility located in Des Moines, Iowa, consists of 168,000 square feet of buildings on 34 acres of land, which we own. We also own a 175-acre farm used principally for testing products, located in Carlisle, Iowa. Our European facility in Fribourg, Switzerland is leased.

Item 3. Legal Proceedings.

From time to time, we may be involved in litigation relating to claims arising out of our operations. On September 9, 2005, United Vaccines, Inc. ("United"), a customer of our OVP segment, filed a lawsuit in Madison, Wisconsin against our Diamond Animal Health, Inc. subsidiary ("Diamond") and Heska Corporation alleging various claims, including breach of contract and breach of warranty, and demanding compensatory and punitive damages. On October 20, 2005, we filed a motion to dismiss certain claims against Diamond and all claims against Heska, as well as an answer to United's claims, affirmative defenses and counterclaims on behalf of Diamond. Both sides subsequently filed amended complaints and the matter is ongoing. While we intend to pursue the matter vigorously and believe we are entitled to damages from United and that United is not entitled to damages from Heska or Diamond, there can be no assurance the ultimate resolution of this case will reflect our current beliefs.

Item 4. Submission of Matters to a Vote of Security Holders.

No matters were submitted to a vote of stockholders during the fourth quarter ended December 31, 2005.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Our common stock is quoted on the Nasdaq Capital Market under the symbol "HSKA." The following table sets forth the high and low closing prices for our common stock as reported by the Nasdaq Capital Market for the periods indicated below.

	High	Low
2004		
First Quarter	\$ 3.24	\$ 1.86
Second Quarter	2.54	1.22
Third Quarter	1.83	1.00
Fourth Quarter	1.86	1.05
2005		
First Quarter	1.28	0.75
Second Quarter	0.84	0.56
Third Quarter	0.93	0.61
Fourth Quarter	1.35	0.85
2006		
First Quarter (through March 29)	1.71	1.13

As of March 14, 2006, there were approximately 316 holders of record of our common stock and approximately 3,300 beneficial stockholders. We have never declared or paid cash dividends on our capital stock and do not anticipate paying any cash dividends in the near future. In addition, we are restricted from paying dividends, other than dividends payable solely in stock, under the terms of our credit facility. We currently intend to retain future earnings, if any, for the development of our business.

Equity Compensation Plan Information

The following table sets forth information about our common stock that may be issued upon exercise of options and rights under all of our equity compensation plans as of December 31, 2005, including the 1988 Stock Option Plan, the 1997 Stock Incentive Plan, the 2003 Stock Incentive Plan and the 1997 Employee Stock Purchase Plan. Our stockholders have approved all of these plans.

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options and Rights	Weighted-Average Exercise Price of Outstanding Options and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (excluding securities reflected in column (a))
Equity Compensation Plans Approved by Stockholders	11,989,582	\$ 1.33	3,190,798(1)
Equity Compensation Plans Not Approved by Stockholders	None	None	None
Total	11,989,582	\$ 1.33	3,190,798

(1) Excludes shares authorized for issuance in connection with our 1997 Stock Incentive Plan which are subject to an automatic annual increase of 1,500,000 shares on January 1, 2006.

Item 6. Selected Consolidated Financial Data.

The following consolidated statement of operations and consolidated balance sheet data have been derived from our consolidated financial statements. The information set forth below is not necessarily indicative of the results of future operations and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and related Notes included as Items 7 and 8 in this Form 10-K.

	Year Ended December 31,				
	2001	2002	2003	2004	2005
(in thousands, except per share amounts)					
Consolidated Statement of Operations Data:					
Revenue:					
Products, net of sales returns and allowances	\$ 46,386	\$ 50,151	\$ 64,033	\$ 65,687	\$ 67,549
Research, development and other	1,897	1,175	1,292	2,004	1,888
Total revenue	48,283	51,326	65,325	67,691	69,437
Cost of revenue:					
Cost of products sold	28,655	30,201	38,399	42,253	42,515
Cost of research, development and other	1,376	734	626	729	1,095
Total cost of revenue	30,031	30,935	39,025	42,982	43,610
Gross profit	18,252	20,391	26,300	24,709	25,827
Operating expenses:					

Selling and marketing	13,981	13,128	15,750	15,616	14,020
Research and development	12,189	7,836	6,146	5,891	3,749
General and administrative	8,181	6,755	7,083	7,442	7,187
Restructuring expenses, loss on sale of assets and other	2,023	1,007	515	—	—
Total operating expenses	36,374	28,726	29,494	28,949	24,956
Income (loss) from operations	(18,122)	(8,335)	(3,194)	(4,240)	871
Interest and other expense, net	569	334	214	575	774
Income (loss) before income taxes	(18,691)	(8,669)	(3,408)	(4,815)	97
Income tax expense (benefit)	—	—	51	—	(185)
Net income (loss)	\$ (18,691)	\$ (8,669)	\$ (3,459)	\$ (4,815)	\$ 282
Basic and diluted net income (loss) per share	\$ (0.48)	\$ (0.18)	\$ (0.07)	\$ (0.10)	\$ 0.01
Shares used for basic net income (loss) per share	38,919	47,720	48,115	49,029	49,650
Shares used for diluted net income (loss) per share	38,919	47,720	48,115	49,029	50,438

Consolidated Balance Sheet Data:

Cash and cash equivalents	\$ 5,710	\$ 6,026	\$ 4,877	\$ 4,982	\$ 5,231
Total current assets	25,675	24,700	28,717	28,442	26,845
Total assets	37,757	35,585	38,896	38,724	36,784
Line of credit	5,737	7,596	7,528	10,375	9,453
Current portion of long-term debt and capital leases	815	2,338	783	302	1,263
Total current liabilities	17,460	19,274	18,516	23,269	20,722
Long-term debt and capital leases	2,109	770	1,746	1,466	2,703
Long-term deferred revenue and other	1,022	6,331	11,978	11,410	10,126
Total stockholders' equity	17,166	9,210	6,656	2,579	3,233

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with "Selected Consolidated Financial Data" and the Consolidated Financial Statements and related Notes included in Items 6 and 8 of this Form 10-K.

This discussion contains forward-looking statements that involve risks and uncertainties. Such statements, which include statements concerning future revenue sources and concentration, gross profit margins, selling and marketing expenses, research and development expenses, general and administrative expenses, capital resources, additional financings or borrowings and additional losses, are subject to risks and uncertainties, including, but not limited to, those discussed below and elsewhere in this Form 10-K, particularly in Item 1A. "Risk Factors," that could cause actual results to differ materially from those projected. The forward-looking statements set forth in this Form 10-K are as of March 29, 2006, and we undertake no duty to update this information.

Overview

We discover, develop, manufacture, market, sell, distribute and support veterinary products. Our business is comprised of two reportable segments, Core Companion Animal Health, which represented 81% of 2005 product revenue, and Other Vaccines, Pharmaceuticals and Products, previously reported as Diamond Animal Health, which represented 19% of 2005 product revenue.

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

Diagnostic and monitoring instruments and supplies represented approximately 45% of our 2005 product revenue. Many products in this area involve placing an instrument in the field and generating future revenue from consumables, including items such as supplies and service, as that instrument is used. A loss of or disruption in supply of consumables we are selling to an installed base of instruments could substantially harm our business. Historically, most revenue growth from consumables has resulted from an increased number of instruments in the field and not greater revenue per instrument. Major products in this area include our handheld electrolyte instrument, our chemistry instrument and our hematology instrument and their affiliated consumables. All products in this area are supplied by third parties, who typically own the product rights and supply the product to us under marketing and/or distribution agreements. In many cases, we have collaborated with a third party to adapt a human instrument for veterinary use.

Single use diagnostic and other tests, vaccines and pharmaceuticals represented approximately 36% of our 2005 product revenue. Since items in this area are single use by their nature, our aim is to build customer satisfaction and loyalty for each product, generate repeat annual sales from existing customers and expand our customer base in the future. Major products in this area include our heartworm preventive, our heartworm diagnostic tests, our allergy diagnostic tests and our allergy immunotherapy. Products in this area are both supplied by third parties and provided by us.

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

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All our Core Companion Animal Health products are ultimately sold to or through veterinarians. In many cases, veterinarians will markup their costs to the end user. The acceptance of our products by veterinarians is critical to our success. Core Companion Animal Health products are sold directly by us as well as through independent third party distributors and other distribution relationships. We believe that one of our largest competitors, IDEXX, effectively prohibits its distributors from selling competitive products, including our diagnostic instruments and heartworm diagnostic tests. We believe the IDEXX restrictions limit our ability to engage national distributors to sell our full line of products and significantly restrict our ability to market our products to veterinarians.

While we have decreased year-over-year operating expenses in both 2004 and 2005 and intend to continue to exercise disciplined expense control, we expect operating expenses to increase as we grow our business in the intermediate term. We intend to reach sustained profitability through a combination of revenue growth, gross margin improvement and expense control. Accordingly, we closely monitor product revenue growth trends in our Core Companion Animal Health segment. Product revenue in this segment grew 4% in 2005 as compared to 2004 and has grown at a compounded annual growth rate of 20% since 1998, our first full year as a public company.

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

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

We have developed our own line of bovine vaccines that are licensed by the USDA. We have a long-term agreement with a distributor, Agri Laboratories, Ltd., (“AgriLabs”), for the marketing and sale of certain of these vaccines which are sold primarily under the Titanium[®] and MasterGuard[®] brands which are registered trademarks of AgriLabs. This agreement generates a significant portion of our OVP segment’s revenue. Subject to certain purchase minimums, under our long term agreement, AgriLabs has the exclusive right to sell the aforementioned bovine vaccines in the United States, Africa, China, Mexico and Taiwan until at least December 2009. This exclusivity may be extended under certain conditions. Our OVP segment also produces vaccines and pharmaceuticals for other third parties.

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 livestock product purposes.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based upon the consolidated financial statements, which have been prepared in accordance with U.S. generally accepted

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

Revenue Recognition

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

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

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

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

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

licensing technology and product rights is reported in our Research, development and other revenue line item.

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

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

Allowance for Doubtful Accounts

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

Inventories

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

Capitalized Patent Costs

We defer and capitalize certain costs, including payments to third-party law firms for patent prosecution to expand the scope of our patents, related to the technology or patents underlying a variety of long-term licensing agreements. We own a portfolio of patents not currently utilized in our product development or manufacture. Several entities have paid upfront licensing fees to utilize the technology supported by these patents in their own product development and commercialization efforts. Because we believe that we have an obligation to protect the underlying patents, we defer the revenue associated with these long-term agreements and the direct and incremental costs of prosecuting the patents that support the agreements. We use the term "patent prosecution" in this context in the narrow sense often used by intellectual property professionals – to describe activities where we seek to expand the scope of existing patents such as geographically, where we may look to expand patent protection into new countries, or for broader applications, such as for newly contemplated uses or expanded claim breadth coverage of the technology defined by those licensing its technology within existing geographies. A situation where a third party has violated our intellectual property rights by using our patented technology without permission and we have filed a corresponding lawsuit would not meet this definition of "patent prosecution" and we would therefore expense the corresponding legal expenses as incurred. In accordance with SFAS No. 95, paragraph 17(c), we have classified patent prosecution expenditures which are capitalized as cash used for investing activities since, like a capital expenditure to improve a building or add a piece of equipment, the cost is a necessary investment into a productive asset to maintain our future revenue process. No internal costs are capitalized. These capitalized costs are amortized over the same period as the licensing revenue related to those patents is recognized. Costs in excess of the amount of remaining related deferred licensing revenue are not capitalized, but are expensed as incurred. The Company capitalized approximately \$420 thousand, \$541 thousand and \$187 thousand for the years ended December 31, 2003, 2004 and 2005, respectively and amortized approximately \$145 thousand, \$393 thousand and \$157 thousand for the same periods, respectively.

The following table summarizes our results of operations for the three most recent fiscal years.

	Year Ended December 31,		
	2003	2004	2005
(in thousands)			
Consolidated Statement of Operations Data:			
Revenue:			
Product revenue, net:			
Core companion animal health	\$ 47,645	\$ 52,719	\$ 54,716
Other vaccines, pharmaceuticals and products	16,388	12,968	12,833
Total product revenue	64,033	65,687	67,549
Research, development and other	1,292	2,004	1,888
Total revenue, net	65,325	67,691	69,437
Cost of revenue:			
Cost of products sold	38,399	42,253	42,515
Cost of research, development and other	626	729	1,095
Total cost of revenue:	39,025	42,982	43,610
Gross profit	26,300	24,709	25,827
Operating expenses:			
Selling and marketing	15,750	15,616	14,020
Research and development	6,146	5,891	3,749
General and administrative	7,083	7,442	7,187
Other	515	—	—
Total operating expenses	29,494	28,949	24,956
Income (loss) from operations	(3,194)	(4,240)	871
Interest and other expense, net	214	575	774
Income (loss) before income taxes	(3,408)	(4,815)	97
Income tax expense (benefit)	51	—	(185)
Net income (loss)	\$ (3,459)	\$ (4,815)	\$ 282
Basic and diluted net income (loss) per share	\$ (0.07)	\$ (0.10)	\$ 0.01

Revenue

Total revenue, which includes product revenue, sponsored research and development and other revenue, increased 3% to \$69.4 million in 2005 compared to \$67.7 million in 2004. Total revenue for 2004 increased 4% to \$67.7 million from \$65.3 million in 2003. Product revenue increased 3% to \$67.5 million in 2005 compared to \$65.7 million in 2004. Product revenue increased 3% to \$65.7 million in 2004 compared to \$64.0 million in 2003.

Core Companion Animal Health segment product revenue increased 4% to \$54.7 million in 2005 compared to \$52.7 million in 2004. Key factors in the increase were higher sales of our instrument consumables, our heartworm preventive and our microalbumin laboratory packs, the latter of which we began to sell in 2005, somewhat offset by lower sales of our hematology instruments due to an offer to certain customers who had previously purchased a hematology analyzer to upgrade to our new hematology analyzer during 2004 which was not repeated in 2005, and of our heartworm diagnostic tests.

2004 product revenue from our Core Companion Animal Health segment increased 11% to \$52.7 million compared to \$47.6 million in 2003. Key factors in the increase were greater sales of our canine heartworm preventive, which was launched in the fourth quarter of 2003, our instrument consumables and our

new hematology analyzer. These increases were somewhat offset by lower domestic sales of our canine heartworm diagnostic test.

Other Vaccines, Pharmaceuticals and Products segment (“OVP”) product revenue decreased 1% to \$12.8 million in 2005 compared to \$13.0 million in 2004. The decrease in 2005 was due to lower sales of small mammal vaccines, somewhat offset by increased sales of our bovine vaccines under our contract with AgriLabs and our fish vaccines.

2004 product revenue from OVP decreased 21% to \$13.0 million compared to \$16.4 million in 2003. The decrease in 2004 was due to lower sales of our bovine vaccines under our contract with AgriLabs and a customer who had purchased for European distribution in 2003, but not in 2004, somewhat offset by increased sales of small mammal vaccines and bulk bovine biologicals.

Revenue from research and development services and other services decreased by 6% to \$1.9 million in 2005 from \$2.0 million in 2004. This decrease was primarily due to the reduced level of activity for research and development efforts for third parties. The 2004 increase of 55% to \$2.0 million from \$1.3 million in 2003 also reflects increases in license fees received in prior years which are being recognized over several years. We recognized approximately \$486 thousand and \$269 thousand in 2004 and 2005, respectively, for the acceleration of deferred revenue related to terminated licensing agreements.

In 2006, we expect continued growth in our Core Companion Animal Health segment. We anticipate OVP revenue will experience a slight decline from 2005. We expect research, development and other revenue to decline slightly in 2006 as compared to 2005.

Cost of Revenue

Cost of revenue consists of two components: 1) cost of products sold and 2) cost of research, development and other revenue, both of which correspond to their respective revenue categories. Cost of revenue totaled \$43.6 million for the twelve months ended December 31, 2005, a 2% increase as compared to \$43.0 million for the corresponding period in 2004. Gross profit increased 5% to \$25.8 million for 2005 as compared to \$24.7 million in 2004. Gross Margin, i.e. gross profit divided by total revenue, increased slightly to 37.2% for 2005 as compared to 36.5% in 2004. Cost of revenue totaled \$43.0 million for 2004, a 10% increase as compared to \$39.0 million for 2003. Gross profit decreased 6% to \$24.7 million for 2004 as compared to \$26.3 million in 2003. Gross Margin decreased to 36.5% for 2004 as compared to 40.3% in 2003.

Cost of products sold increased 1% to \$42.5 million in the twelve months ended December 31, 2005 from \$42.3 million in 2004. Gross profit on product revenue increased 7% to \$25.0 million for 2005 from \$23.4 million in the prior year. Product Gross Margin, i.e. gross profit on product revenue divided by product revenue, increased to 37.1% in 2005 as compared to 35.7% in 2004. Key factors in the improvement were higher sales and margins in our heartworm preventive product, where we now have taken in house certain manufacturing operations we previously outsourced and increased instrument consumable sales, which typically carry a higher than average gross margin, somewhat offset by certain supplier price increases resulting from a contract renegotiation in the second half of 2004. Cost of products sold increased 10% to \$42.3 million in 2004 as compared to \$38.4 million in 2003. Gross profit on product revenue decreased 9% to \$23.4 million for 2004 from \$25.6 million in 2003. Product Gross Margin decreased to 35.7% in 2004 as compared to 40.0% in 2003. The decline was principally due to significantly lower gross margins on OVP product sales, lower gross margins on sales of diagnostic instruments, the loss of relatively high margin consumable sales to the installed base of end users of our previous hematology instrument, price increases on certain products we purchase and lower gross margins on sales of our heartworm diagnostic products. Significantly lower OVP gross margins were due to sales from a greater proportion of relatively lower gross margin products as compared to 2003. A significant reason for the decline in gross margin in new instrument

product sales was an offer to certain customers who had previously purchased a hematology analyzer from us to upgrade to our new hematology analyzer, which was launched in January 2004. We initially made a decision to make this offer to certain customers in January 2004 and subsequently extended the period the offer was available through the second quarter of 2004 as business conditions changed. We settled litigation with the supplier of our previous hematology instrument and agreed not to sell certain consumables to the installed base of end users of our previous hematology instrument until December 2004. This, as well as competition from the supplier of our previous hematology instrument, reduced our sales of relatively high margin consumables to the installed base of end users of our previous hematology instrument. The price increases on certain products we purchase referred to above was the result of a contract renegotiation in the second half of 2004. Lower gross margins on sales of our heartworm diagnostic products were primarily the result of increased competition.

Cost of research, development and other revenue increased 50% to \$1.1 million in the twelve months ended December 31, 2005 as compared to \$729 thousand in 2004. Gross profit on research, development and other revenue decreased 38% to \$793 thousand for 2005 from \$1.3 million in 2004. Other Gross Margin, i.e. gross profit on research, development and other revenue divided by research, development and other revenue, declined to 42.0% for 2005 as compared to 63.6% in 2004. The primary reason for the decrease is a greater proportion of patent-related costs being expensed as incurred in 2005 rather than capitalized when compared to the prior year. Cost of research, development and other revenue increased 16% to \$729 thousand in 2004 as compared to \$626 thousand in 2003. Gross profit on research, development and other revenue increased 91% to \$1.3 million for the twelve months ended December 31, 2004 from \$666 thousand in 2003. Other Gross Margin increased to 63.6% for 2004 as compared to 51.5% in 2003. The primary reason for the increase was the recognition of license fee revenue received in previous years which was recognized in 2004 when certain third parties did not extend their rights to certain of our patents and greater royalties on pet food products.

We expect our gross margin on product sales will increase in 2006 as compared to 2005 as we expect to sell a greater proportion of total sales in relatively higher margin products.

Operating Expenses

Selling and marketing expenses decreased by 10% to \$14.0 million in 2005 compared to \$15.6 million in 2004 primarily due to marketing spending related to the initial rollout of our new hematology instrument and greater outside consulting fees related to corporate branding in 2004. Selling and marketing expenses decreased by 1% to \$15.6 million in 2004 as compared to \$15.8 million in 2003 due primarily to lower personnel costs at our European subsidiary.

Research and development expenses decreased by 36% to \$3.7 million in 2005 from \$5.9 million in 2004. Key factors in the decrease were lower personnel costs and spending on clinical trials. Research and development expenses decreased by 4% to \$5.9 million in 2004 from \$6.1 million in 2003. This decrease was due primarily to lower personnel costs.

General and administrative expenses decreased by 3% to \$7.2 million in 2005 from \$7.4 million in 2004. Key factors in the decrease were lower consulting fees and legal fees, somewhat offset by an increase in rent expense. General and administrative expenses increased by 5% to \$7.4 million in 2004 from \$7.1 million in 2003. Greater usage of consultants was a key factor in the increase. Our audit fees, including the usage of outside accountants and consultants for the anticipated need to comply with Section 404 of Sarbanes-Oxley, increased in 2004 when compared to 2003 as did the usage of consultants for various projects.

We recorded other operating expense of approximately \$515 thousand in 2003 related to settlement costs associated with the resolution of litigation.

In 2006, we expect total operating expenses to increase as compared to 2005. We expect operating expenses generally will increase more slowly than increases in revenue.

Interest and Other Expense, Net

Interest expense increased to \$1.1 million in 2005 from \$690 thousand in 2004 and \$459 thousand in 2003. The increase in both cases reflects the greater usage of borrowings under our credit and security agreement with Wells Fargo Business, Inc. ("Wells Fargo"), negotiated spread rate increases with Wells Fargo and increases in Wells Fargo's prime rate. The 2005 increase in interest expense was partially offset by a \$249 thousand gain in Other, net,

primarily due to gains on foreign currency translation of approximately \$224 thousand. This foreign currency gain resulted primarily from a transaction under which funds were transferred from Heska AG, our operating subsidiary in Switzerland, to the United States-based parent company via an intercompany receivable/payable and certain inventory transactions involving non-U.S. dollar currencies. Because this intercompany loan was to be repaid in the foreseeable future, changes in the amount of U.S. dollars receivable by Heska AG resulting from changes in foreign currency exchange rates are required to be recorded through earnings or loss. The impact of the foreign currency exchange rate changes resulted in a gain on the loan due to a strengthening U.S. dollar relative to the Swiss franc. In 2004 and 2003, income from other, net of \$90 thousand and \$174 thousand, respectively, somewhat offset interest expense; this was primarily due to certain prior year tax credits in both cases. We do not expect such tax credits in the future.

We expect net interest expense to increase in 2006 due to additional term loan borrowings agreed to in July 2005 with Wells Fargo and as we use our revolving credit facility more extensively to fund our growth.

Income Tax Expense (Benefit)

Historically, we have not been consistently profitable and, accordingly, have not recognized a tax benefit on our pre-tax losses. Based on the profitable operating performance of Heska AG, we have concluded that our net operating loss carryforward (“NOL”) in Switzerland is realizable on a more-likely-than-not basis. We reduced the related valuation allowance in the fourth quarter of 2005, resulting in an income tax benefit of approximately \$185 thousand. This results in a deferred tax asset equal to the approximate value of income taxes Heska will recognize in its future statements of operations as income tax that it will not actually pay in cash as Heska utilizes its NOLs.

Heska AG has a “tax holiday” from canton, municipal and church income taxes in the canton of Fribourg through August 31, 2007. NOLs utilized during such a “tax holiday” do not contribute to the deferred tax asset as the tax rate is effectively zero during the tax holiday. These tax holidays reduce the amount of deferred tax asset that otherwise would be recorded by approximately \$255 thousand. The Company does not have a “tax holiday” for federal taxes in Switzerland. Accordingly, we expect to incur approximately \$75 thousand in 2006 tax expense related to federal taxes in Switzerland.

Net Income (Loss)

In 2005, we recorded the first full year of profitability in our history. Our 2005 net income was \$282 thousand as compared to annual losses of \$4.8 million in 2004 and \$3.5 million in 2003. The 2005 improvement was due to increased product revenue, higher gross profit percentage on product sales, lower operating expenses and reversal of valuation allowances against our Swiss net operating loss deferred income tax assets for Heska AG. The decrease in our net loss in 2004 as compared to 2003 was due primarily to our lower gross profit percentage on product sales.

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In 2006, we expect to increase our net income primarily due to increased revenue and increased gross margins somewhat offset by increased operating expenses.

Liquidity, Capital Resources and Financial Condition

We have incurred net cumulative negative cash flow from operations since inception in 1988. For the year ended December 31, 2005, we had total revenue of \$69.4 million and net income of \$282 thousand. In 2005, net cash provided by operations was \$148 thousand. At December 31, 2005, we had \$5.2 million of cash and cash equivalents, working capital of \$6.1 million, \$9.5 million of outstanding borrowings under our revolving line of credit, discussed below, and \$4.0 million of other debt and capital leases.

At December 31, 2005, we had a \$12.0 million asset-based revolving line of credit with Wells Fargo which had a maturity date of June 30, 2009 as part of our credit and security agreement with Wells Fargo. At December 31, 2005, \$9.5 million was outstanding under this line of credit. Our ability to borrow under this line of credit varies based upon available cash, eligible accounts receivable and eligible inventory. On December 31, 2005, interest on the term note was charged at a stated rate of Prime plus 2.75% and was payable monthly. We are required to comply with various financial and non-financial covenants, and we have made various representations and warranties. Among the financial covenants is a requirement to maintain a minimum liquidity (cash plus excess borrowing base) of \$1.5 million. Additional requirements include covenants for minimum capital monthly and minimum net income quarterly. Failure to comply with any of the covenants, representations or warranties could result in our being in default on the loan and could cause all outstanding amounts payable to Wells Fargo, including those discussed above, as well as our other borrowings, to become immediately due and payable or impact our ability to borrow under the agreement. Any default under the Wells Fargo agreement could also accelerate the repayment of our other borrowings. We were in compliance with all financial covenants as of December 31, 2005. At December 31, 2005, our remaining available borrowing capacity based upon eligible accounts receivable and eligible inventory under our revolving line of credit was approximately \$567 thousand.

At December 31, 2005, we also had outstanding obligations for long-term debt and capital leases totaling approximately \$4.0 million primarily related to three term loans with Wells Fargo and a subordinated promissory note with a significant customer with the proceeds used for facilities enhancements. One term loan is secured by real estate and had an outstanding balance at December 31, 2005 of approximately \$905 thousand due in monthly installments of \$17,658 plus interest, with a balloon payment of approximately \$163 thousand due on June 30, 2009. The term loan had a stated interest rate of prime plus 2.75% on December 31, 2005. In July 2005, we borrowed an additional \$2.5 million from Wells Fargo which was secured by machinery and equipment at our Des Moines, Iowa and Loveland, Colorado locations (the “Equipment Notes”). The Equipment Notes had a stated interest rate of prime plus 2.75% on December 31, 2005. Principal payments on the Equipment Notes of \$46,296 plus interest are due monthly beginning February 1, 2006 with a balloon payment of approximately \$602 thousand due upon maturity of the credit facility agreement on June 30, 2009. The subordinated promissory note is secured by our production facility, has a stated interest rate of prime plus 1.0% and a remaining balance of \$500 thousand payable in May 2006 and the lender has subordinated its first security interest to Wells Fargo. In addition, we have a promissory note to the City of Des Moines with an outstanding balance at December 31, 2005 of approximately \$34 thousand, due in monthly installments through June 2006. This promissory note has a stated interest rate of 3.0%. The note is secured by first security interests in essentially all of our OVP segment’s assets and the lender has subordinated its first security interest to Wells Fargo. Our capital lease obligations totaled approximately \$27 thousand at December 31, 2005. The terms of our debt agreement includes provisions where non-compliance with certain covenants could, in specified circumstances result in acceleration of the repayment of these borrowings.

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Net cash flows from operating activities provided cash of \$148 thousand in 2005 as compared to using \$1.1 million in 2004 and providing \$570 thousand in 2003. Major factors in the improvement in our cash provided from operations in 2005 as compared to the net used in 2004 were a \$5.1 million improvement in our net income and an approximately \$1.4 million improvement in cash provided by inventory; these items were somewhat offset by a \$2.1 million decrease in cash provided by deferred revenue and other long term liabilities, primarily related to an upfront payment received for marketing rights in 2004 not repeated in 2005, a \$2.0 million decrease in cash provided by accounts payable and a \$1.1 million dollar decrease in accrued liabilities. Our net use of cash for operations in 2004 as compared to the net cash provided in 2003 was due to product rights and licensing arrangements generating \$4.6 million less in cash in 2004 than 2003, accounts payable providing \$1.3 million less in 2004 compared to 2003 and an increased net loss of \$1.4 million; these items were somewhat offset by \$5.0 million in cash provided by accounts receivable due to the lower fourth quarter sales in 2004 as compared to 2003.

Net cash flows from investing activities used cash of \$1.5 million in 2005, used cash of \$1.4 million in 2004 and used cash of \$1.8 million in 2003. Expenditures for property and equipment totaled approximately \$1.4 million, \$1.3 million and \$1.4 million in 2005, 2004 and 2003, respectively. In 2004, approximately \$1.8 million in capital expenditures and capitalized patent costs were somewhat offset by approximately \$400 thousand of proceeds from the licensing of certain rights related to one of our products and \$100 thousand of proceeds from the repayment of a loan. In 2003, approximately \$1.8 million in capital expenditures and capitalized patent costs were somewhat offset by approximately \$35 thousand of proceeds from the disposition of property and equipment.

Net cash flows from financing activities provided cash of \$1.8 million in 2005 as compared to providing \$2.5 million in 2004 and using \$28 thousand in 2003. In 2005, the primary source of cash was \$2.5 million from the Equipment Notes, somewhat offset by \$922 thousand repayment of borrowings under our revolving line of credit with Wells Fargo. In 2004, the primary source of funds was \$2.8 million in borrowings under our revolving credit facility. In 2003, \$619 thousand in proceeds from the exercise of stock options and a new loan from the City of Des Moines related to our Des Moines facility provided cash of \$819 thousand that offset cash used to repay other debt and capital lease obligations.

At December 31, 2005, we had intangible assets of approximately \$1.5 million related to deferred patent costs. These deferred patent costs are being recognized as a component of cost of research, development and other on a straight-line basis over the remaining lives of the agreements, products, patents or technology. We also had deferred revenue and other long term liabilities, net of current portion, of approximately \$10.1 million. Included in this total is approximately \$9.9 million of deferred revenue related to up-front fees that have been received for certain product rights and technology rights out-licensed. These deferred amounts are being recognized on a straight-line basis over the remaining lives of the agreements, products, patents or technology. On December 31, 2004, we included approximately \$142 thousand related to pension liabilities for a defined benefit pension plan which was frozen in October 1992 in deferred revenue, net of current portion, and other. We did not have a corresponding pension liability in deferred revenue, net of current portion, and other as of December 31, 2005.

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

Our financial plan for 2006 indicates that our available cash and cash equivalents, together with cash from operations and borrowings expected to be available under our revolving line of credit, will be sufficient to fund our operations through 2006 and into 2007. Our financial plan for 2006 expects that we will have positive cash flow from operations, primarily through increased revenue, improved gross margins and limiting any increase in operating expenses to a modest degree. However, our actual results may differ from this plan, and we may be required to consider alternative strategies. We may be required to raise additional capital in the future. If necessary, we expect to raise these additional funds through one or more of the following: (1) sale of equity or debt securities; (2) obtaining new loans secured by unencumbered assets, or refinancing loans currently outstanding on properties with historical appraised values significantly in excess of related debt; (3) sale of assets, products or marketing rights; and (4) licensing of technology. There is no guarantee that additional capital will be available from these sources on acceptable terms, if at all, and certain of these sources may require approval by existing lenders. If we cannot raise the additional funds through these options on acceptable terms or with the necessary timing, management could also reduce discretionary spending to decrease our cash burn rate through actions such as delaying or canceling research projects or marketing plans. These actions would likely extend the then available cash and cash equivalents, and then available borrowings. See "Risk Factors" In Item 1A.

A summary of our contractual obligations at December 31, 2005 is shown below.

	Total	Payments Due by Period			
		Less Than 1 Year	1-3 Years	4-5 Years	After 5 Years
Contractual Obligations					
Long-term Debt	\$ 3,939	\$ 1,256	\$ 2,683	\$ —	\$ —
Capital Lease Obligations	27	7	20	—	—
Interest Payments on Debt	1,527	1,230	249	48	—
Line of Credit	9,453	9,453	—	—	—
Operating Leases	27,365	1,257	4,043	2,890	19,175
Unconditional Purchase Obligations	14,581	5,246	9,035	300	—
Total Contractual Cash Obligations	\$ 56,892	\$ 18,449	\$ 16,030	\$ 3,238	\$ 19,175

In addition to those agreements considered above where our contractual obligation is fixed, we are party to commercial agreements which may require us to make milestone payments under certain circumstances. All milestone obligations which we believe are likely to be triggered but are not yet paid are included in "Unconditional Purchase Obligations" in the table above. We do not believe other potential milestone obligations, some of which we consider to be of remote likelihood of ever being triggered, will have a material impact on our liquidity, capital resources or financial condition in the foreseeable future.

Net Operating Loss Carryforwards

As of December 31, 2005, we had a net domestic operating loss carryforward, or NOL, of approximately \$171.7 million, a domestic alternative minimum tax credit of approximately \$23 thousand and a domestic research and development tax credit carryforward of approximately \$307 thousand. The NOL and tax credit carryforwards are subject to alternative minimum tax limitations and to examination by the tax authorities. In addition, we 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”). We believe the latest, and most restrictive, Ownership Change occurred at the time of our initial public offering in July 1997. We do not believe this Ownership Change will place a significant restriction on our ability to utilize our NOLs in the future. We also have net operating loss carryforwards in Switzerland of approximately \$1.9 million related to losses previously recorded by Heska AG. Heska AG also has a “tax holiday” from canton, municipal and church income taxes in the canton of Fribourg through August 31, 2007.

Recent Accounting Pronouncements

Recent accounting pronouncements that are relevant to us include Statement of Financial Accounting Standards (“SFAS”) No. 123R.

SFAS No. 123R, “Share-Based Payment” (Revised 2004)

Statement of Financial Accounting Standards No. 123 “Share-Based Payments” (“SFAS No. 123R”) was revised and promulgated in December 2004. We intend to adopt this standard when required. On April 14, 2005, the SEC issued a release amending the compliance dates for SFAS No. 123R. Under the SEC’s new rule, companies in our position may implement SFAS No. 123R at the beginning of their next fiscal year, instead of the next reporting period as originally required under SFAS No. 123R, that begins after June 15, 2005. We originally intended to adopt SFAS No. 123R beginning on July 1, 2005 but based on the SEC’s action on April 14, 2005, we currently intend to adopt this standard effective on January 1, 2006 – the first day of our coming fiscal year. We intend to adopt SFAS No. 123R under the modified prospective method of adoption. Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation” (“SFAS No. 123”), which became effective in 1996, allowed for the continued measurement of compensation cost for stock-based compensation using the intrinsic value based method under Accounting Principles Board Opinion No. 25 “Accounting for Stock Issued to Employees” (“APB No. 25”), provided that pro forma disclosures are made of net income or loss, assuming the fair value based method of SFAS No. 123 had been applied. We have elected to account for our stock-based compensation plans under APB No. 25. Upon adoption of SFAS No. 123R, we will be required to recognize compensation expense using the fair value-based model for options that vest after the effective date of SFAS No. 123R adoption, including those that were granted prior to the effective date of SFAS No. 123R adoption. This will result in recording compensation expense for periods after the effective date of SFAS No. 123R adoption. Historically, under APB No. 25, we have recorded minimal amounts of stock-based compensation. On December 2, 2004 the Compensation Committee of the our Board of Directors considered the significant impact that the use of fair values, rather than intrinsic values, would have on our future results of operations, as well as factors including that the management team had requested that their salaries be frozen for 2005, many non-management employees’ 2005 raises were to be below market levels, no management bonus payments were made for 2004 and the 2005 management incentive plan called for a performance in excess of our internal budget before any bonus payments were to be made, and approved the acceleration of vesting of outstanding but unvested stock options with an exercise price greater than \$1.08. These options were not “in-the-money” at that time, and therefore, there was no compensation expense recorded in accordance with APB No. 25 as a result of this modification. However, for pro forma purposes, in accordance with SFAS No. 123, the remaining unamortized compensation related to these options, calculated under SFAS No. 123 of approximately \$2.1 million, was recorded in 2004. This action effected options to purchase approximately 2.2 million shares, approximately 1.1 million of which were held by our Directors and Executive Officers. Had this action not been taken, and had all approximately 2.2 million options continued to vest according to the vesting schedules in place prior to the acceleration, we would have recorded compensation expense related to these options of approximately \$870 thousand on a pro forma basis for the year ending December 31, 2005. On February 24, 2005, our Board of Directors considered the significant impact that the use of fair values, rather than intrinsic values, would have on our future results of operations, as well as factors including that the management team had requested that their salaries be frozen for 2005, many non-management employees’ 2005 raises were to be below market levels, no management bonus payouts were made for 2004 and the 2005 management incentive plan calls for a performance in excess of our internal budget before any bonus payments are made, and authorized our Stock Option Committee, which consists solely of our Chief Executive Officer, to immediately vest all options granted from that date through June 30, 2005 and to accelerate the vesting of any outstanding but unvested stock options with a strike price that is not “in-the-money” at its discretion (the aggregate authorization to the Stock Option Committee to be known as the “Vesting Authorization”) through June 30, 2005; for similar reasons and understanding the SEC had issued a

release amending the compliance date for SFAS No. 123R, on May 9, 2005 our Board of Directors approved the extension of the Vesting Authorization to our Stock Option Committee from June 30, 2005 to December 31, 2005. On March 30, 2005 our Stock Option Committee exercised its discretion and accelerated the vesting of outstanding but unvested stock options with a strike price greater than or equal to \$0.82. These options were not “in-the-money” at that time, and therefore, there was no compensation expense recorded in accordance with APB No. 25 as a result of this modification. However, for pro forma purposes, in accordance with SFAS No. 123, the remaining unamortized compensation related to these options, calculated under SFAS No. 123 of approximately \$540 thousand, was recorded in 2005. This action effected approximately 750 thousand options, approximately 55 thousand of which were held by our Directors and Executive Officers. Had this action not been taken, and had all approximately 750 thousand options continued to vest according to the vesting schedules in place prior to the acceleration, we would have recorded incremental compensation related to these options of approximately \$275 thousand on a pro forma basis for the nine months ending December 31, 2005. We also have an employee stock purchase plan under which we expect to recognize compensation expense under SFAS No. 123R beginning on January 1, 2006.

There are four key inputs to the Black-Scholes model which we use to value our options: 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 fair value calculated for the option. Our expected term input was estimated in 2005 based on our historical experience for time from option grant to option exercise for all employees and in 2004 and 2003 based on a software program to which an input was our historical exercise experience for current employees; 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 2005 and 2003 and a combination of our historical price volatility and a peer group volatility in 2004. Our risk-free interest rate input was determined based on the U.S. Treasury yield curve at the time of option issuance in 2005, 2004 and 2003. Our expected dividends input was zero in 2005, 2004 and 2003. Different assumptions could materially impact the resulting option value calculated. In the twelve months ended December 31, 2005, we had pro forma stock option compensation of approximately \$3.020 million related to recognition of the vesting of options to purchase approximately 5.1 million shares. The underlying assumptions made in valuing these stock options, weighted by number of

options and stock fair value at the time of grant, were as follows: expected term of 3.1 years, expected volatility of 91%, risk-free interest rate of 4.01% and expected dividends of zero. A tranche of “at-the-money” options granted under these assumptions in the same number as above would require a fair value price of approximately \$0.98 per share (the “Benchmark Tranche”) to yield the same value as above (the “Benchmark Value”). The following table represents the approximate decrease, in thousands of dollars, of the value of the Benchmark Tranche under different expected term and expected volatility assumptions assuming all other inputs are the same. For example, the Benchmark Tranche is “at-the-money” options to purchase approximately 5.1 million shares with a fair market stock value of \$0.98 per share, and if the Benchmark Tranche is valued using an expected term of 3.1 years, expected volatility of 91%, a risk-free interest rate of 4.01% and expected dividends of zero, we obtain a fair value of approximately \$3.020 million – the Benchmark Value. If we value the Benchmark Tranche under the same assumptions, except we assume an expected term of 5.0 years instead of 3.1 years and an expected volatility of 60% instead of 91%, we obtain a value of approximately \$2.725 million, or a decrease of approximately \$295 thousand as compared to the Benchmark Value.

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Time to Expiration (in years)	Volatility									
	15%	30%	45%	60%	75%	90%	105%	120%	135%	150%
1	2,622	2,336	2,050	1,769	1,494	1,223	963	718	478	254
2	2,397	2,009	1,621	1,249	887	545	228	(68)	(338)	(578)
3	2,203	1,749	1,295	861	453	80	(261)	(562)	(823)	(1,052)
4	2,025	1,524	1,024	550	116	(272)	(614)	(904)	(1,149)	(1,348)
5	1,861	1,325	790	295	(154)	(547)	(879)	(1,154)	(1,369)	(1,542)
6	1,708	1,147	586	70	(384)	(772)	(1,088)	(1,338)	(1,527)	(1,670)
7	1,560	984	402	(124)	(578)	(950)	(1,251)	(1,476)	(1,639)	(1,756)
8	1,422	831	239	(292)	(741)	(1,103)	(1,379)	(1,583)	(1,721)	(1,818)
9	1,290	693	86	(445)	(884)	(1,231)	(1,481)	(1,665)	(1,782)	(1,859)
10	1,162	560	(47)	(578)	(1,006)	(1,333)	(1,568)	(1,726)	(1,828)	(1,889)

Pro forma stock option compensation related to recognition of the vesting of options of approximately \$3.020 million for the year ending on December 31, 2005 may not be indicative of the future impact of SFAS No. 123R. Assuming all options vest according to the vesting schedules currently in place, we have approximately \$83 thousand of compensation cost to be recognized after 2005 underlying employee stock options currently outstanding, approximately \$78 thousand of which is to be recognized in 2006. Under our current Director Compensation Policy, we expect to recognize approximately \$260 thousand of compensation expense for options we expect to issue to Outside Directors in 2006. The Compensation Committee of our Board of Directors is currently considering alternatives regarding different forms of long-term compensation for future use, including the continued use of stock options. The decisions of the Compensation Committee of our Board of Directors regarding stock options is likely to be a key factor in the future impact of SFAS No. 123R on our financial statements.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk.

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

Interest Rate Risk

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 effected by changes in market interest rates. At December 31, 2005, approximately \$9.5 million was outstanding on these lines of credit and other borrowings with a weighted average interest rate of 9.93%. We also had approximately \$5.2 million of cash and cash equivalents at December 31, 2005, the majority of which was invested in liquid interest bearing accounts. We had no interest rate hedge transactions in place on December 31, 2005. We completed an interest rate risk sensitivity analysis based on the above and an assumed one-percentage point increase/decrease in interest rates. If market rates increase/decrease by one percentage point, we would experience an increase/decrease in annual interest expense of approximately \$43 thousand based on our outstanding balances as of December 31, 2005.

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Foreign Currency Risk

Our investment in foreign assets consists primarily of our investment in our European subsidiary. Foreign currency risk may impact our results of operations. In cases where we purchase inventory in one currency and sell corresponding products in another, our gross margin percentage is typically at risk based on foreign currency exchange rates. In addition, in cases where we may be generating operating income in foreign currencies, the magnitude of such operating income when translated into U.S. dollars will be at risk based on foreign currency exchange rates. Our agreements with suppliers and customers vary significantly in regard to the existence and extent of currency adjustment and other currency risk sharing provisions. We had no foreign currency hedge transactions in place on December 31, 2005.

We have a wholly-owned subsidiary in Switzerland which uses the Swiss Franc as its functional currency. We purchase inventory in foreign currencies, primarily Japanese Yen and Euros, and sell corresponding products in U.S. dollars. We also sell products in foreign currencies, primarily Japanese Yen and Euros, where our inventory costs are in U.S. dollars. Based on our 2005 results of operations, if foreign currency exchange rates were to strengthen/weaken by 25% against the dollar, we would expect a resulting pre-tax loss/gain of approximately \$900 thousand.

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HESKA CORPORATION

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

[Report of Independent Registered Public Accounting Firm](#)[Consolidated Balance Sheets as of December 31, 2004 and 2005](#)[Consolidated Statements of Operations and Comprehensive Income \(Loss\) for the years ended December 31, 2003, 2004 and 2005](#)[Consolidated Statements of Stockholders' Equity for the years ended December 31, 2003, 2004 and 2005](#)[Consolidated Statements of Cash Flows for the years ended December 31, 2003, 2004 and 2005](#)[Notes to Consolidated Financial Statements](#)

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders
Heska Corporation:

We have audited the accompanying consolidated balance sheets of Heska Corporation (a Delaware corporation) and subsidiaries as of December 31, 2004 and 2005, and the related consolidated statements of operations and comprehensive income (loss), stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2005. In connection with our audits of these consolidated financial statements, we also have audited the financial statement schedule of valuation and qualifying accounts. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule 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 audit 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, as well as 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, 2004 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule of valuation and qualifying accounts, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/S/ KPMG LLP

Denver, Colorado
March 29, 2006

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

	December 31,	
	2004	2005
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 4,982	\$ 5,231
Accounts receivable, net of allowance for doubtful accounts of \$95 and \$88, respectively	10,634	9,008
Inventories, net	11,726	11,654
Other current assets	1,100	952
Total current assets	28,442	26,845
Property and equipment, net	7,925	7,428
Intangible assets, net	1,499	1,529
Goodwill	643	714
Deferred tax asset, net of current portion	—	110
Other assets	215	158
Total assets	\$ 38,724	\$ 36,784

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Accounts payable	\$ 6,697	\$ 5,186
Accrued liabilities	3,187	1,908
Current portion of deferred revenue	2,708	2,912
Line of credit	10,375	9,453
Current portion of capital lease obligations	6	7
Current portion of long-term debt	296	1,256
Total current liabilities	<u>23,269</u>	<u>20,722</u>
Capital lease obligations, net of current portion	27	20
Long-term debt, net of current portion	1,439	2,683
Deferred revenue, net of current portion, and other	11,410	10,126
Total liabilities	<u>36,145</u>	<u>33,551</u>
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$.001 par value, 25,000,000 shares authorized; none issued or outstanding	—	—
Common stock, \$.001 par value, 75,000,000 shares authorized; 49,338,636 and 50,042,355 shares issued and outstanding, respectively	49	50
Additional paid-in capital	212,533	213,054
Deferred compensation	(67)	—
Accumulated other comprehensive income (loss)	170	(47)
Accumulated deficit	(210,106)	(209,824)
Total stockholders' equity	<u>2,579</u>	<u>3,233</u>
Total liabilities and stockholders' equity	<u>\$ 38,724</u>	<u>\$ 36,784</u>

See accompanying notes to consolidated financial statements.

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HESKA CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

(in thousands, except per share amounts)

	Year Ended December 31,		
	2003	2004	2005
Revenue:			
Product revenue, net:			
Core companion animal health	\$ 47,645	\$ 52,719	\$ 54,716
Other vaccines, pharmaceuticals and products	16,388	12,968	12,833
Total product revenue, net	<u>64,033</u>	<u>65,687</u>	<u>67,549</u>
Research, development and other	1,292	2,004	1,888
Total revenue, net	<u>65,325</u>	<u>67,691</u>	<u>69,437</u>
Cost of revenue:			
Cost of products sold	38,399	42,253	42,515
Cost of research, development and other	626	729	1,095
Total cost of revenue	<u>39,025</u>	<u>42,982</u>	<u>43,610</u>
Gross profit	<u>26,300</u>	<u>24,709</u>	<u>25,827</u>
Operating expenses:			
Selling and marketing	15,750	15,616	14,020
Research and development	6,146	5,891	3,749
General and administrative	7,083	7,442	7,187
Other	515	—	—
Total operating expenses	<u>29,494</u>	<u>28,949</u>	<u>24,956</u>
Income (loss) from operations	(3,194)	(4,240)	871
Interest and other expense (income):			
Interest income	(71)	(25)	(63)
Interest expense	459	690	1,086
Other, net	—	—	—
	(174)	(90)	(249)
Income (loss) before income taxes	<u>(3,408)</u>	<u>(4,815)</u>	<u>97</u>
Income tax expense (benefit)	51	—	(185)
Net income (loss)	<u>(3,459)</u>	<u>(4,815)</u>	<u>282</u>
Other comprehensive income (loss):			
Foreign currency translation adjustments	159	207	(340)
Other	34	31	123
Other comprehensive income (loss)	<u>193</u>	<u>238</u>	<u>(217)</u>
Comprehensive income (loss)	<u>\$ (3,266)</u>	<u>\$ (4,577)</u>	<u>\$ 65</u>
Basic and diluted net income (loss) per share	<u>\$ (0.07)</u>	<u>\$ (0.10)</u>	<u>\$ 0.01</u>
Weighted average outstanding shares used to compute basic net income (loss) per share			
	<u>48,115</u>	<u>49,029</u>	<u>49,650</u>

Weighted average outstanding shares used to compute diluted net income (loss) per share	48,115	49,029	50,438
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See accompanying notes to consolidated financial statements.

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

	Common Stock		Additional Paid-in Capital	Deferred Compensation	Accumulated Other Comprehensive Gain (Loss)	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amount					
Balances January 1, 2003	47,808	\$ 48	\$ 211,726	\$ (471)	\$ (261)	\$ (201,832)	\$ 9,210
Issuance of common stock related to options, ESPP and other	1,022	1	618	—	—	—	619
Cancellation of restricted stock	(3)	—	(213)	213	—	—	—
Recognition of stock based compensation	—	—	—	93	—	—	93
Minimum pension liability adjustments	—	—	—	—	34	—	34
Foreign currency translation adjustments	—	—	—	—	159	—	159
Net income (loss)	—	—	—	—	—	(3,459)	(3,459)
Balances, December 31, 2003	48,827	49	212,131	(165)	(68)	(205,291)	6,656
Issuance of common stock related to options, ESPP and other	519	—	409	—	—	—	409
Cancellation of restricted stock	(7)	—	(7)	7	—	—	—
Recognition of stock based compensation	—	—	—	91	—	—	91
Minimum pension liability adjustments	—	—	—	—	31	—	31
Foreign currency translation adjustments	—	—	—	—	207	—	207
Net income (loss)	—	—	—	—	—	(4,815)	(4,815)
Balances, December 31, 2004	49,339	49	212,533	(67)	170	(210,106)	2,579
Issuance of common stock related to options, ESPP and other	769	1	579	—	—	—	580
Repurchase of stock	(66)	—	(58)	—	—	—	(58)
Recognition of stock based compensation	—	—	—	67	—	—	67
Minimum pension liability adjustments	—	—	—	—	96	—	96
Unrealized gain on available for sale investments	—	—	—	—	27	—	27
Foreign currency translation adjustments	—	—	—	—	(340)	—	(340)
Net income (loss)	—	—	—	—	—	282	282
Balances, December 31, 2005	50,042	\$ 50	\$ 213,054	\$ —	\$ (47)	\$ (209,824)	\$ 3,233

See accompanying notes to consolidated financial statements.

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

	Year Ended December 31,		
	2003	2004	2005
CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:			
Net income (loss)	\$ (3,459)	\$ (4,815)	\$ 282
Adjustments to reconcile net income (loss) to cash provided by (used in) operating activities:			
Depreciation and amortization	1,749	1,337	1,850
Amortization of intangible assets	145	393	157
Deferred tax benefit	—	—	(185)
Stock based compensation	93	91	90
Loss on disposition of assets	163	—	17
Unrealized gain on foreign currency translation	—	—	(149)
Changes in operating assets and liabilities:			

Accounts receivable	(2,893)	2,067	1,585
Inventories	(2,137)	(1,398)	38
Other current assets	(78)	(261)	86
Other long-term assets	(14)	(2)	84
Accounts payable	1,824	511	(1,494)
Accrued liabilities	(640)	(199)	(1,265)
Deferred revenue and other long-term liabilities	5,817	1,138	(948)
Net cash provided by (used in) operating activities	570	(1,138)	148
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from licensing of technology and product rights	—	400	—
Proceeds from disposition of property and equipment	35	—	—
Proceeds from repayment of loan	—	—	100
Purchases of property and equipment	(1,407)	(1,290)	(1,376)
Capitalized patent costs	(420)	(541)	(187)
Net cash provided by (used in) investing activities	(1,792)	(1,431)	(1,463)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of common stock	619	409	557
Repurchase of stock	—	—	(58)
Proceeds from (repayments of) line of credit borrowings, net	(68)	2,847	(922)
Proceeds from long-term debt	200	—	2,500
Repayments of debt and capital lease obligations	(779)	(761)	(302)
Net cash provided by (used in) financing activities	(28)	2,495	1,775
EFFECT OF EXCHANGE RATE CHANGES ON CASH	101	179	(211)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(1,149)	105	249
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	6,026	4,877	4,982
CASH AND CASH EQUIVALENTS, END OF YEAR	\$ 4,877	\$ 4,982	\$ 5,231

See accompanying notes to consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND BUSINESS

Heska Corporation (“Heska” or the “Company”) discovers, develops, manufactures, markets, sells, distributes and supports veterinary products. Heska’s core focus is on the canine and feline companion animal health markets. The Company has devoted substantial resources to the research and development of innovative products in these areas, where it strives to provide high value products for unmet needs and advance the state of veterinary medicine.

Heska is comprised of two reportable segments, Core Companion Animal Health and Other Vaccines, Pharmaceuticals and Products. The Core Companion Animal Health segment includes diagnostic and monitoring instruments and supplies as well as single use diagnostic and other tests, vaccines and pharmaceuticals, primarily for canine and feline use. These products are sold directly by the Company as well as through independent third party distributors and other distribution relationships. The Other Vaccines, Pharmaceuticals and Products segment (“OVP”), previously reported as the Diamond Animal Health segment, includes private label vaccine and pharmaceutical production, primarily for cattle but also for other animals including small mammals, horses and fish. All OVP products are sold by third parties under third party labels.

Cumulative net losses from inception of the Company in 1988 through December 31, 2005, have totaled \$209.8 million. During the year ended December 31, 2005, the Company recorded a net income of approximately \$282 thousand and operations provided cash of approximately \$148 thousand. The Company’s ability to achieve sustained profitable operations will depend primarily upon its ability to successfully market its products and commercialize new products. There can be no guarantee that the Company will be successful in these endeavors or attain quarterly, annual, or sustained profitability in the future.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements include the accounts of the Company and of its wholly-owned subsidiaries since their respective dates of acquisitions. All material intercompany transactions and balances have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported 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/obsolete inventory, in determining the period over which the Company’s obligations are fulfilled under agreements to license product rights and/or technology rights, evaluating long-lived assets for impairment and in determining the need for, and the amount of, a valuation allowance on deferred tax assets.

Reclassifications

Certain prior year amounts have been reclassified to be consistent with the current year presentation. These reclassifications include certain amortized fees totaling approximately \$83 thousand and \$130 thousand for the years ended December 31, 2003 and 2004, respectively, previously reflected as

Research, Development and Other Revenue which are now included in Product Revenue and certain costs previously reflected as Research and Development Expenses totaling approximately \$626 thousand and \$729 thousand for the years ended December 31, 2003 and 2004, respectively, which are now included in Cost of Research, Development and Other Revenue.

Trade Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company determines the allowance based on historical write-off experience. The Company reviews its allowance for doubtful accounts monthly. Past due balances over 90 days and over a specified amount are reviewed individually for collectibility. Account balances are charged against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance-sheet credit exposure related to its customers.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash and cash equivalents and accounts receivable. The Company maintains the majority of its cash and cash equivalents with financial institutions that management believes are creditworthy in the form of demand deposits, U.S. government agency obligations and U.S. corporate commercial paper. The Company has no significant off-balance sheet concentrations of credit risk such as foreign exchange contracts, options contracts or other currency foreign hedging arrangements. Its accounts receivable balances are due primarily from domestic veterinary clinics and individual veterinarians, and both domestic and international corporations.

Cash and Cash Equivalents

Cash and cash equivalents are stated at cost, which approximates market, and include short-term, highly liquid investments with original maturities of less than three months. The Company valued its European 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. The Company held 567 and 10,391 Euros at December 31, 2004 and 2005, respectively. The Company held 5,556,840 and 30,178,209 Yen at December 31, 2004 and 2005, respectively.

Fair Value of Financial Instruments

The Company's financial instruments consist of cash and cash equivalents, short-term trade receivables and payables and notes payable, including the revolving line of credit. The carrying values of cash and cash equivalents and short-term trade receivables and payables approximate fair value. The fair value of notes payable is estimated based on current rates available for similar debt with similar maturities and collateral, and at December 31, 2004 and 2005, 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 market using the first-in, first-out method. Inventory manufactured by the Company includes the cost of material, labor and overhead. If the cost of inventories exceeds estimated fair value, provisions are made to reduce the carrying value to fair value.

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

	December 31,	
	2004	2005
Raw materials	\$ 3,537	\$ 3,002
Work in process	3,526	3,090
Finished goods	5,022	6,318
Allowance for excess or obsolete inventory	(359)	(756)
	<u>\$ 11,726</u>	<u>\$ 11,654</u>

Property and Equipment

Property and equipment are recorded at cost and depreciated on a straight-line basis over the estimated useful lives of the related assets. Leasehold improvements are amortized over the applicable lease period or their estimated useful lives, whichever is shorter. Maintenance and repairs are charged to expense when incurred, and major renewals and improvements are capitalized.

Property and equipment consist of the following (in thousands):

	Estimated Useful Life	December 31,	
		2004	2005
Land	N/A	\$ 377	\$ 377
Building	10 to 20 years	2,678	2,678
Machinery and equipment	3 to 15 years	19,743	20,427
Leasehold and building improvements	7 to 15 years	5,632	4,931
		<u>28,430</u>	<u>28,413</u>
Less accumulated depreciation and amortization		(20,505)	(20,985)
		<u>\$ 7,925</u>	<u>\$ 7,428</u>

Depreciation and amortization expense for property and equipment was \$1.7 million, \$1.3 million and \$1.9 million for the years ended December 31, 2003, 2004 and 2005, respectively.

The Company continually evaluates whether events and circumstances have occurred that indicate the remaining estimated useful life of long-lived assets may warrant revision, or that the remaining balance of these assets may not be recoverable. When deemed necessary, the Company completes this evaluation by comparing the carrying amount of the assets against 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.

Goodwill and Other Intangible Assets

Goodwill is subject to an annual assessment for impairment. Impairment is indicated when the carrying amount of the related reporting unit is greater than its estimated fair value.

The Company's recorded goodwill relates to the acquisition in 1997 of Heska AG. This goodwill is reviewed at least annually for impairment. At December 31, 2004 and 2005, goodwill was approximately \$643 thousand and \$714 thousand, respectively, and is included in the assets of the Core Companion Animal Health segment. The Company completed its annual analysis of the fair value of its goodwill at December 31, 2005 and determined there was no indicated impairment of its goodwill. There can be no assurance that future goodwill impairments will not occur. There are no other intangible assets that are not being amortized on a periodic basis.

The Company incurs costs, paid to third-party law firms, to prosecute patents on its proprietary technologies. The Company capitalizes qualifying costs related to its patents. At December 31, 2004 and 2005, respectively, the cost basis of the capitalized patent costs was approximately \$2.1 million and \$2.3 million, the accumulated amortization was approximately \$594 thousand and \$748 thousand, and the net book value was approximately \$1.5 million at each year end. The Company expects amortization expense for these capitalized patent costs of approximately \$153 thousand in 2006 and approximately \$153 thousand for each of the four years thereafter. These costs are being amortized over an average life of 15 years which is the estimated life of the patents. Amortization expense for the years ended December 31, 2003, 2004 and 2005, was approximately \$145 thousand, \$393 thousand and \$157 thousand, respectively.

Derivative Instruments and Hedging Activities

The Company has utilized derivative financial instruments to reduce financial market risks in the past. If used, these instruments may be used to hedge foreign currency, interest rate and certain equity market exposures of underlying assets, liabilities and other obligations. The Company does not use derivative financial instruments for speculative or trading purposes. The Company had no hedging activities in 2003, 2004 and 2005.

Revenue Recognition

The Company generates its revenues through sale of products, licensing of product and technology rights, and research and development services. Revenue is accounted for in accordance with the guidelines provided by SEC Codification of Staff Accounting Bulletins, Topic 13: Revenue Recognition. The Company's 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, if required, with an appropriate provision for estimated returns and other allowances. 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. The Company maintains an allowance for sales returns based upon its customer policies and historical experience. Shipping and handling costs charged to customers is included as revenue, and the related costs are recorded as a component of cost of products sold.

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

Upfront payments received by the Company under arrangements for product, patent or technology rights in which the Company retains 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 or technology. The Company received approximately \$6.0 million, \$3.2 million and \$560 thousand of such payments in 2003, 2004 and 2005, respectively. Revenue from royalties is recognized based upon historical experience or as the Company is informed that the related products have been sold.

For multiple-element arrangements that are not subject to a higher level of authoritative literature, the Company follows the guidelines of the Financial Accounting Standards Board's ("FASB") Emerging Issues Task Force ("EITF") Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables" ("EITF 00-21"), in determining the separate units of accounting. For those arrangements subject to the separation criteria of EITF 00-21, the Company accounts for each of the individual units of accounting as a separate and discrete earnings process considering, among other things, whether a delivered item has value to the client on a standalone basis. For such multiple-element arrangements, total revenue is allocated to the separate units of accounting based upon objective and reliable evidence of the fair value of the undelivered item. The determination of separate units of accounting, and the determination of objective and reliable evidence of fair value of the undelivered item, both require judgments to be made by the Company.

Royalties payable in connection with certain licensing agreements (see Note 10) are reflected in cost of products sold as incurred.

Stock-Based Compensation

The Company accounts for its stock-based compensation plans using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), and related interpretations, and follows the disclosure provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123") and Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure" ("SFAS No. 148"). At December 31, 2005, the Company had two stock-based compensation plans. See Note 7 for a description of these plans and additional disclosures regarding the plans. The Company recorded compensation expense of \$93 thousand, \$91 thousand and \$67 thousand for the years ended December 31, 2003, 2004 and 2005, respectively, related to grants of restricted common stock. The Company recognized \$23 thousand of compensation expense related to the exercise of one option in 2005.

Had compensation expense for the Company's stock-based compensation plans been based on the fair value at the grant dates for awards under those plans, consistent with the methodology of SFAS No. 123, the Company's net loss and net loss per share for the years ended December 31, 2003, 2004 and 2005 would approximate the pro forma amounts as follows (in thousands, except per share amounts):

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	Year Ended December 31,		
	2003	2004	2005
	(in thousands except per share data)		
Net income (loss) as reported	\$ (3,459)	\$ (4,815)	\$ 282
Stock-based employee compensation expense included in the determination of net loss, as reported	93	91	90
Stock-based employee compensation expense as if the fair value based method had been applied to all awards	(1,649)	(4,129)	(3,175)
Net income (loss), pro forma	\$ (5,015)	\$ (8,853)	\$ (2,803)
Net income (loss) per share:			
Basic and diluted – as reported	\$ (0.07)	\$ (0.10)	\$ 0.01
Basic and diluted – pro forma	\$ (0.10)	\$ (0.18)	\$ (0.06)

As discussed in more detail in Note 7, in December 2004 and March 2005 the vesting of options to purchase approximately 2.2 million shares and 750 thousand shares, respectively, was accelerated. These options were not "in-the-money" at the time of acceleration and, therefore, there was no compensation expense recorded in accordance with APB No. 25 as a result of the modifications. However, for pro forma purposes in accordance with SFAS No. 123, the remaining unamortized compensation related to these options, calculated under SFAS No. 123 of approximately \$2.1 million and \$540 thousand was recorded in 2004 and 2005, respectively, and included in the table above.

Advertising Costs

The Company expenses advertising costs as incurred. Advertising expenses were \$748 thousand, \$712 thousand and \$353 thousand for the years ended December 31, 2003, 2004 and 2005, respectively.

Other

The Company recorded approximately \$515 thousand of other operating expense resulting from settlement of litigation for the year ended December 31, 2003.

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 judgmental assessment of available evidence if deemed more likely than not that some or all of the deferred tax assets will not be realized.

Basic and Diluted Net Income (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

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stock equivalents (such as stock options and warrants) determined using the treasury stock method. Prior to fiscal 2005, due to the Company's net losses, all potentially dilutive securities are anti-dilutive and as a result, basic net loss per share is the same as diluted net loss per share for all periods prior to 2005. At December 31, 2003, 2004 and 2005, securities that have been excluded from diluted net income (loss) per share because they would be anti-dilutive are outstanding options to purchase 7,954,648, 9,350,959 and 7,918,601 shares, respectively, of the Company's common stock. Securities included in the diluted

net income per share calculation at December 31, 2005, using the treasury stock method, were outstanding options to purchase 788,000 shares of the Company's common stock.

Comprehensive Income (Loss)

Comprehensive incomes (loss) includes net income (loss) adjusted for the results of certain stockholders' equity changes not reflected in the consolidated statements of operations. Such changes include foreign currency items and minimum pension liability adjustments. At December 31, 2005, Accumulated Other Comprehensive Income consists of \$74 thousand loss for cumulative translation adjustments and \$27 thousand of unrealized gain on available for sale investments. At December 31, 2004, Accumulated Other Comprehensive Loss consists of cumulative translation loss adjustments of \$311 thousand and income from minimum pension liability adjustments and other of \$141 thousand. At December 31, 2003, Accumulated Other Comprehensive Loss consists of cumulative translation loss adjustments of \$104 thousand and income from minimum pension liability adjustments and other of \$172 thousand.

Foreign Currency Translation

The functional currency of the Company's international subsidiary, Heska AG, is the Swiss Franc. Assets and liabilities of the Company's international 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.

New Accounting Pronouncements

SFAS No. 123R, "Share-Based Payment" (Revised 2004)

Statement of Financial Accounting Standards No. 123 ("SFAS No. 123R") was revised and promulgated in December 2004. The Company intends to adopt this standard when required. On April 14, 2005, the Securities and Exchange Commission ("SEC") issued a release amending the compliance dates for SFAS No. 123R. Under the SEC's new rule, companies in Heska's position may implement SFAS No. 123R at the beginning of their next fiscal year, instead of the next reporting period as originally required under SFAS No. 123R, that begins after June 15, 2005. The Company originally intended to adopt SFAS No. 123R on July 1, 2005 but based on the SEC's action on April 14, 2005, the Company currently intends to adopt SFAS No. 123R effective January 1, 2006. The Company plans to adopt SFAS No. 123R under the modified prospective method of adoption. Statement of Financial Accounting Standards No. 123 "Accounting for Stock-Based Compensation" ("SFAS No. 123"), which became effective in 1996, allows for the continued measurement of compensation cost for stock-based compensation using the intrinsic value based method under "Accounting for Stock Issued to Employees" ("APB No. 25"), provided that pro forma disclosures are made of net income or loss, assuming the fair value based method of SFAS No. 123 had been applied. The Company has elected to account for its stock-based compensation plans under APB No. 25. Upon adoption of SFAS No. 123R, the Company will be required to recognize compensation expense using the fair value-based model for options that vest after the effective date of SFAS No. 123R adoption, including those that were granted prior to the effective date of SFAS No. 123R adoption. This will result in recording compensation expense for periods after the effective date of SFAS No. 123R adoption. The Company also has an employee stock purchase plan under which it will recognize compensation expense under SFAS No. 123R beginning on the effective date of 123R adoption. Historically, under APB No. 25, the Company

recorded minimal amounts of stock-based compensation. Assuming all options vest according to the vesting schedule in place at December 31, 2005, the Company has approximately \$83 thousand of compensation cost underlying employee stock options currently outstanding to be recognized after 2005, approximately \$78 thousand of which is to be recognized in 2006. The Compensation Committee of the Company's Board of Directors is currently considering alternatives regarding different forms of long-term compensation for future use, including the continued use of stock options. The decisions of the Compensation Committee of the Company's Board of Directors regarding stock options is likely to be a key factor in the future impact of SFAS No. 123R on the Company's financial statements.

3. CAPITAL LEASE OBLIGATIONS

The Company has entered into certain capital lease agreements for laboratory equipment, office equipment, machinery and equipment, and computer equipment and software. At December 31, 2004 and 2005, the Company had capitalized machinery and equipment under capital leases with a gross value of approximately \$38 thousand and \$38 thousand, respectively, and net book value of approximately \$34 thousand and \$25 thousand, respectively. The capitalized cost of the equipment under capital leases is included in the accompanying consolidated balance sheets under the respective asset classes. Under the terms of the Company's lease agreements, the Company is required to make monthly payments of principal and interest through the year 2009, at interest rates ranging from 11.0% to 14.0% per annum. The equipment under the capital leases serves as security for the leases.

The future annual minimum required payments under capital lease obligations as of December 31, 2005 were as follows (in thousands):

Year Ending December 31,	
2006	\$ 10
2007	10
2008	10
2009	3
Total future minimum lease payments	33
Less amount representing interest	(6)
Present value of future minimum lease payments	27
Less current portion	(7)
Total long-term capital lease obligations	\$ 20

4. RESTRUCTURING EXPENSES

In 2002, the Company recorded restructuring charges of \$566 thousand for personnel severance costs and other expenses related to 32 individuals and \$150 thousand related to the closure of a leased facility. The Company also reversed approximately \$330 thousand of the restructuring charge recorded in the fourth quarter of 2001 due to the favorable settlement of certain liabilities. For 2002, the Company recorded net restructuring expenses totaling \$386 thousand.

Shown below is a reconciliation of restructuring costs for the years ended December 31, 2003, 2004 and 2005 (in thousands):

	Balance at December 31, 2002	Payments Through December 31, 2003	Balance at December 31, 2003
Severance pay and benefits	\$ 73	\$ (73)	\$ —
Leased facility closure costs	120	(69)	51
Products and other	150	(80)	70
Total	<u>\$ 343</u>	<u>\$ (222)</u>	<u>\$ 121</u>

	Balance at December 31, 2003	Payments Through December 31, 2004	Balance at December 31, 2004
Leased facility closure costs	\$ 51	\$ (36)	\$ 15
Products and other	70	(70)	—
Total	<u>\$ 121</u>	<u>\$ (106)</u>	<u>\$ 15</u>

	Balance at December 31, 2004	Payments Through December 31, 2005	Balance at December 31, 2005
Leased facility closure costs	\$ 15	\$ (15)	\$ —

The balance of \$15 thousand is included in accrued liabilities in the accompanying consolidated balance sheets as of December 31, 2004.

5. LONG-TERM DEBT

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

	December 31,	
	2004	2005
Promissory note to the City of Des Moines, due in monthly installments through June 2006, with a stated interest rate of 3%.	\$ 102	\$ 34
Real estate mortgage loan with a commercial bank, due in monthly installments, with the balance due of \$163 thousand in full June 30, 2009, with a stated interest rate of prime plus 2.5% at December 31, 2004 and prime plus 2.75% at December 31, 2005 (7.75% and 10.0%, respectively).	1,117	905
Term loan with a commercial bank, secured by machinery and equipment, paid in full January 2005.	16	—
Term loan with a commercial bank, secured by machinery and equipment, due in monthly installments beginning February 2006 with the balance due of \$481 thousand in full June 30, 2009, with a stated interest rate of prime plus 2.75% at December 31, 2005 (10.0%).	—	2,000
Term loan with a commercial bank, secured by machinery and equipment, due in monthly installments beginning February 2006 with the balance due of \$120 thousand in full June 30, 2009, with a stated interest rate of prime plus 2.75% at December 31, 2005 (10.0%).	—	500
Subordinated promissory note with a significant customer for facilities improvements in Des Moines, secured by the manufacturing facility, due in annual installments of \$250 in 2004 and \$500 in 2006, with a stated interest rate of prime plus 1.0% at December 31, 2004 and December 31, 2005 (6.25% and 8.25%, respectively).	500	500
	<u>1,735</u>	<u>3,939</u>
Less installments due within one year	(296)	(1,256)
	<u>\$ 1,439</u>	<u>\$ 2,683</u>

The Company has a credit and security agreement with Wells Fargo Business Credit, Inc., an affiliate of Wells Fargo Bank, which expires June 30, 2009. The agreement includes the real estate mortgage loan and term loans above, and a \$12.0 million asset-based revolving line of credit with a stated interest rate at December 31, 2005 of prime plus 2.75%. Amounts due under the credit facility are secured by a first security interest in essentially all of the Company's assets. Under the agreement, the Company is required to comply with certain financial and non-financial covenants. Among the financial covenants are requirements for monthly minimum book net worth, quarterly minimum net income and monthly minimum liquidity. The amount available for borrowings under the line of credit varies based upon available cash, eligible accounts receivable and eligible inventory. As of December 31, 2005, approximately \$9.5 million was outstanding on the line of credit and there was \$567 thousand available capacity for additional borrowings under the line of credit agreement. The Company is restricted from paying dividends under the terms of the credit facility agreement.

The City of Des Moines promissory note is secured by a first security interest in essentially all assets of the OVP segment except assets acquired through capital leases and are included as cross-collateralized obligations by the respective lenders. The City of Des Moines has subordinated its security interest in these assets to Wells Fargo.

Maturities of long-term debt as of December 31, 2005 were as follows (in thousands):

Year Ending December 31,	
2006	\$ 1,256
2007	768
2008	768
2009	1,147
	<u>\$ 3,939</u>

6. INCOME TAXES

As of December 31, 2005, the Company had a net domestic operating loss carryforward (“NOL”), of approximately \$171.7 million, a domestic alternative minimum tax credit of approximately \$23 thousand and a domestic research and development tax credit carryforward of approximately \$307 thousand. 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 believes the latest, and most restrictive, Ownership Change occurred at the time of its initial public offering in July 1997. The Company does not believe this Ownership Change will place a significant restriction on its ability to utilize its NOLs in the future. The Company also has net operating loss carryforwards in Switzerland of approximately \$1.9 million at December 31, 2005 related to losses previously recorded by Heska AG, the Company’s operating subsidiary in Switzerland.

The Company’s domestic NOLs represent a deferred tax asset, which has been completely offset by a valuation allowance. Recognition of this asset requires future taxable income and the Company believes, based on its history of domestic operating losses since inception, that it is more likely than not that it will be unable to generate sufficient taxable income to utilize the domestic NOLs, and therefore, a valuation allowance has been established for the entire domestic deferred tax asset and no benefit for domestic income taxes has been recognized in the accompanying consolidated statements of operations. Based on the profitable operating performance of Heska AG, the Company’s evaluation determined that the NOL in Switzerland is realizable on a more-likely-than-not basis and the related valuation allowance was released in the fourth quarter of 2005, resulting in an income tax benefit of approximately \$185 thousand. Heska AG has a “tax holiday” from canton, municipal and church income taxes in the canton of Fribourg through August 31, 2007. These tax holidays reduce the amount of the deferred tax asset that would otherwise be recorded by approximately \$255 thousand. The Company does not have a “tax holiday” for federal taxes in Switzerland. Accordingly, the Company expects to incur approximately \$75 thousand in 2006 tax expense related to federal taxes in Switzerland.

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

	Year Ended December 31,		
	2003	2004	2005
Domestic	\$ (3,752)	\$ (5,718)	\$ (1,080)
Foreign	344	903	1,177
	<u>\$ (3,408)</u>	<u>\$ (4,815)</u>	<u>\$ 97</u>

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

	December 31,	
	2004	2005
Current deferred tax assets (liabilities):		
Inventory	\$ 156	\$ 309
Accrued compensation	41	17
Restructuring reserve	6	—
Net operating loss carryforwards—foreign	—	75
Other	310	317
	<u>513</u>	<u>718</u>
Valuation allowance	(513)	(643)
Total current deferred tax assets (liabilities)	<u>—</u>	<u>75</u>
Noncurrent deferred tax assets (liabilities):		
Research and development and other credits	607	330
Deferred revenue	5,211	4,853
Pension liability	17	—
Amortization of intangible assets	(573)	(584)
Property and equipment	858	945
Net operating loss carryforwards—domestic	64,847	65,635
Net operating loss carryforwards—foreign	—	110
	<u>70,967</u>	<u>71,289</u>
Valuation allowance	(70,967)	(71,179)
Total noncurrent deferred tax assets (liabilities)	<u>\$ —</u>	<u>\$ 110</u>

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

	Year Ended December 31,		
	2003	2004	2005
Current income tax expense (benefit):			
Federal	\$ 50	\$ —	\$ —
State	1	—	—

Foreign	—	—	—
Total current expense (benefit)	51	—	—
Deferred income tax expense (benefit):			
Federal	(1,075)	(1,790)	—
State	(145)	(231)	—
Foreign	—	—	(185)
Total deferred benefit	(1,220)	(2,021)	(185)
Valuation allowance	1,220	2,021	—
Total income tax expense (benefit)	\$ 51	\$ —	\$ (185)

The Company's income tax benefit relating to losses, respectively, for the periods presented differ from the amounts that would result from applying the federal statutory rate to those losses as follows:

	Year Ended December 31,		
	2003	2004	2005
Statutory federal tax rate	(34)%	(34)%	34%
State income taxes, net of federal benefit	(3)%	(4)%	4%
Other permanent differences	1%	1%	107%
Foreign NOL utilization	—	—	(95)%
Foreign rate difference	—	—	(199)%
Current year impact of foreign tax holiday	—	—	(166)%
Swiss NOL carry forward	—	—	(190)%
Change in valuation allowance	37%	37%	352%
Other	—	—	(38)%
Effective income tax rate	1%	0%	(191)%

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7. CAPITAL STOCK

Stock Option Plans

The Company has two stock option plans which authorize granting of stock options and stock purchase rights to employees, officers, directors and consultants of the Company to purchase shares of common stock. In 1997, the board of directors adopted the 1997 Stock Incentive Plan and terminated two prior option plans. However, options granted and unexercised under the prior plans are still outstanding. All shares that remained available for grant under the terminated plans were incorporated into the 1997 Plan. In addition, all shares subsequently cancelled under the prior plans are added back to the 1997 Plan on a quarterly basis as additional options available to grant. The number of shares reserved for issuance under the 1997 Plan increases automatically on January 1 of each year by a number equal to the lesser of (a) 1,500,000 shares or (b) 5% of the shares of common stock outstanding on the immediately preceding December 31. In May 2003, the stockholders approved a new plan, the 2003 Stock Incentive Plan, which allows for the granting of options for up to 2,390,500 shares of the Company's common stock. The number of shares reserved for issuance under all plans as of January 1, 2006 was 3,984,701.

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 the Company is sold or merged, outstanding options will either be assumed by the surviving corporation or vest immediately.

SFAS No. 123

SFAS No. 123, "Accounting for Stock-Based Compensation," defines a fair value based method of accounting for employee stock options, employee stock purchases, and similar equity instruments. However, SFAS No. 123 allows the continued measurement of compensation cost for such plans using the intrinsic value based method prescribed by APB No. 25, provided that pro forma disclosures are made of net income or loss, assuming the fair value based method of SFAS No. 123 had been applied. The Company has elected to account for its stock-based compensation plans under APB No. 25. For disclosure purposes, the Company has computed the fair values of all options granted during 2003, 2004 and 2005, using the Black-Scholes option pricing model and the following weighted average assumptions:

	2003	2004	2005
Risk-free interest rate	2.73%	3.62%	4.17%
Expected lives	4.6 years	4.5 years	2.8 years
Expected volatility	132%	76%	86%
Expected dividend yield	0%	0%	0%

Cumulative compensation cost recognized in pro forma basic net income or loss with respect to options that are forfeited prior to vesting is adjusted as a reduction of pro forma compensation expense in the period of forfeiture. Fair value computations are highly sensitive to the volatility factor assumed; the greater the volatility, the higher the computed fair value of the options granted.

The total fair value of stock options granted was computed to be approximately \$1.9 million, \$3.0 million and \$2.2 million for the years ended December 31, 2003, 2004 and 2005, respectively. The amounts are amortized ratably over the vesting periods of the options. Pro forma stock-based compensation, net of the effect of forfeitures from stock options, was \$1.5 million, \$4.0 million and \$3.0 million for 2003, 2004 and 2005, respectively.

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

	Year Ended December 31,					
	2003		2004		2005	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of period	6,378,589	\$ 1.8142	7,954,648	\$ 1.5163	9,350,959	\$ 1.4509
Granted at Market	2,505,117	\$ 0.8907	2,575,830	\$ 1.8890	3,999,897	\$ 1.0130
Granted above Market	26,121	\$ 1.4936	418	\$ 2.6300	—	\$ —
Cancelled	(618,704)	\$ 2.2869	(792,963)	\$ 3.8742	(821,161)	\$ 1.6345
Exercised	(336,472)	\$ 1.0898	(386,974)	\$ 0.7476	(540,113)	\$ 0.7222
Outstanding at end of period	7,954,648	\$ 1.5163	9,350,959	\$ 1.4509	11,989,582	\$ 1.3251
Exercisable at end of period	4,646,765	\$ 1.8790	7,939,567	\$ 1.5532	11,765,335	\$ 1.3373

The weighted average estimated fair value of options granted during the years ended December 31, 2003, 2004 and 2005 were \$0.7628, \$1.1631 and \$0.5633, respectively.

The following table summarizes information about stock options outstanding and exercisable at December 31, 2005.

Exercise Prices	Options Outstanding			Options Exercisable		
	Number of Options Outstanding at December 31, 2005	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Number of Options Exercisable at December 31, 2005	Weighted Average Exercise Price	
\$0.34 - \$0.80	2,064,421	7.24	\$ 0.6379	1,840,174	\$ 0.6325	
\$0.81 - \$0.95	2,636,542	8.66	\$ 0.8945	2,636,542	\$ 0.8945	
\$0.96 - \$1.24	2,152,665	5.62	\$ 1.1278	2,152,665	\$ 1.1278	
\$1.25 - \$1.57	2,270,169	8.73	\$ 1.2974	2,270,169	\$ 1.2974	
\$1.58 - \$13.75	2,865,785	7.08	\$ 2.3863	2,865,785	\$ 2.3863	
\$0.34 - \$13.75	11,989,582	7.50	\$ 1.3251	11,765,335	\$ 1.3373	

Modifications to and Vesting of Certain Stock Option Grants

On December 2, 2004 the Compensation Committee of the Company's Board of Directors (the "Compensation Committee") considered the significant impact that the use of fair values, rather than intrinsic values, would have on the Company's future results of operations, as well as factors including that the management team had requested that their salaries be frozen for 2005, many non-management employees' 2005 raises were to be below market levels, no management bonus payments were made for 2004 and the 2005 management incentive plan called for a performance in excess of the Company's internal budget before any bonus payments were to be made, and approved the acceleration of vesting of outstanding but unvested stock options with an exercise price greater than \$1.08. These options were not "in-the-money" at that time, and therefore, there was no compensation expense recorded in accordance with APB No. 25 as a result of this modification. However, for pro forma purposes, in accordance with SFAS No. 123, the remaining unamortized compensation related to these options, calculated under SFAS No. 123 of approximately \$2.1 million, was recorded in 2004. This action effected options to purchase approximately 2.2 million shares, approximately 1.1 million of which were held by the Company's Directors and Executive Officers. Had this action not been taken, and had all approximately 2.2 million options continued to vest according to the vesting schedules in place prior to the acceleration, compensation expense related to these options of \$870 thousand would have been recorded on a pro forma basis during the year ended December 31, 2005, with the remainder, approximately \$1.2 million, recorded as compensation expense after the adoption of SFAS 123R when required on January 1, 2006. On February 24, 2005, the Company's Board of Directors (the "Board of Directors") considered the significant impact that the use of fair values, rather than intrinsic values, would have on the Company's future results of operations, as well as factors including that the management team had requested that their salaries

be frozen for 2005, many non-management employees' 2005 raises were to be below market levels, no management bonus payments were made for 2004 and the 2005 management incentive plan called for a performance in excess of the Company's internal budget before any bonus payments were to be made, and authorized the Company's Stock Option Committee (the "Stock Option Committee"), which consisted solely of the Company's Chief Executive Officer, to immediately vest all options granted from that date through June 30, 2005 and to accelerate the vesting of any outstanding but unvested stock options with a strike price that is not "in-the-money" at its discretion (the aggregate authorization to the Stock Option Committee to be known as the "Vesting Authorization") through June 30, 2005; for similar reasons and understanding the SEC had issued a release amending the compliance date for SFAS No. 123R, on May 9, 2005, the Board of Directors approved the extension of the Vesting Authorization to the Stock Option Committee from June 30, 2005 to December 31, 2005. On March 30, 2005, the Stock Option Committee exercised its discretion and accelerated the vesting of outstanding but unvested stock options with a strike price greater than or equal to \$0.82. These options were not "in-the-money" at that time, and therefore, there was no compensation expense recorded in accordance with APB No. 25 as a result of this modification. However, for pro forma purposes, in accordance with SFAS No. 123, the remaining unamortized compensation related to these options, calculated under SFAS No. 123 of approximately \$540 thousand, was recorded in 2005. This action effected options to purchase approximately 750 thousand shares, approximately 55 thousand of which were held by the Company's Directors and Executive Officers. Had this action not been taken and had all approximately 750 thousand options continued to vest according to the vesting schedules in place prior to the acceleration, compensation expense related to these options of \$275 thousand would have been recorded on a pro forma basis during the nine months ended December 31, 2005, with the remainder, approximately \$265 thousand, recorded as compensation expense after the adoption of SFAS 123R when required on January 1, 2006. All options granted in 2005 on or after March 30, 2005, which totaled options to purchase approximately 3.9 million shares, were granted with immediate vesting.

Employee Stock Purchase Plan (the "ESPP")

Under the 1997 Employee Stock Purchase Plan, the Company is authorized to issue up to 2,750,000 shares of common stock to its employees, of which 2,043,903 had been issued as of December 31, 2005. Employees of the Company and its U.S. subsidiaries who are expected to work at least 20 hours per week and five months per year are eligible to participate. Under the terms of the plan, employees can choose to have up to 10% of their annual base earnings withheld to purchase the Company's common stock. The purchase price of the stock for June 30, 2005 is 85% of the lower of its beginning-of-enrollment period or end-of-measurement period market price. Each enrollment period is one year, with six-month measurement periods ending June 30 and December 31. The purchase price of the stock for December 31 was 85% of the end-of-measurement-period market price.

For the years ended December 31, 2003, 2004 and 2005, the weighted-average fair value of the purchase rights granted was \$0.32, \$0.44 and \$0.27 per share, respectively. Pro forma stock-based compensation was approximately \$127 thousand, \$58 thousand and \$65 thousand in 2003, 2004 and 2005, respectively, for the ESPP.

Restricted Stock Exchange

On August 9, 2001, the Board of Directors approved a proposal to give Colorado-based Heska employees an opportunity to exchange all options outstanding with exercise prices greater than \$3.90 per share under the 1997 Stock Incentive Plan for shares of restricted stock. The offer closed on September 28, 2001 with options to purchase 1,044,900 shares of common stock exchanged for 1,044,900 shares of restricted stock. The fair value of the restricted stock at the time of the exchange was \$0.68 per share. The restricted stock vested over 48 months beginning November 1, 2001. This exchange resulted in deferred compensation of approximately \$710,000 that was recognized over the vesting period of the restricted stock. The Company recognized \$93 thousand, \$91 thousand and \$67 thousand of non-cash compensation expense from this exchange in 2003, 2004 and 2005, respectively. A total of approximately 728 thousand shares vested under the exchange offer. The final vesting date was October 1, 2005 and employees may sell previously vested shares.

8. MAJOR CUSTOMERS

The Company had no customers in 2004 or 2005 who represented 10% or more of total revenue. In 2003, the Company had one customer who purchased vaccines from the Company's OVP segment and who represented 15% of total revenues. No customer represented 10% or more of total accounts receivable at December 31, 2004 or December 31, 2005.

9. SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

	Year Ended December 31,		
	2003	2004	2005
	(in thousands)		
Cash paid for interest	\$ 459	\$ 690	\$ 1,004
Purchase of assets under capital lease financing	\$ 14	\$ 24	\$ —

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. In the years ended December 31, 2003, 2004 and 2005, royalties of \$1.1 million, \$1.0 million and \$895 thousand became payable under these agreements, respectively.

The Company has contracts with two suppliers for unconditional annual minimum inventory purchases totaling approximately \$11.2 million through fiscal 2007.

The Company has entered into operating leases for its office and research facilities and certain equipment with future minimum payments as of December 31, 2005 as follows (in thousands):

Year Ending December 31,	
2006	\$ 1,257
2007	1,310
2008	1,347
2009	1,386
2010	1,425
Thereafter	20,640
	<u>\$ 27,365</u>

The Company had rent expense of \$806 thousand, \$774 thousand and \$1.4 million in 2003, 2004 and 2005, respectively.

From time to time, the Company may be involved in litigation relating to claims arising out of its operations. For example, Heska and its Diamond Animal Health, Inc. subsidiary ("Diamond") are currently engaged in litigation in Madison, Wisconsin (the "UV Litigation") with United Vaccines, Inc. ("United"), a customer of the Company's OVP segment. While the Company intends to pursue the UV Litigation vigorously and believes Diamond is entitled to damages from United and that United is not entitled to damages from Heska or Diamond, there can be no assurance the ultimate resolution of this case will reflect the Company's current beliefs. As of December 31, 2005, the Company was not party to any legal proceedings other than the United Litigation that are expected, individually or in the aggregate, to have a material effect on its business, financial condition or operating results. In 2003, the Company settled

litigation regarding alleged patent infringement, resulting in a charge of \$515 thousand to other operating expenses.

The Company generally warrants that its products and services will conform to published specifications. The typical warranty period is one year from delivery of the product or service. 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, and as a result, does not maintain a warranty reserve.

The Company's licensing arrangements generally include a product indemnification provision that will indemnify and defend a licensee in actions brought against the licensee that claim the Company's patents infringe upon a copyright, trade secret or valid patent. Historically, the Company has not incurred any significant costs related to product indemnification claims, and as a result, does not maintain a reserve for such exposure.

11. SEGMENT REPORTING

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

Additionally, the Company generates non-product revenue from research and development projects for third parties, licensing of technology and royalties. The Company performs these research and development projects for both companion animal and livestock purposes.

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

	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
2003:			
Revenue	\$ 48,719	\$ 16,606	\$ 65,325
Operating income (loss)	(6,906)	3,712	(3,194)
Total assets	22,047	16,849	38,896
Capital expenditures	467	940	1,407
Depreciation and amortization	533	1,216	1,749
Amortization of intangible assets	145	—	145
Interest expense	267	192	459

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	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
2004:			
Revenue	\$ 54,474	\$ 13,217	\$ 67,691
Operating income (loss)	(5,704)	1,464	(4,240)
Total assets	23,357	15,367	38,724
Capital expenditures	277	1,013	1,290
Depreciation and amortization	378	959	1,337
Amortization of intangible assets	393	—	393
Interest expense	372	318	690

	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
2005:			
Revenue	\$ 56,604	\$ 12,833	\$ 69,437
Operating income (loss)	(595)	1,466	871
Total assets	22,848	13,936	36,784
Capital expenditures	931	445	1,376
Depreciation and amortization	846	1,004	1,850
Amortization of intangible assets	157	—	157
Interest expense	652	434	1,086

Total revenue by principal geographic area was as follows (in thousands):

	For the Years Ended December 31,		
	2003	2004	2005
United States	\$ 58,709	\$ 59,452	\$ 60,849
Europe	3,976	4,484	4,151
Other International	2,640	3,755	4,437
Total	\$ 65,325	\$ 67,691	\$ 69,437

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

	December 31,		
	2003	2004	2005

United States	\$	36,289	\$	35,123	\$	33,414
Europe		2,607		3,601		3,370
Other International		—		—		—
Total	\$	38,896	\$	38,724	\$	36,784

12. QUARTERLY FINANCIAL INFORMATION (unaudited)

The following summarizes selected quarterly financial information for each of the two years in the period ended December 31, 2005 (amounts in thousands, except per share data).

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	Q1	Q2	Q3	Q4	Total
2004:					
Total revenue	\$ 16,741	\$ 17,796	\$ 15,939	\$ 17,215	\$ 67,691
Gross profit	6,145	6,187	6,000	6,377	24,709
Operating income (loss)	(2,057)	(1,205)	(710)	(268)	(4,240)
Net income (loss)	(1,994)	(1,388)	(876)	(557)	(4,815)
Net income (loss) per share – basic and diluted	(0.04)	(0.03)	(0.02)	(0.01)	(0.10)
2005:					
Total revenue	\$ 17,154	\$ 16,565	\$ 19,340	\$ 16,378	\$ 69,437
Gross profit	5,918	5,525	7,678	6,706	25,827
Operating Income (loss)	(1,103)	(707)	1,472	1,209	871
Net income (loss)	(1,308)	(767)	1,234	1,123	282
Net income (loss) per share – basic and diluted	(0.03)	(0.02)	0.02	0.02	0.01

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

Item 9A. Controls and Procedures.

(a) *Evaluation of Disclosure Controls and Procedures.* Our management, with the participation of our chief executive officer and our chief financial officer, evaluated the effectiveness of our disclosure controls and procedures, as defined by Rule 13a-15 of the Exchange Act, as of the end of the period covered by this Annual Report on Form 10-K. Based on this evaluation, our chief executive officer and our chief financial officer have concluded that our disclosure controls and procedures are adequate to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

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

If, as of June 30, 2006, we meet the definition of "accelerated filer," as defined by Rule 12b-2 of the Exchange Act, we will be required by the Sarbanes-Oxley Act of 2002 to include an assessment of our internal control over financial reporting and attestation from our independent registered public accounting firm in our Annual Report on Form 10-K for our fiscal year ending December 31, 2006. If, however we are not deemed an "accelerated filer" at that time, under current SEC rules we will not have to include such assessment and attestation until our Annual Report on Form 10-K for our fiscal year ended December 31, 2007.

Item 9B. Other Information.

On March 29, 2006, we entered into a new employment agreement with Robert B. Grieve, our Chief Executive Officer, which supercedes and replaces his prior agreement dated February 23, 2000. The new agreement is for an initial term of three years and is automatically renewable every year for an additional one-year term, unless we notify Dr. Grieve at least 180 days in advance of the anniversary date of our intention not to renew. We will pay Dr. Grieve an annual salary of \$341,000, subject to subsequent adjustment at the discretion of the Board of Directors. Dr. Grieve is also eligible to participate in the Management Incentive Plan ("MIP"), or such other bonus programs established by the Compensation Committee of the Board of Directors, at a target percentage that is no less than 50% of Dr. Grieve's annual base salary then in effect (the "Target Bonus"), with the actual amount paid subject to adjustment based on Dr. Grieve's individual performance.

Dr. Grieve remains an "at-will" employee and either party may terminate the agreement for any reason at any time. However, if we terminate Dr. Grieve's employment without "cause" or he terminates his employment for "good reason" other than in connection with certain changes in control of the Company, he is entitled to receive: (i) one year of his base salary; (ii) one year paid health and dental benefit coverage; (iii) any bonuses that would have been received under the terms of the MIP pro-rated for the period beginning January 1 and ending on the date of separation, to be paid in the next fiscal year when payments are made to other participants in the MIP; and (iv) one year of additional vesting of all equity compensation awards held by Dr. Grieve at the time of termination. If we terminate Dr. Grieve's employment without "cause" or he terminates his employment for "good reason" in connection with certain changes in control of the Company, he is entitled to receive: (i) two years base salary, (ii) two years paid health and dental benefit coverage; (iii) a payment equal to the higher of: (a) two times Dr. Grieve's Target Bonus for the year in which the change in control occurred or (b) the highest annual bonus paid to Dr. Grieve over the preceding three fiscal years; and (iv) immediate vesting under any stock arrangement.

PART III

Certain information required by Part III is incorporated by reference to our definitive Proxy Statement filed with the Securities and Exchange Commission in connection with the solicitation of proxies for our 2006 Annual Meeting of Stockholders.

Item 10. Directors and Executive Officers of the Registrant.

Executive Officers

The information required by this item with respect to executive officers is incorporated by reference to Item 1 of this report and can be found under the caption "Executive Officers."

Directors

The information required by this section with respect to our directors will be incorporated by reference to the information in the sections entitled "Election of Directors" and "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement.

Audit Committee Financial Expert

The Board has determined that Audit Committee member William A. Aylesworth is an audit committee financial expert as defined by Item 401(h) of Regulation S-K of the Exchange Act and is independent within the meaning of Item 7(d)(3)(iv) of Schedule 14A of the Exchange Act.

Audit Committee

We have a separately designated standing Audit Committee established in accordance with Section 3(a)(58)(A) of the Exchange Act. The members of the Audit Committee are William A. Aylesworth, Peter Eio and Elisabeth DeMarse.

Code of Ethics

Our Board of Directors has adopted a code of ethics for senior executive and financial officers (including our principal executive officer, principal financial officer and principal accounting officer). The code of ethics is available on our website at www.heska.com. We intend to disclose any amendments to or waivers from the code of ethics at that location.

Item 11. Executive Compensation.

The information required by this section will be incorporated by reference to the information in the sections entitled "Director Compensation" and "Executive Compensation" in the Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management.

The information required by this section will be incorporated by reference to the information in the section entitled "Common Stock Ownership of Certain Beneficial Owners and Management" in the Proxy Statement.

Item 13. Certain Relationships and Related Transactions.

The information required by this section will be incorporated by reference to the information in the sections entitled "Executive Compensation—Employment, Severance and Change of Control Agreements," "Executive Compensation—Loan to Executive Officer" and "Certain Transactions and Relationships" in the Proxy Statement.

Item 14. Principal Accountant Fees and Services.

The information required by this section will be incorporated by reference to the information in the section entitled "Auditor Fees and Services" in the Proxy Statement.

PART IV

Item 15. Exhibits and Financial Statement Schedules.

(a) The following documents are filed as a part of this Form 10-K.

(1) **Financial Statements:**

Reference is made to the Index to Consolidated Financial Statements under Item 8 in Part II of this Form 10-K.

(2) **Financial Statement Schedules:**

Schedule II – Valuation and Qualifying Accounts.

SCHEDULE II

HESKA CORPORATION AND SUBSIDIARIES
VALUATION AND QUALIFYING ACCOUNTS
(amounts in thousands)

	Balance at Beginning of Year	Additions Charged to Costs and Expenses	Other Additions	Deductions	Balance at End of Year
Allowance for doubtful accounts					
Year ended:					
December 31, 2003	\$ 229	\$ 57	—	\$ (94)(a)	\$ 192
December 31, 2004	\$ 192	\$ (32)	—	\$ (65)(a)	\$ 95
December 31, 2005	\$ 95	\$ 43	—	\$ (50)(a)	\$ 88
Allowance for restructuring charges					
Year ended:					
December 31, 2003	\$ 343	\$ —	—	\$ (222)(b)	\$ 121
December 31, 2004	\$ 121	\$ —	—	\$ (106)(b)	\$ 15
December 31, 2005	\$ 15	\$ —	—	\$ (15)(b)	\$ —
Allowance for tax valuation					
Year ended:					
December 31, 2003	\$ 68,102	\$ 1,273	—	\$ —	\$ 69,375
December 31, 2004	\$ 69,375	\$ 2,105	—	\$ —	\$ 71,480
December 31, 2005	\$ 71,480	\$ 342	—	\$ —	\$ 71,822

(a) Write-offs of uncollectible accounts.

(b) Payments for personnel severance costs, contractual obligations and facility closing costs.

(3) **Exhibits:**

The exhibits listed below are required by Item 601 of Regulation S-K. Each management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-K has been identified.

Exhibit Number	Notes	Description of Document
3(i)	(5)	Restated Certificate of Incorporation of the Registrant.
3(ii)	(6)	Bylaws of the Registrant.
10.1+	(2)	Supply Agreement between Registrant and Quidel Corporation, dated July 3, 1997.
10.2+	(3)	Exclusive Distribution Agreement between Registrant and Novartis Agro K.K., dated August 18, 1998.
10.3	(3)	Right of First Refusal Agreement between Registrant, Novartis Animal Health, Inc. and Novartis Agro K.K., dated August 18, 1998.
10.4+	(7)	Amended and Restated Distribution Agreement between Registrant and i-STAT Corporation, dated February 9, 1999.
10.5+	(7)	First Amendment to Product Supply Agreement between Registrant and Quidel Corporation, dated March 15, 1999.
10.6+	(9)	Amended and Restated Bovine Vaccine Distribution Agreement between Diamond Animal Health, Inc. and AGRI Laboratories, Ltd., dated September 30, 2002.
10.7*	(6)	1997 Incentive Stock Plan of Registrant, as amended and restated.
10.8*	(1)	Forms of Option Agreement.
10.9*	(1)	1997 Employee Stock Purchase Plan of Registrant, as amended.
10.10*	(1)	Form of Indemnification Agreement entered into between Registrant and its directors and certain officers.
10.11		Amended and Restated Employment Agreement with Robert B. Grieve, dated March 29, 2006.
10.12*	(5)	Employment agreement between Registrant and Carol Talkington Verser, dated May 1, 2000.
10.13*	(8)	Employment Agreement between Registrant and Michael A. Bent, dated May 1, 2000.
10.14*	(8)	Employment Agreement between Registrant and Jason A. Napolitano, dated May 6, 2002.
10.15*	(11)	Employment Agreement between Registrant and Joseph H. Ritter, dated May 1, 2004.
10.16+	(10)	Distribution Agreement between Registrant and Arkray Global Business Inc., dated November 1, 2004.
10.17+	(11)	Supply and Distribution Agreement between Registrant and Boule Medical AB, dated June 17, 2003, Letter Amendment to Supply and Distribution Agreement between Registrant and Boule Medical AB, dated June 1, 2004 and Letter Amendment to Supply and Distribution Agreement between Registrant and Boule Medical AB, dated December 31, 2004.

10.18+	(11)	Distribution Agreement between Registrant and i-STAT Corporation, dated October 1, 2004.
10.19+	(11)	Second Amendment to Amended and Restated Bovine Vaccine Distribution Agreement between Diamond Animal Health, Inc. and Agri Laboratories, Ltd., dated December 10, 2004.
10.20+		Third Amended and Restated Credit and Security Agreement between Registrant, Diamond Animal Health, Inc. and Wells Fargo Business Credit, Inc., dated December 30, 2005.
10.21+	(11)	Supply and License Agreement between Registrant and Schering-Plough Animal Health Corporation, dated August 1, 2003.

Exhibit Number	Notes	Description of Document
10.22*		Summary Sheet for Executive Cash Compensation.
10.23	(12)	Second Amendment to Net Lease Agreement between Registrant and CCMRED 40 LLC, dated July 14, 2005.
10.24*		Management Incentive Plan Master Document and 2006 Management Incentive Plan.
10.25*	(13)	Director Compensation Policy.
21.1		Subsidiaries of the Company.
23.1		Consent of KPMG LLP, Independent Registered Public Accounting Firm.
24.1		Power of Attorney (See page 73 of this Form 10-K).
31.1		Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.
31.2		Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.
32.1		Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Notes

- * Indicates management contract or compensatory plan or arrangement.
+ Portions of the exhibit have been omitted pursuant to a request for confidential treatment.
- (1) Filed with Registrant's Registration Statement on Form S-1 (File No. 333-25767).
 - (2) Filed with the Registrant's Form 10-Q for the quarter ended September 30, 1997.
 - (3) Filed with the Registrant's Form 10-K for the year ended December 31, 1998.
 - (4) Filed with the Registrant's Form 10-K for the year ended December 31, 1999.
 - (5) Filed with the Registrant's Form 10-Q for the quarter ended June 30, 2000.
 - (6) Filed with the Registrant's Form 10-Q for the quarter ended June 30, 2001.
 - (7) Filed with the Registrant's Form 10-K for the year ended December 31, 2001.
 - (8) Filed with the Registrant's Form 10-K for the year ended December 31, 2002.
 - (9) Filed with the Registrant's Form 10-Q for the quarter ended September 30, 2002.
 - (10) Filed with the Registrant's Form 10-Q for the quarter ended March 31, 2005.
 - (11) Filed with the Registrant's Form 10-K for the year ended December 31, 2004.
 - (12) Filed with the Registrant's Form 10-Q for the quarter ended June 30, 2005.
 - (13) Filed with the Registrant's Form 10-Q for the quarter ended September 30, 2005.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on March 29, 2006.

HESKA CORPORATION

By: /s/ ROBERT B. GRIEVE

Robert B. Grieve
Chairman of the Board and Chief Executive Officer

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Robert B. Grieve, Jason A. Napolitano and Michael A. Bent, and each of them, his or her true and lawful attorneys-in-fact, each with full power of substitution, for him or her in any and all capacities, to sign any amendments to this report on Form 10-K and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact or their substitute or substitutes may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

Signature	Title	Date
/s/ ROBERT B. GRIEVE Robert B. Grieve	Chairman of the Board and Chief Executive Officer (Principal Executive Officer) and Director	March 29, 2006

<u>/s/ JASON A. NAPOLITANO</u> Jason A. Napolitano	Executive Vice President, Chief Financial Officer and Secretary (Principal Financial Officer)	March 29, 2006
<u>/s/ MICHAEL A. BENT</u> Michael A. Bent	Vice President, Controller (Principal Accounting Officer)	March 29, 2006
<u>/s/ WILLIAM A. AYLESWORTH</u> William A. Aylesworth	Director	March 29, 2006
<u>/s/ ELISABETH DEMARSE</u> Elisabeth DeMarse	Director	March 29, 2006
<u>/s/ A. BARR DOLAN</u> A. Barr Dolan	Director	March 29, 2006
<u>/s/ PETER EIO</u> Peter Eio	Director	March 29, 2006
<u>/s/ G. IRWIN GORDON G.</u> Irwin Gordon	Director	March 29, 2006
<u>/s/ TINA S. NOVA</u> Tina S. Nova	Director	March 29, 2006
<u>/s/ JOHN F. SASEN, Sr.</u> John F. Sasen, Sr.	Director	March 29, 2006
<u>/s/ LYNNOR B. STEVENSON</u> Lynnor B. Stevenson	Director	March 29, 2006

EMPLOYMENT AGREEMENT

This Employment Agreement (the “**Agreement**”), is made effective March 29, 2006 (the “**Effective Date**”), between Heska Corporation, a Delaware corporation (“**Heska**”) and Robert B. Grieve, Ph.D. (“**Executive**”).

RECITALS

Executive is currently the Chairman of Heska Board of Directors (the “**Board**”), and Chief Executive Officer (“**CEO**”) of Heska. Executive and Heska entered into an employment agreement dated February 23, 2000 (the “**Prior Agreement**”).

Executive and Heska now wish to enter into this new agreement regarding the terms of Executive’s employment, which shall become effective upon execution.

AGREEMENT

In consideration of the promises, covenants and agreements set forth below, it is mutually agreed:

1. **Duties and Scope of Employment.**

(a) **Position and Duties.** As of the Effective Date, Executive will continue to serve as CEO and Chairman of Heska. Executive will render such business and professional services in the performance of his duties, consistent with Executive’s position within Heska, as will reasonably be assigned to him by the Board. The period of Executive’s employment under this Agreement is referred to herein as the “**Term of Agreement.**”

(b) **Board Membership.** At each meeting of Heska’s stockholders when Executive is up for Board election, Heska will nominate Executive to serve as a member of the Board. Executive’s service as a member of the Board will be subject to any required stockholder approval. Executive’s continuing service as Chairman will be subject to the discretion of the Corporate Governance Committee and the Board, and any decision of the Board to separate the positions of CEO and Chairman will not affect or trigger any other provision of this Agreement.

(c) **Obligations.** During the Term of Agreement, Executive will devote Executive’s full business efforts and time to Heska. For the duration of the Term of Agreement, Executive agrees not to actively engage in any other employment, occupation or consulting activity for any direct or indirect remuneration without the prior approval of the Board or the Corporate Governance Committee of the Board (which approval will not be unreasonably withheld); provided, however, that Executive may, without the approval of the Board or the Corporate Governance Committee, serve in any capacity with any civic, educational or charitable organization, provided such services do not interfere with Executive’s obligations to Heska.

2. **At-Will Employment.** Subject to the provisions of paragraphs 3, 4, 7 and 8 below, Executive and Heska agree that Executive’s employment constitutes “at-will” employment. Executive and Heska acknowledge that this employment relationship may be terminated at any time, upon written notice to the other party (which in the case of Heska will mean the Board), with or without good cause or for any or no cause, at the option either of Heska or Executive. However, as described in this Agreement, Executive will be entitled to severance benefits depending upon the circumstances of Executive’s termination of employment. In the event Heska terminates Executive’s employment for “Cause” as defined in Section 9(b) below, such written notice shall detail the reasons for termination. Upon the termination of Executive’s employment for any reason, and without diminution, Executive will be entitled to payment of all accrued but unpaid compensation, vacation, expense reimbursements, and other benefits due to Executive through his termination date under any company-provided or paid plans, policies, and arrangements. Executive agrees to resign from all positions that he holds with Heska, including, without limitation, his position as a member of the Board, immediately following the termination of his employment if the Board so requests.

3. **Term of Agreement.** This Agreement will have an initial term of three years commencing on the Effective Date. On the third anniversary of the Effective Date, and on each annual anniversary of the Effective Date thereafter, this Agreement automatically will renew for an additional one-year term unless Heska provides Executive with notice of non-renewal at least 180 days prior to the date of automatic renewal.

4. **Cash Compensation; Vacation.**

(a) **Base Salary.** During fiscal year 2006, Heska will pay Executive an annual salary of \$341,000 as compensation for his services (the “**Base Salary**”). The Base Salary will be paid periodically in accordance with Heska’s normal payroll practices and be subject to the usual, required withholding. Executive’s salary will be subject to review, and adjustments will be made by the Compensation Committee of the Board (the “**Committee**”) based upon Heska’s standard practices.

(b) **Annual Bonus.** During the Term of Agreement, Executive will be eligible to participate in the Management Incentive Plan (the “**Bonus Plan**”), or such other bonus programs as established by the Committee, at a target percentage that is no less than 50% of Executive’s annual base salary then in effect (the “**Target Bonus**”). The actual bonus paid may be higher or lower than the Target Bonus for over or under-achievement of Executive’s performance goals, as determined by the Committee. Bonuses, if any, will accrue and become payable in accordance with the Committee’s standard practices for paying executive incentive compensation, provided however that any bonus payable under this Section 4(b) will be payable within two-and-one-half months after the end of the taxable year to which it relates or such longer period as may be permitted by Treasury regulations in order to avoid application of Section 409A of the Internal Revenue Code to such bonuses.

(c) **Vacation.** Executive shall continue to accrue vacation and/or paid time off at the same rate and on the same compensation basis that he accrued vacation and/or paid time off as of January 1, 2006 (or at such greater rate that may, under Heska policy adopted from time to time, apply to Heska’s executive officers).

5. **Expenses.** In addition to the foregoing, Heska will reimburse Executive for his reasonable out-of-pocket travel, entertainment, and other expenses, in accordance with Heska's expense reimbursement policies as in effect from time to time.

6. **Employee Benefits.** During the Term of Agreement, Executive will be eligible to participate in accordance with the terms of all Heska employee benefit plans, policies, and arrangements that are applicable to other senior executives of Heska, as such plans, policies, and arrangements may exist from time to time.

7. **Severance.**

(a) **Termination without Cause or for Good Reason other than in connection with a Change of Control.** If Executive's employment is terminated by Heska without Cause, or by Executive for Good Reason, or is terminated due to the death or Disability (as defined in Section 9(e) below) of Executive, and the termination is not in connection with a Change of Control, Executive will receive subject to Section 8:

(i) A payment of an amount equal to 12 months of his Base Salary, payable in accordance with Heska's standard payroll practices over the shorter of the following periods (i) in equal installments over the period beginning on the date of such termination and ending on the one-year anniversary thereof, or (ii) in equal installments on a monthly basis corresponding to the amount he would normally receive as salary each month if he were still employed, with a lump sum of any remaining balance of the amount specified above on March 15 of the year following the year of termination.

(ii) Company-paid coverage for Executive and Executive's eligible dependents under Heska's Benefits Plans (as defined below) for 12 months, or if earlier, until Executive becomes employed by another employer who provides comparable benefits;

(iii) A bonus, if any, that would have been received under the terms of the Bonus Plan but pro-rated for the period beginning January 1 and ending on his separation date, to be paid to Executive in the next fiscal year when payments are made to other participants in the Bonus Plan; and

(iv) 12 months of accelerated vesting of equity awards held by Executive at the time of his termination. In addition, Executive will have until the later of December 31 of the calendar year in which, or the 15th day of the third month following the date, the award would otherwise (but for this Section 7(a)(iv)) have expired to exercise such award.

(b) **Termination without Cause or for Good Reason in connection with a Change of Control.** If Executive's employment is terminated by Heska without Cause or by Executive for Good Reason, and the termination is in Connection with a Change of Control, then, subject to Section 8, Executive will receive:

(i) A payment of an amount equal to 24 months of his Base Salary, payable in equal installments in accordance with the standard payroll schedule over the

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shorter of the following periods (i) the period beginning on the date of such termination and ending on the one-year anniversary thereof, or (ii) the period beginning on the date of such termination and ending on March 15 of the year following the year of termination;

(ii) A lump sum payment equal to the higher of (A) two times Executive's Target Bonus for the year in which the Change of Control occurred, or (B) the highest annual bonus paid to Executive over the preceding 3 fiscal years;

(iii) Company-paid coverage for Executive and Executive's eligible dependents under Heska's Benefits Plans for 24 months following the termination date, or if earlier, until Executive becomes employed by another employer who provides comparable benefits; and

(iv) Full (100%) acceleration of vesting of any unvested equity awards held by Executive at the time of his termination. In addition, to the extent such awards are not (after taking into account such accelerated vesting) terminated in connection with the closing of the Change of Control, then Executive will have until the later of December 31 of the calendar year in which, or the 15th day of the third month following the date, the award would otherwise (but for this Section 7(b)(iv)) have expired to exercise such award.

(c) **Voluntary Termination without Good Reason; Termination for Cause.** If Executive's employment with Heska terminates voluntarily by Executive without Good Reason or is terminated for Cause by Heska, then (i) all further vesting of Executive's outstanding equity awards will terminate immediately, (ii) all payments of compensation by Heska to Executive hereunder will terminate immediately (except as to amounts already earned), and (iii) Executive will not be entitled to any severance but Executive will be paid all accrued but unpaid vacation, expense reimbursements and other benefits due to Executive through his termination date under any Company-provided or paid plans, policies, and arrangements.

(d) **Reformation of Agreement.** It is the parties' intent that no payment made or to be made hereunder shall be subject to the provisions of Section 409A(a)(1)(B) of the Internal Revenue Code. Accordingly, notwithstanding any payment date or schedule specified above, the parties agree to work expeditiously to amend this Agreement to conform to their intent as set forth in this Section 7(d). Notwithstanding anything in this Section 7 to the contrary, to the extent that Heska in good faith determines that any payment provided for in this Section 7 constitutes a "deferral of compensation" under Code Section 409A, no amounts shall be payable to Executive prior to the earliest of (a) Executive's death or "disability" (within the meaning of Code Section 409A(a)(2)(C)) following the termination date, (b) the date that is six months following the date of Executive's "separation from service" with the Company (within the meaning of Code Section 409A), or (c) the effective date of a change in the ownership or effective control of the Company, or in the ownership of a substantial portion of the assets of the Company (in each case within the meaning of Code Section 409A).

(e) **Excise Tax.** In the event that any benefits payable to Executive pursuant to this Agreement ("Termination Benefits") (i) constitute "parachute payments" within the meaning of Section 280G of the Internal Revenue Code, or any comparable successor provisions,

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and (ii) but for this Section 7(e) would be subject to the excise tax imposed by Section 4999 of the Code, or any comparable successor provisions (the “Excise Tax”), then Executive’s Termination Benefits hereunder shall be either (a) provided to Executive in full, or (b) provided to Executive as to such lesser extent which would result in no portion of such benefits being subject to the Excise Tax, whichever of the foregoing amounts, when taking into account applicable federal, state, local and foreign income and employment taxes, the Excise Tax, and any other applicable taxes, results in the receipt by Executive, on an after-tax basis, of the greatest amount of benefits, notwithstanding that all or some portion of such benefits may be taxable under the Excise Tax. Unless the Company and Executive otherwise agree in writing, any determination required under this Section 7(e) shall be made in writing in good faith by the Company’s independent accountants. In the event of a reduction of benefits hereunder, Executive shall be given the choice of which benefits to reduce. If Executive does not provide written identification to the Company of which benefits he chooses to reduce within ten (10) days after written notice of the accountants’ determination, and Executive has not disputed the accountants’ determination, then the Company shall select the benefits to be reduced. For purposes of making the calculations required by this Section 7(e), the accountants may make reasonable assumptions and approximations concerning applicable taxes and may rely on reasonable, good faith interpretations concerning the application of the Code, and other applicable legal authority. The Company and Executive shall furnish to the accountants such information and documents as the Accountants may reasonably request in order to make a determination under this Section 7(e). The Company shall bear all costs the accountants may reasonably incur in connection with any calculations contemplated by this Section 7(e).

8. **Conditions to Receipt of Severance; No Duty to Mitigate.**

(a) **Separation Agreement and Release of Claims.** The receipt of any severance pursuant to Section 7 will be subject to Executive signing and not revoking a separation agreement and release of claims in a form reasonably acceptable to Heska. Such agreement will provide (among other things) that the Parties will not disparage each other or the Company, its directors, or its executive officers. No severance will be paid or provided until the separation agreement and release agreement becomes effective which shall be prepared and executed before the termination date.

(b) **Non-Competition.** In the event of a termination of Executive’s employment that otherwise would entitle Executive to the receipt of severance pursuant to Section 7(b), Executive agrees not to engage in Competition (as defined below) for 12 months following the termination date. If Executive engages in Competition within such period all continuing payments and benefits to which Executive otherwise may be entitled pursuant to Section 7(b) will cease immediately. In addition to the remedy specified in the preceding sentence, the Company will have against Executive in the event of his breach of this Section 8(b) any and all remedies available to it in law or in equity, including without limitation the right to seek recovery of any amounts paid under Section 7 of this Agreement.

(c) **Nonsolicitation.** In the event of a termination of Executive’s employment that otherwise would entitle Executive to the receipt of severance pursuant to Section 7, Executive agrees that, for 24 months following the termination date, Executive, directly or indirectly, whether as employee, owner, sole proprietor, partner, director, member, consultant,

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agent, founder, co-venturer or otherwise, (i) will not solicit, induce, or influence any person to modify his or her employment or consulting relationship with the Company (the “No-Inducement”), and (ii) not intentionally divert business away from the Company by soliciting business from any of the Company’s substantial customers and users who would otherwise have placed the solicited order with the Company (the “No Solicit”). If Executive breaches the No-Inducement or No Solicit, all continuing payments and benefits to which Executive otherwise may be entitled pursuant to Section 7 will cease immediately. In addition to the remedy specified in the preceding sentence, the Company will have against Executive in the event of his breach of this Section 8(c) any and all remedies available to it in law or in equity, including without limitation the right to seek recovery of any amounts paid under Section 7 of this Agreement.

(d) **No Duty to Mitigate.** Executive is under no duty or requirement to mitigate the amount of any payment contemplated by this Agreement, nor will any earnings that Executive may receive from any other source reduce any such payment.

9. **Definitions.**

(a) **Benefit Plans.** For purposes of this Agreement, “Benefit Plans” means plans, policies, or arrangements that Heska sponsors (or participates in) and that immediately prior to Executive’s termination of employment provide Executive and Executive’s eligible dependents with medical, dental, or vision benefits. Benefit Plans do not include any other type of benefit (including, but not by way of limitation, financial counseling, disability, life insurance, or retirement benefits). A requirement that Heska provide Executive and Executive’s eligible dependents with coverage under the Benefit Plans will not be satisfied unless the coverage is no less favorable than that provided to Executive and Executive’s eligible dependents immediately prior to Executive’s termination of employment. Subject to the immediately preceding sentence, Heska, or its successor, may, at its option, satisfy any requirement that Heska provide coverage under any Benefit Plan by instead providing coverage under a separate plan or plans providing coverage that is no less favorable or by paying Executive a lump-sum payment which is, on an after-tax basis, sufficient to provide Executive and Executive’s eligible dependents with equivalent coverage under a third party plan that is reasonably available to Executive and Executive’s eligible dependents.

(b) **Cause.** For purposes of this Agreement, “Cause” shall mean the occurrence of one or more of the following: (i) conviction of, or a entry of a plea of *nolo contendere* to, any crime (including one involving moral turpitude), whether a felony or misdemeanor, or any crime which reflects so negatively on Heska to be detrimental to Heska’s image or interests, or any act of fraud or dishonesty that has such negative reflection upon Heska; (ii) the repeated commitment of insubordination or refusal to comply with any reasonable request of the Board related to the scope or performance of Executive’s duties; (iii) possession of any illegal drug on Heska premises or being under the influence of illegal drugs or abusing prescription drugs or alcohol while on Heska business, attending Heska-sponsored functions or on Heska premises; (iv) the gross misconduct or gross negligence in the performance of Executive’s responsibilities which, based upon good faith and reasonable factual investigation of the Board, demonstrates Executive’s unfitness to serve; (v) material breach of Executive’s obligations under this Agreement; or (vi) material breach of any fiduciary duty of Executive to

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Heska which results in material damage to Heska or its business; provided that if any of the foregoing events is capable of being cured, Heska will provide notice to Executive describing the nature of such event and Executive will thereafter have 30 days to cure such event and if such event is cured with that 30-day period, then grounds will no longer exist for terminating his employment for Cause.

(c) **Change of Control.** For purposes of this Agreement, “**Change of Control**” means (i) a sale of all or substantially all of Heska’s assets, (ii) any merger, consolidation or other business combination transaction of Heska with or into another corporation, entity or person, other than a transaction in which the holders of at least a majority of the shares of voting capital stock of Heska outstanding immediately prior to such transaction continue to hold (either by such shares remaining outstanding or by their being converted into shares of voting capital stock of the surviving entity) a majority of the total voting power represented by the shares of voting capital stock of Heska (or the surviving entity) outstanding immediately after such transaction, (iii) the direct or indirect acquisition (including by way of a tender or exchange offer) by any person, or persons acting as a group, of beneficial ownership or a right to acquire beneficial ownership of shares representing a majority of the voting power of the then outstanding shares of capital stock of Heska, (iv) a contested election of Directors, as a result of which or in connection with which the persons who were Directors before such election or their nominees cease to constitute a majority of the Board, or (v) a dissolution or liquidation of Heska.

(d) **Competition.** For purposes of this Agreement, Executive will be deemed to have engaged in “Competition” if he, without the consent of the Board or an authorized officer of any successor company to Heska, following a Change of Control and following a termination of his employment described in Section 7(b), directly or indirectly provides services relating to the companion animal health industry (whether as an employee, consultant, agent, corporate officer, director, or otherwise) to, or participates in the financing, operation, management, or control of a “Restricted Company or a “Restricted Division” as identified in writing by Heska and Executive. Notwithstanding the foregoing, nothing contained in this Section 9(d) or in Section 8(b) above shall prohibit Executive from being employed or engaged in a corporate function or senior management position (and holding commensurate equity interests) with a Restricted Company that is engaged in multiple lines of business, one of which includes a Restricted Division, so long as Executive does not provide to the Restricted Division services of a sort that differ significantly from the services he provides to the other divisions, units or affiliates for which he has responsibility within the overall organization.

(e) **Disability.** For purposes of this Agreement, Disability shall have the same defined meaning as in Heska’s long-term disability plan applicable to senior executive officers.

(f) **Good Reason** For purposes of this Agreement, “**Good Reason**” means the occurrence of any of the following without Executive’s express written consent:

(i) Executive’s position with Heska is, or his duties and responsibilities as CEO are, materially diminished relative to his position, duties and

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responsibilities as in effect immediately prior to such change, other than the removal from the position of Chairman if the Board decides to separate the roles of CEO and Chairman;

(ii) a reduction in Executive’s Base Salary as in effect immediately prior to such reduction; provided, that an across-the-board reduction in the base compensation and benefits of all other executive officers of Heska by the same percentage amount (or under the same terms and conditions) as part of a general base compensation reduction and/or benefit reduction shall not constitute such a qualifying reduction;

(iii) a relocation of Executive’s principal place of employment such that the new location results in a commute for Executive that is both (A) longer than his commute prior to the relocation and (B) greater than fifty (50) road miles each way from his home in the Severance, Colorado area;

(iv) any material breach by Heska of any provision of this Agreement, after written notice delivered to Heska of such breach and Heska’s failure to cure such breach, if curable, within thirty (30) days following delivery of such notice; and

(v) any acquiring company fails to assume or be bound by the terms of this Agreement in Connection with a Change of Control.

(g) **In Connection with a Change of Control.** For purposes of this Agreement, a termination of Executive’s employment with the Company is “**in Connection with a Change of Control**” if Executive’s employment is terminated without Cause or for Good Reason during the period beginning three months prior to a Change of Control and ending eighteen months following a Change of Control.

10. **Indemnification and Insurance.** Executive will be covered under Heska’s insurance policies and, subject to applicable law, will be provided indemnification to the maximum extent permitted by Heska’s bylaws and Certificate of Incorporation. The Company will provide Executive with Director and Officer error and omissions insurance and ERISA fiduciary insurance in accordance with the Heska’s insurance practices for executive officers during the Term of Agreement, and shall also purchase and maintain “tail coverage” for at least two years post termination for any actions taken by Executive in good faith during the Term of Agreement.

11. **Confidential Information.** Executive acknowledges that he has executed Heska’s standard employee Confidential Information and Invention Agreement (the “Confidentiality Agreement”). During the Term of Agreement, and for two years after termination if requested by Heska, Executive agrees to execute any updated versions of the Company’s form of employee confidential information agreement as may be required of substantially all of the Company’s executive officers.

12. **Notices.** All notices, requests, demands, and other communications called for hereunder will be in writing and will be deemed given (a) on the date of delivery if delivered personally, (b) one day after being delivered to a nationally recognized overnight courier service or (c) five (5) business days after the date of mailing if sent certified or registered mail. Notice

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to Heska shall be sent to its principal place of business with a copy provided by facsimile to the Chair of the Committee, and notice to Executive will be delivered personally or sent to Executives last known address provided to Heska.

13. **Successors and Assigns.** This Agreement will be binding upon and inure to the benefit of (a) the heirs, executors, and legal representatives of Executive upon Executive's death and (b) any successor of Heska. Any such successor of Heska will be deemed substituted for Heska under the terms of this Agreement for all purposes. For this purpose, "successor" means any person, firm, corporation, or other business entity which at any time, whether by purchase, merger, or otherwise, directly or indirectly acquires all or substantially all of the assets or business of Heska. None of the rights of Executive to receive any form of compensation payable pursuant to this Agreement may be assigned or transferred except by will or the laws of descent and distribution. Any other attempted assignment, transfer, conveyance, or other disposition of Executive's right to compensation or other benefits will be null and void.

14. **Integration.** This Agreement, together with the Confidential Agreement, Heska's stock plans, Executive's stock option and restricted stock agreements, represents the entire agreement and understanding between the parties as to the subject matter herein and supersedes all prior or contemporaneous agreements whether written or oral, including the Prior Agreement. No waiver, alteration, or modification of any of the provisions of this Agreement will be binding unless in a writing that specifically references this Section and is signed by duly authorized representatives of the parties hereto.

15. **Interpretation.** Article titles and section headings contained herein are inserted for convenience of reference only and are not intended to be a part of or to affect the meaning or interpretation of this Agreement.

16. **Expenses.** The Company will reimburse Executive, up to \$7,500, for reasonably legal and tax advice expenses incurred by him in connection with the negotiation and execution of this Agreement.

17. **Waivers.** Any term or provision of this Agreement may be waived, or the time for its performance may be extended, by the party or parties entitled to the benefit thereof. Any such waiver shall be validly and sufficiently authorized for the purposes of this Agreement if, as to any party, it is authorized in writing by an authorized representative of such party. The failure of any party hereto to enforce at any time any provision of this Agreement shall not be construed to be a waiver of such provision, nor in any way to affect the validity of this Agreement or any part hereof or the right of any party thereafter to enforce each and every such provision. No waiver of any breach of this Agreement shall be held to constitute a waiver of any other or subsequent breach.

18. **Partial Invalidity.** Wherever possible, each provision hereof shall be interpreted in such manner as to be effective and valid under applicable law, but in case any one or more of the provisions contained herein shall, for any reason, be held to be invalid, illegal or unenforceable in any respect, such provision shall be ineffective to the extent, but only to the extent, of such invalidity, illegality or unenforceability without invalidating the remainder of

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such invalid, illegal or unenforceable provision or provisions or any other provisions hereof, unless such a construction would be unreasonable.

19. **Tax Matters.**

(a) Except as provided in paragraph 7(e) above, Executive agrees that he is responsible for any applicable taxes of any nature (including any penalties or interest that may apply to such taxes) that are reasonably determined to apply to any payment made to Executive hereunder (or any arrangement contemplated hereunder), that Executive's receipt of any benefit hereunder is conditioned on his satisfaction of any applicable withholding or similar obligations that apply to such benefit, and that any cash payment owed to Executive hereunder will be reduced to satisfy any such withholding or similar obligations that may apply thereto. Executive and Heska agree to cooperate to make such amendments to the terms of this Agreement as may be necessary to avoid the imposition of penalties and additional taxes under Section 409A of the Internal Revenue Code of 1986, as amended; provided however, that no such amendment shall materially increase the cost to, or impose any liability on, Heska with respect to any benefits contemplated or provided hereunder.

(b) Executive acknowledges that no representative or agent of Heska has provided him with any tax advice of any nature, and Executive has consulted with his own legal, tax and financial advisor(s) as to tax and related matters concerning the compensation to be received under this Agreement.

20. **Governing Law; Waiver of Jury Trial.** THIS AGREEMENT SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE INTERNAL LAWS OF THE STATE OF COLORADO WITHOUT REGARD TO CONFLICT OF LAW PRINCIPLES. THE PARTIES HERETO EACH WAIVE THEIR RESPECTIVE RIGHTS TO A JURY TRIAL OF ANY AND ALL SUCH CLAIMS AND CAUSES OF ACTION.

21. **Arbitration; Attorneys' Fees.** If any dispute arises under this Agreement or by reason of any asserted breach of it, or from the parties' employment relationship or any other relationship, either party may elect to have the dispute resolved through arbitration. The arbitration shall be binding and conducted pursuant to the rules of the American Arbitration Association under its National Rules for the Resolution of Employment Disputes and the arbitrator shall allocate the fees and expenses of such arbitration. Regardless of whether the dispute is resolved through arbitration or litigation, the prevailing party shall be entitled to recover all costs and expenses, including reasonable attorneys' fees, incurred in enforcing or attempting to enforce any of the terms, covenants and conditions, including costs incurred prior to commencement of arbitration or legal action, and all costs and expenses, including reasonable attorneys' fees, incurred in any appeal from an action brought to enforce any of the terms, covenants or conditions. For purposes of this section, "prevailing party" includes, without limitation, a party who agrees to dismiss a suit or proceeding upon the other's payment or performance of substantially the relief sought.

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22. **Counterparts.** This Agreement may be executed in counterparts, and each counterpart will have the same force and effect as an original and will constitute an effective, binding agreement on the part of each of the undersigned

IN WITNESS WHEREOF, Heska has caused this Employment Agreement to be duly executed by an officer thereunto duly authorized, and Executive has hereunto set his hand, all as of the day and year first above written.

HESKA CORPORATION

/s/ PETER EIO

Peter Eio, Chair of the Compensation Committee Acting
with Authority of the Board in its Entirety

EXECUTIVE:

/s/ ROBERT B. GRIEVE

Robert B. Grieve, Ph.D.

[***] – Certain information in this exhibit have been omitted and filed separately with the Securities and Exchange Commission. Confidential treatment has been requested with respect to the omitted portions.

**THIRD AMENDED AND RESTATED
CREDIT AND SECURITY AGREEMENT**

BY AND BETWEEN

**HESKA CORPORATION,
DIAMOND ANIMAL HEALTH, INC.,**

AND

**WELLS FARGO BANK, NATIONAL ASSOCIATION
as successor in interest to Wells Fargo Business Credit, Inc.**

Dated as of December 30, 2005

**THIRD AMENDED AND RESTATED
CREDIT AND SECURITY AGREEMENT**

Dated as of December 30, 2005

HESKA CORPORATION, a Delaware corporation (“Heska”) and DIAMOND ANIMAL HEALTH, INC., an Iowa corporation (“Diamond”) (each of Heska and Diamond may be referred to herein individually as a “Borrower” and collectively as the “Borrowers”) and WELLS FARGO BANK, NATIONAL ASSOCIATION, acting through its Wells Fargo Business Credit operating division (the “Lender”), as successor in interest to Wells Fargo Business Credit, Inc., hereby agree as follows:

RECITALS

The Borrowers and Center Laboratories, Inc., a Delaware corporation (“Center”), and the Lender entered into a Second Amended and Restated Credit and Security Agreement dated as of June 14, 2000 (the “Former Credit Agreement”).

Shortly after the Former Credit Agreement was executed, Center was sold to an unrelated entity and is no longer a Borrower under the Former Credit Agreement or under this Agreement.

The Borrowers have requested that the Former Credit Agreement be amended and restated in its entirety as set forth herein.

NOW THEREFORE, in consideration of the premises and the mutual promises herein contained, the parties hereto agree that the Former Credit Agreement be amended and restated to read in its entirety as follows:

ARTICLE I

Definitions

Section 1.1 **Definitions.** For all purposes of this Agreement, except as otherwise expressly provided or unless the context otherwise requires:

(a) the terms defined in this Article have the meanings assigned to them in this Article, and include the plural as well as the singular; and

(b) all accounting terms not otherwise defined herein have the meanings assigned to them in accordance with GAAP.

“Accounts” means all of the Borrowers’ accounts, as such term is defined in the UCC, including each and every right of the Borrowers to the payment of money, whether such right to payment now exists or hereafter arises, whether such right to payment arises

out of a sale, lease or other disposition of goods or other property, out of a rendering of services, out of a loan, out of the overpayment of taxes or other liabilities, or otherwise arises under any contract or agreement, whether such right to payment is created, generated or earned by the Borrowers or by some other person who subsequently transfers such person's interest to the Borrowers, whether such right to payment is or is not already earned by performance, and howsoever such right to payment may be evidenced, together with all other rights and interests (including all Liens) which the Borrowers may at any time have by law or agreement against any account debtor or other obligor obligated to make any such payment or against any property of such account debtor or other obligor; all including but not limited to all present and future accounts, contract rights, loans and obligations receivable, chattel papers, bonds, notes and other debt instruments, tax refunds and rights to payment in the nature of general intangibles.

"Additional Capital" means any of the following received by a Borrower on or after June 30, 2005: (a) net cash proceeds from issuance of Heska common stock, including common stock issued under an employee stock purchase plan or as a result of the exercise of options or warrants, (b) net cash proceeds from issuance of Heska preferred stock, (c) net cash proceeds from a Borrower's issuance of debt instruments subject to a subordination agreement acceptable to Wells Fargo in its sole discretion, and (d) net cash proceeds from the licensing or sale of [***].

"Advance" means a Revolving Advance, an Equipment Advance, or a Term Loan B Advance.

"Affiliate" or "Affiliates", for any Borrower, means any Person controlled by, controlling or under common control with such Borrower, including (without limitation) any Subsidiary of such Borrower. For purposes of this definition, "control," when used with respect to any specified Person, means the power to direct the management and policies of such Person, directly or indirectly, whether through the ownership of voting securities, by contract or otherwise.

"Aggregate Borrowing Base" means at any time the lesser of (a) the Maximum Line or (b) the sum of each Borrower's Borrowing Base.

"Aggregate L/C Amount" means at any time the sum of each Borrower's L/C Amount.

"Agreement" means this Third Amended and Restated Credit and Security Agreement, as amended, supplemented or restated from time to time.

"Availability" for a Borrower means the difference of (i) such Borrower's Borrowing Base and (ii) the sum of (A) the outstanding principal balance of such Borrower's Revolving Note and (B) such Borrower's L/C Amount.

"Banking Day" means a day other than a Saturday, Sunday or other day on which banks are generally not open for business in Denver, Colorado and Minneapolis, Minnesota.

"Book Net Worth" of a Borrower means the aggregate of the common and preferred stockholders' equity in such Borrower, determined in accordance with GAAP, but excluding (a) the non-cash impact of expensing options, restricted stock or other stock-based compensation under APB 25, SFAS 123, SFAS 123R and/or SFAS 148, and (b) the non-cash impact of income or expense relating to deferred tax assets and liabilities caused by the use of net loss carry-forwards, in each case after December 31, 2004.

"Borrower" means Heska or Diamond, and "Borrowers" means Heska and Diamond.

"Borrowing Base" for a Borrower means, at any time the lesser of:

- (a) the Maximum Line; or
- (b) subject to change from time to time in the Lender's sole discretion:
 - (i) 85% of Eligible Accounts of such Borrower, plus
 - (ii) During the Foreign Accounts Eligibility Period, the lesser of (A) 85% of Eligible Foreign Accounts or (B) the FREP Sublimit, plus
 - (iii) the lesser of (A) the sum of (1) Eligible Inventory of such Borrower consisting of raw materials multiplied by the Raw Materials Advance Rate plus (2) 55% of Eligible Inventory of such Borrower consisting of finished goods, or (B) the difference of (1) \$4,500,000 less (2) the aggregate amount of Advances made to all Borrowers other than such Borrower in reliance on Eligible Inventory.

"Capital" of a Borrower means the sum of Book Net Worth plus Subordinated Debt of such Borrower plus the lesser of (a) the amount of Debt that was formerly Subordinated Debt payable to Agri-Laboratories, Ltd. but that has been forgiven and is booked as a long-term liability, such as deferred revenue, or (b) \$500,000.

"Capital Expenditures" for any Borrower for a period means the sum of (a) any expenditure of money for the purchase or construction of assets, or for improvements or additions thereto during such period, which are capitalized on such Borrower's balance sheet, whether financed or unfinanced, but excluding expenditures to purchase Rental Inventory, plus (b) all expenditures of money to purchase [***] in excess of \$1,500,000 during the fiscal year in which such period occurs.

"Cash" means instantly available cash and cash equivalents (including, without limitation, investments permitted by Section 7.4(a)(i) and the investments identified at item (i) on Schedule 7.4).

"Collateral" means all of the Borrowers' Accounts, chattel paper, deposit accounts, documents, Equipment, General Intangibles, goods, instruments, Inventory, Investment Property, letter-of-credit rights, letter of credit, all sums on deposit in any Collateral Account, and any items in any Lockbox; together with (i) all substitutions and

replacements for and products of any of the foregoing; (ii) in the case of all goods, all accessions; (iii) all accessories, attachments, parts equipment and repairs now or hereafter attached or affixed to or used in connection with any goods; (iv) all warehouse receipts, bills of lading and other documents of title now or hereafter covering such goods; (v) all collateral subject to the Lien of any Security Document; (vi) any money, or other assets of any Borrower that now or hereafter come into the possession, custody, or control of the Lender; (vii) all sums on deposit in the Special Account; and (viii) proceeds of any and all of the foregoing.

“Collateral Account” for Diamond means (a) the Collateral Account, as defined in the Collateral Account Agreement and (b) the Deposit Account listed on Exhibit A of Diamond’s Deposit Account Control Agreement, and for Heska means (a) the “Lender Account” as defined in the Heska’s Lockbox Agreement and (b) the Deposit Account listed on Exhibit A of Heska’s Deposit Account Control Agreement.

“Collateral Account Agreement” means the Collateral Account Agreement dated as of October 16, 1997, by and among Diamond, the Lender, as successor in interest to Norwest Bank Iowa, NA, and the Lender.

“Commitment” means the Lender’s commitment to make Advances to or for the Borrowers’ account pursuant to Article II.

“Credit Facility” means the credit facility being made available to the Borrowers by the Lender pursuant to Article II.

“Debt” of any Person means all items of indebtedness or liability which in accordance with GAAP would be included in determining total liabilities as shown on the liabilities side of a balance sheet of that Person as at the date as of which Debt is to be determined. For purposes of determining a Person’s aggregate Debt at any time, “Debt” shall also include the aggregate payments required to be made by such Person at any time under any lease that is considered a capitalized lease under GAAP.

“Default” means an event that, with giving of notice or passage of time or both, would constitute an Event of Default.

“Default Period” means any period of time beginning on the day on which a Default or Event of Default has occurred and ending on the date the Lender notifies the Borrowers in writing that such Default or Event of Default has been cured or waived.

“Default Rate” means, (i) with respect to the Revolving Advances, an annual rate equal to three percent (3.0%) over the Revolving Floating Rate, which rate shall change when and as the Revolving Floating Rate changes, and (ii) with respect to the Term Advances, an annual rate equal to three percent (3.0%) over the Term Floating Rate, which rate shall change when and as the Term Floating Rate changes.

“Deposit Account Control Agreement” for a Borrower means the Deposit Account Control Agreement dated as of February 21, 2005, by and among such

Borrower, the Lender, as successor in interest to Wells Fargo Business Credit, Inc., and the Lender.

“Diamond Equipment Note” means the Equipment Note (Diamond) dated as of July 26, 2005, payable to the order of the Lender in the original principal amount of \$2,000,000, and any note or notes issued in substitution therefor, as the same may hereafter be amended, supplemented or restated from time to time.

“Diamond Revolving Note” means the Second Amended and Restated Revolving Note (Diamond Animal Health) dated as of March 26, 2004, payable to the order of the Lender in the original principal amount of \$12,000,000, as the same may hereafter be amended, supplemented or restated from time to time.

“Director” means, with respect to any Borrower, a director if such Borrower is a corporation, a governor, manager, or managing member if such Borrower is a limited liability company, or a partner if such Borrower is a partnership.

“Discretionary Reduction” means any of the following that is unilaterally adopted by the Lender through the exercise of its sole discretion: (a) a reduction (in accordance with subsection (b) of the definition of Borrowing Base) in any advance rate under any Borrower’s Borrowing Base; (b) disqualification (in accordance with subsection (xiv) of the definition of Eligible Accounts) of any Account that would otherwise have been an Eligible Account; or (c) disqualification (in accordance with subsection (x) of the definition of Eligible Inventory) of any Inventory that would otherwise have been Eligible Inventory.

“Discretionary Reduction Date” means any date on which the Aggregate Borrowing Base is at least \$3,000,000 less than it would have been had no Discretionary Reductions been adopted.

“ERISA” means the Employee Retirement Income Security Act of 1974, as amended.

“Eligible Accounts” for a Borrower means all unpaid Accounts of such Borrower, net of any credits, except the following shall not in any event be deemed Eligible Accounts:

(i) That portion of Accounts with terms of 60 days or less that are over 60 days past due, and all other Accounts over 90 days past the invoice date; provided, however, that certain Accounts which are billed pursuant to dated term invoices with payment terms of not greater than 180 days from the invoice date (“Dated Term Accounts”) which (A) do not remain unpaid more than 180 days from such Dated Term Account’s invoice date, (B) are not more than 30 days past due, and (C) are approved by the Lender in its sole discretion, shall, despite the terms of this subsection (i), be deemed Eligible Accounts;

(ii) That portion of Accounts that is disputed or subject to a claim of offset or a contra account (up to the amount of such dispute), including that

portion of Accounts due from customers who have made prepayments, up to the amount of the prepayment;

(iii) That portion of Accounts not yet earned by the final delivery of goods or rendition of services, as applicable, by such Borrower to the customer;

(iv) Accounts owed by any unit of government, whether foreign or domestic (provided, however, that there shall be included in Eligible Accounts that portion of Accounts owed by such units of government for which such Borrower has provided evidence satisfactory to the Lender that (A) the Lender has a first priority perfected security interest and (B) such Accounts may be enforced by the Lender directly against such unit of government under all applicable laws);

(v) Accounts owed by an account debtor located outside the United States and Canada which are not (A) backed by a bank letter of credit naming the Lender as beneficiary or assigned to the Lender, in the Lender's possession or control, and with respect to which a control agreement concerning the letter-of-credit rights is in effect, and acceptable to the Lender in all respects, in its sole discretion, or (B) covered by a foreign receivables insurance policy acceptable to the Lender in its sole discretion;

(vi) Accounts owed by an account debtor that such Borrower has learned or has determined to be insolvent, is the subject of bankruptcy proceedings or has gone out of business;

(vii) Accounts owed by an Owner, Subsidiary, Affiliate, officer or employee of any Borrower;

(viii) Accounts not subject to a duly perfected security interest in the Lender's favor or which are subject to any lien, security interest or claim in favor of any Person, other than Permitted Liens;

(ix) That portion of Accounts that has been restructured, extended, amended or modified;

(x) That portion of Accounts that constitutes advertising, finance charges, service charges or sales or excise taxes;

(xi) Accounts owed by an account debtor, regardless of whether otherwise eligible, if 10% or more of the total amount due under Accounts from such debtor is ineligible under clauses (i), (ii) or (ix) above;

(xii) That portion of the aggregate Accounts of a single customer owed to all Borrowers in the aggregate that exceeds 15% of all Accounts of all Borrowers in the aggregate; provided, however, that for the customers listed below, such limit shall instead be the greater of the foregoing or the amount set forth opposite such customer in the following table:

<u>Customer</u>	<u>Concentration Limit</u>
[***]	25%
[***]	20%

(xiii) That portion of Accounts that arises from research contracts;

(xiv) Accounts, or portions thereof, otherwise deemed ineligible by the Lender in its sole discretion.

“Eligible Equipment” of a Borrower means Equipment owned by such Borrower and designated by the Lender as eligible from time to time in its sole discretion but excluding any Equipment having any of the following characteristics:

(i) Equipment that is subject to any Lien other than in favor of the Lender;

(ii) Equipment that has not been delivered to the Premises;

(iii) Equipment in which the Lender does not hold a first priority security interest;

(iv) Equipment that is obsolete or not currently saleable;

(v) Equipment that is not covered by standard “all risk” insurance for an amount equal to its forced liquidation value;

(vi) Equipment that requires proprietary software in order to operate in the manner in which it is intended when such software is not freely assignable to the Lender or any potential purchaser of such Equipment;

(vii) Equipment consisting of computer hardware, software, tooling, or molds;

(viii) Equipment consisting of Rental Inventory; and

(ix) Equipment otherwise deemed unacceptable to Lender in its sole discretion.

“Eligible Foreign Accounts” for a Borrower means all Accounts due and owing by an account debtor located outside the United States to such Borrower; but excluding any Accounts having any of the following characteristics:

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- (i) That portion of Accounts (other than dated Accounts) unpaid 120 days or more after the invoice date, (B) that portion of dated Accounts unpaid more than 90 days after the stated due date, and (C) that portion of Accounts that do not provide for payment in full within 120 days after the shipment date;
- (ii) That portion of Accounts related to goods or services with respect to which such Borrower has received notice of a claim or dispute, which are subject to a claim of offset or a contra account, or which reflect a reasonable reserve for warranty claims or returns;
- (iii) That portion of Accounts not yet earned by the final delivery of goods or rendition of services, as applicable, by such Borrowers to the customer;
- (iv) That portion of Accounts for which an invoice has not been sent to the applicable account debtor;
- (v) Accounts owed by any unit of government;
- (vi) Accounts owed by an account debtor that is insolvent, the subject of bankruptcy proceedings or has gone out of business;
- (vii) Accounts owed by an Owner, Subsidiary, Affiliate, Officer or employee of any Borrower;
- (viii) Accounts not subject to a duly perfected security interest in the Lender’s favor or which are subject to any Lien in favor of any Person other than the Lender, other than Permitted Liens;
- (ix) That portion of Accounts that has been restructured, extended, amended or modified;
- (x) That portion of Accounts that constitutes advertising, finance charges, service charges or sales or excise taxes;
- (xi) That portion of Accounts owed by any one account debtor that would permit Revolving Advances supported by such account debtor’s Accounts to exceed \$300,000 at any one time;
- (xii) Accounts denominated in any currency other than United States dollars, Canadian dollars, Swiss francs, Japanese yen, United Kingdom pounds sterling or European Union euros;
- (xiii) Accounts with respect to which the Borrower has not instructed the Account debtor to pay the Account to the Collateral Account;
- (xiv) Accounts owed by debtors located in countries not acceptable to the Lender in its sole discretion;

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- (xv) Accounts owed by an account debtor, regardless of whether otherwise eligible, if 10% or more of the total amount due under Accounts from such debtor is ineligible under clauses (i), (ii) or (ix) above;
- (xvi) Accounts otherwise deemed unacceptable to the Lender in its sole discretion.

“Eligible Inventory” for a Borrower means all Inventory of such Borrower, at the lower of cost or market value as determined in accordance with GAAP; provided, however, that the following shall not in any event be deemed Eligible Inventory:

- (i) Inventory that is: in-transit; located at any warehouse, job site or other premises not approved by the Lender in writing; located outside of the states, or localities, as applicable, in which the Lender has filed financing statements to perfect a first priority security interest in such Inventory; covered by any negotiable or non-negotiable warehouse receipt, bill of lading or other document of title; on consignment from or to any Person or subject to any bailment unless such consignee or bailee has executed an agreement with the Lender;
- (ii) Supplies, packaging or parts Inventory;
- (iii) Work-in-process Inventory;
- (iv) Inventory that is damaged, obsolete, or not currently saleable in the normal course of such Borrower’s operations;
- (v) Inventory that such Borrower has returned, has attempted to return, is in the process of returning or intends to return to the vendor thereof;
- (vi) Inventory that is perishable or live; provided, however, that Inventory with an expiration date shall be deemed Eligible Inventory, up to 90 days before the expiration date of such Inventory;
- (vii) Inventory that is subject to a security interest in favor of any Person other than the Lender, except for Permitted Liens;
- (viii) Inventory manufactured by any Borrower pursuant to a license that (A) prohibits the Lender from exercising its rights against such Inventory or (B) restricts such Borrower’s ability to grant the Lender the right to sell such Inventory, in either case unless the

(viii) Sample Inventory;

(ix) all Rental Inventory that has been delivered to, or is in transit to, a customer, and all Rental Inventory that is not substantially the same in functionality and quality as other Inventory carried for sale by such Borrower; and

(x) Inventory otherwise deemed ineligible by the Lender in its sole discretion.

“Environmental Laws” has the meaning specified in Section 5.12.

“Equipment” of a Borrower means all of such Borrower’s equipment, as such term is defined in the UCC, whether now owned or hereafter acquired, including but not limited to all present and future machinery, vehicles, furniture, fixtures, manufacturing equipment, shop equipment, office and recordkeeping equipment, parts, tools, supplies, and including specifically (without limitation) the goods described in any equipment schedule or list herewith or hereafter furnished to the Lender by any Borrower.

“Equipment Advance” has the meaning given in Section 2.3.

“Equipment Note” means the Heska Equipment Note or the Diamond Equipment Note.

“Event of Default” has the meaning specified in Section 8.1.

“Existing Revolving Advances” has the meaning specified in Section 2.1.

“Excess Collateral Base” for a Borrower means the difference of (i) such Borrower’s Borrowing Base calculated without taking into account the limitation imposed by the Maximum Line, and (ii) the sum of (A) the outstanding principal balance of such Borrower’s Revolving Note and (B) such Borrower’s L/C Amount.

“Factory Mortgage” means the Combination Mortgage, Assignment of Rents and Fixture Financing Statement, executed by Diamond for the benefit of the Lender, dated as of September 8, 1998, concerning the Factory Mortgaged Property, as amended.

“Factory Mortgaged Property” means Mortgaged Property as defined in the Factory Mortgage.

“Farm Mortgage” means the Combination Mortgage, Assignment of Rents and Fixture Financing Statement, executed by Diamond for the benefit of the Lender, dated as of September 8, 1998, concerning the Farm Mortgaged Property, as amended.

“Farm Mortgaged Property” means Mortgaged Property as defined in the Farm Mortgage.

“Foreign Accounts Eligibility Period” means the period beginning on the first day of any month in which a Borrower requests in writing that Eligible Foreign Accounts be

included in the Borrowing Base and ending on the last day of any month in which a Borrower requests in writing that Eligible Foreign Accounts no longer be included in the Borrowing Base; provided, however, that the Foreign Accounts Eligibility Period shall automatically terminate on the earlier of the Termination Date or on the first date on which (i) the Borrowers have failed to make any payment of the fee provided for in Section 2.9(e), or (ii) the foreign receivables eligibility program in which the Lender participates becomes unavailable to the Lender, or (iii) any Borrower’s foreign Accounts cease for any reason to be eligible for coverage under such foreign receivables eligibility program.

“Former Credit Agreement” has the meaning given in the Recitals.

“FREP Sublimit” means an amount from zero to \$500,000, as adjusted from time to time in increments of \$100,000 in the Borrowers’ discretion.

“GAAP” means generally accepted accounting principles, applied on a basis consistent with the accounting practices applied in the financial statements described in Section 5.5.

“General Intangibles” of a Borrower means all of such Borrower’s general intangibles, as such term is defined in the UCC, whether now owned or hereafter acquired, including (without limitation) all present and future patents, patent applications, copyrights, trademarks, trade names, trade secrets, customer or supplier lists and contracts, manuals, operating instructions, permits, franchises, the right to use the Borrower’s name, and the goodwill of the Borrower’s business.

“Guarantors” shall mean Diamond and any other Person who executes a guaranty of all or any part of the Obligations for the benefit of the Lender.

“Hazardous Substance” has the meaning given in Section 5.12.

“Heska Equipment Note” means the Equipment Note (Heska) dated as of July 26, 2005, payable to the order of the Lender in the original principal amount of \$500,000, as the same may hereafter be amended, supplemented or restated from time to time.

“Heska Revolving Note” means the Second Amended and Restated Revolving Note (Heska) dated as of March 26, 2004, payable to the order of the Lender in the original principal amount of \$12,000,000, as the same may hereafter be amended, supplemented or restated from time to time.

“Intellectual Property License” means a license owned by any Borrower, which license allows such Borrower the use of any patent, trademark, trade name, or copyrighted material owned by a Person that is not a Borrower.

“Inventory” of a Borrower means all of such Borrower’s inventory, as such term is defined in the UCC, whether now owned or hereafter acquired, whether consisting of whole goods, spare parts or components, supplies or materials, whether acquired, held or

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furnished for sale, for lease or under service contracts or for manufacture or processing, and wherever located, and including, without limitation, all Rental Inventory.

“Investment Property” of a Borrower means all of such Borrower’s investment property, as such term is defined in the UCC, whether now owned or hereafter acquired, including but not limited to all securities, security entitlements, securities accounts, commodity contracts, commodity accounts, stocks, bonds, mutual fund shares, money market shares and U.S. Government securities.

“L/C Amount” for a Borrower means the sum of (i) the Aggregate Face Amount of any issued and outstanding Letters of Credit for which such Borrower is the account party and (ii) the unpaid amount of the Obligation of Reimbursement with respect to such Letters of Credit.

“L/C Application” means an application and agreement for Letters of Credit in a form acceptable to the Lender.

“Letter of Credit” has the meaning given it in Section 2.18.

“Lien” means any security interest, mortgage, deed of trust, pledge, lien, charge, encumbrance, title retention agreement or analogous instrument or device, including the interest of each lessor under any capitalized lease and the interest of any bondsman under any payment or performance bond, in, of or on any assets or properties of a Person, whether now owned or hereafter acquired and whether arising by agreement or operation of law.

“Liquidity” means the sum of Cash (excluding Cash located in accounts outside the United States or owned by an entity not incorporated in the United States) plus Excess Collateral Base less Past Due Payables.

“Loan Documents” means this Agreement, the Notes and the Security Documents.

“Lockbox” for any Borrower has the meaning given in such Borrower’s Lockbox Agreement.

“Lockbox Agreement” for Diamond means the Agreement as to Lockbox Service by and among Diamond, the Lender, as successor in interest to Norwest Bank Iowa, NA, and the Lender, as successor in interest to Wells Fargo Business Credit, Inc., dated as of October 16, 1997, and for Heska means the Lockbox and Collection Account Agreement among Heska, Regulus West LLC (“Regulus”), the Lender, as successor in interest to Wells Fargo Business Credit, Inc., and the Lender, dated as of June 14, 2000.

“Maturity Date” means June 30, 2009.

“Maximum Line” means \$12,000,000, unless said amount is reduced pursuant to Section 2.12, in which event it means the amount to which said amount is reduced.

“Minimum Interest Charge” has the meaning given in Section 2.8(d).

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“Net Income” for a Borrower means, for any period, after-tax net income from continuing operations (that is, not including extraordinary items, or gains or losses from unusual items or discontinued operations), in each case for such Borrower for such period, as determined in accordance with GAAP, but excluding (a) the non-cash impact of expensing options, restricted stock or other stock-based compensation under APB 25, SFAS 123, SFAS 123R and/or SFAS 148, and (b) the non-cash impact of income or expense relating to deferred tax assets and liabilities caused by the use of net loss carry-forwards.

“Non-Core IP” means intellectual property (including, without limitation, any patent, trademark, trade name, or copyrighted material) of any Borrower that is unrelated to the Borrowers’ veterinary product sales and [***] would not have a material adverse effect on any Borrower.

“Note” means a Revolving Note, an Equipment Note, or the Term Loan B Note, and “Notes” means the Revolving Notes, the Equipment Notes, and the Term Loan B Note.

“Obligation of Reimbursement” has the meaning given in Section 2.19.

“Obligations” means each and every debt, liability and obligation of every type and description which any Borrower may now or at any time hereafter owe to the Lender, related to the indebtedness arising under this Agreement, the Notes or any other agreement between any such Borrower and the Lender, entered into in connection with the Credit Facility, including without limitation the Obligation of Reimbursement.

“Owner” means with respect to a Borrower, each Person having legal or beneficial title to an ownership interest in such Borrower or a right to acquire such an interest.

“Past Due Payables” means accounts payable (other than accounts payable to Affiliates) that are 60 days or more past due.

“Permitted Lien” has the meaning given in Section 7.1.

“Person” means any individual, corporation, partnership, joint venture, limited liability company, association, joint-stock company, trust, unincorporated organization or government or any agency or political subdivision thereof.

“Plan” means an employee benefit plan or other plan maintained for any Borrower’s employees and covered by Title IV of ERISA.

“Premises” means all premises where any Borrower conducts its business and has any rights of possession, including (without limitation) the premises legally described in Exhibit A attached hereto.

“Prepayment Factor” means three percent (3%) at all times unless one of the following conditions applies: (a) if Heska achieves, on a consolidated basis, Net Income greater than \$0 for its fiscal year ending December 31, 2006, “Prepayment Factor” shall

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mean two percent (2%) from July 1, 2006 through and including June 30, 2007; and (b) if Heska achieves, on a consolidated basis, Net Income greater than \$0 for its fiscal year ending December 31, 2007, “Prepayment Factor” shall mean two percent (2%) from July 1, 2007 through and including June 30, 2008; and (c) if Heska achieves, on a consolidated basis, Net Income greater than \$0 for its fiscal year ending December 31, 2008, “Prepayment Factor” shall mean one percent (1%) from July 1, 2008 through and including June 30, 2009.

“Prime Rate” means the rate publicly announced from time to time by Wells Fargo Bank, N.A. as its “prime rate” or, if such bank ceases to announce a rate so designated, any similar successor rate designated by the Lender.

“Raw Materials Advance Rate” means 35%.

“Receivables” of a Borrower means each and every right of such Borrower to the payment of money, whether such right to payment now exists or hereafter arises, whether such right to payment arises out of a sale, lease or other disposition of goods or other property, out of a rendering of services, out of a loan, out of the overpayment of taxes or other liabilities, or otherwise arises under any contract or agreement, whether such right to payment is created, generated or earned by such Borrower or by some other person who subsequently transfers such person’s interest to such Borrower, whether such right to payment is or is not already earned by performance, and howsoever such right to payment may be evidenced, together with all other rights and interests (including all liens and security interests) which such Borrower may at any time have by law or agreement against any account debtor or other obligor obligated to make any such payment or against any property of such account debtor or other obligor; all including but not limited to all present and future accounts, contract rights, loans and obligations receivable, chattel papers, bonds, notes and other debt instruments, tax refunds and rights to payment in the nature of general intangibles.

“Rental Inventory” of a Borrower means diagnostic and monitoring instruments purchased by such Borrower for the purpose of demonstrating, loaning, leasing or renting to customers, whether accounted for as equipment or as inventory.

“Reportable Event” shall have the meaning assigned to that term in Title IV of ERISA.

“Revolving Advance” has the meaning given in Section 2.2.

“Revolving Floating Rate” means an annual rate equal to the sum of the Prime Rate plus the Spread, which annual rate shall change when and as the Prime Rate changes.

“Revolving Note” means the Heska Revolving Note or the Diamond Revolving Note.

“Security Documents” means this Agreement, each Collateral Account Agreement, each Lockbox Agreement, each Deposit Account Control Agreement, the

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Factory Mortgage, the Farm Mortgage, and any other document delivered to the Lender from time to time to secure the Obligations, as the same may hereafter be amended, supplemented or restated from time to time.

“Security Interest” has the meaning given in Section 3.1.

“Special Account” means a specified cash collateral account maintained by a financial institution acceptable to the Lender in connection with Letters of Credit, as contemplated by Sections 2.20 and 3.8.

“Spread” has the meaning given in Section 2.7.

“Subordinated Debt” of a Borrower means all Debt of such Borrower that is subject to a Subordination Agreement.

“Subordination Agreement” means any subordination agreement accepted by the Lender from time to time.

“Subsidiary” means any Person of which more than 50% of the outstanding ownership interests having general voting power under ordinary circumstances to elect a majority of the directors or the equivalent of such Person, regardless of whether or not at the time ownership interests of any

other class or classes shall have or might have voting power by reason of the happening of any contingency, is at the time directly or indirectly owned by a Borrower, by a Borrower and one or more other Subsidiaries, or by one or more other Subsidiaries.

“Tangible Net Worth” of a Borrower means the difference between (i) the tangible assets of such Borrower, which, in accordance with GAAP are tangible assets, after deducting adequate reserves in each case where, in accordance with GAAP, a reserve is proper and (ii) all Debt of such Borrower; provided, however, that notwithstanding the foregoing in no event shall there be included as such tangible assets patents, trademarks, trade names, copyrights, licenses, goodwill, receivables from Affiliates, directors, officers or employees, prepaid expenses, deposits, deferred charges or treasury stock or any securities or Debt of such Borrower or any other securities unless the same are readily marketable in the United States of America or entitled to be used as a credit against federal income tax liabilities, and any other assets designated from time to time by the Lender, in its reasonable discretion.

“Tax Expense” for a Borrower as of any date means state and federal income taxes recorded by such Borrower for the year-to-date period ending on such date.

“Term Advances” means the Equipment Advance and the Term Loan B Advances.

“Term Floating Rate” means an annual rate equal to the sum of the Prime Rate plus the Spread, which annual rate shall change when and as the Prime Rate changes.

“Term Loan B Advance” has the meaning specified in Section 2.5.

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“Term Loan B Note” means the Term Loan B Note of the Borrowers, dated as of June 14, 2000 and payable to the order of the Lender in the original principal amount of \$2,062,500, and any note or notes issued in substitution therefor, as the same may hereafter be amended, supplemented or restated from time to time.

“Termination Date” means the earliest of (i) the Maturity Date, (ii) the date the Borrowers terminate the Credit Facility, or (iii) the date the Lender demands payment of the Obligations after an Event of Default pursuant to Section 8.2

“UCC” means the Uniform Commercial Code as in effect from time to time in the state designated in Section 9.15 as the state whose laws shall govern this Agreement, or in any other state whose laws are held to govern this Agreement or any portion hereof.

“Wells Fargo Bank” means Wells Fargo Bank West, National Association.

Section 1.2 Other Definitional Terms; Rules of Interpretation. The words ‘hereof’, ‘herein’ and ‘hereunder’ and words of similar import when used in the Agreement shall refer to this Agreement as a whole and not to any particular provision of this Agreement. All accounting terms not otherwise defined herein have the meanings assigned to them in accordance with GAAP. All terms defined in the UCC and not otherwise defined herein have the meanings assigned to them in the UCC. References to Articles, Sections, subsections, Exhibits, Schedules and the like, are to Articles, Sections and subsections of, or Exhibits or Schedules attached to, this Agreement unless otherwise expressly provided. The words ‘include’, ‘includes’ and ‘including’ shall be deemed to be followed by the phrase ‘without limitation’. Unless the context in which used herein otherwise clearly requires, ‘or’ has the inclusive meaning represented by the phrase ‘and/or’. Defined terms include in the singular number the plural and in the plural number the singular. Reference to any agreement (including the Loan Documents), document or instrument means such agreement, document or instrument as amended or modified and in effect from time to time in accordance with the terms thereof (and, if applicable, in otherwise explicitly provided, and reference to any promissory note includes any promissory note which is an extension or renewal thereof or a substitute or replacement therefore. Reference to any law, rule, regulation, order, decree, requirement, policy, guideline, directive or interpretation means as amended, modified, codified, replaced or reenacted, in whole or in part, and in effect on the determination date, including rules and regulations promulgated thereunder.

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ARTICLE II

Amount and Terms of the Credit Facility

Section 2.1 Existing Revolving Advances. The Lender has made various revolving advances to the Borrowers (the “Existing Revolving Advances”) in accordance with the Former Credit Agreement. As of December 28, 2005, the outstanding principal balance of the Existing Revolving Advances to Heska was \$8,545,126.50 and the outstanding principal balance of the Existing Revolving Advances to Diamond was \$541,186.19. Upon execution and delivery of this Agreement, the Existing Revolving Advances shall be deemed to be Revolving Advances pursuant to Section 2.2.

Section 2.2 Revolving Advances. The Lender agrees, on the terms and subject to the conditions herein set forth, to make advances (the “Revolving Advances”) to any Borrower from time to time until the Termination Date, on the terms and subject to the conditions herein set forth. The Lender shall have no obligation to make a Revolving Advance to a Borrower if, after giving effect to such requested Revolving Advance, (a) the sum of the outstanding and unpaid Revolving Advances to such Borrower exceed such Borrower’s Borrowing Base, or (b) the sum of the outstanding and unpaid Revolving Advances would exceed the Aggregate Borrowing Base. Each Borrower’s obligation to pay the Revolving Advances shall be evidenced by such Borrower’s Revolving Note and shall be secured by the Collateral as provided in Article III and the Mortgaged Property as defined in each of the Factory Mortgage and the Farm Mortgage. Within the limits set forth in this Section 2.2, each Borrower may borrow, prepay pursuant to Section 2.12 and reborrow. Each Borrower agrees to comply with the following procedures in requesting Revolving Advances under this Section 2.2:

(a) Such Borrower shall make each request for a Revolving Advance to the Lender before 11:00 a.m. (Denver time) of the day of the requested Revolving Advance. Requests may be made in writing or by telephone, specifying the date of the requested Revolving Advance and the amount thereof. Each request shall be by (i) any officer of such Borrower; or (ii) any person designated as such Borrower’s agent by any officer of

such Borrower in a writing delivered to the Lender; or (iii) any person whom the Lender reasonably believes to be an officer of such Borrower or such a designated agent.

(b) Upon fulfillment of the applicable conditions set forth in Article IV, the Lender shall disburse the proceeds of the requested Revolving Advance by crediting the same to such Borrower's demand deposit account maintained with Wells Fargo Bank unless the Lender and such Borrower shall agree in writing to another manner of disbursement. Upon the Lender's request, such Borrower shall promptly confirm each telephonic request for an Advance by executing and delivering an appropriate confirmation certificate to the Lender. Each Borrower shall repay all such Advances even if the Lender does not receive such confirmation and even if the person requesting such Advance was not in fact authorized to do so. Any request for an Advance by a Borrower, whether written or telephonic, shall be deemed to be a representation by such Borrower that the conditions set forth in Section 4.2 have been satisfied as of the time of the request.

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Section 2.3 Equipment Advances. On July 28, 2005, the Lender made an Equipment Advance to Heska in the amount of \$500,000 and an Equipment Advance to Diamond in the amount of \$2,000,000, each in accordance with the Former Credit Agreement. As of December 28, 2005, the outstanding principal balance of the Equipment Advance to Heska was \$500,000, and the outstanding principal balance of the Equipment Advance to Diamond was \$2,000,000. Each Borrower's obligation to pay the Equipment Advances shall be evidenced by such Borrower's Equipment Note and shall be secured by the Collateral as provided in Article III and the Mortgaged Property as defined in each of the Factory Mortgage and the Farm Mortgage.

Section 2.4 Payment of Equipment Note. The outstanding principal balance of each Equipment Note shall be due and payable as follows:

- (a) On February 1, 2006, and the first day of each month thereafter, Diamond shall pay monthly installments of \$37,037.04
- (b) On February 1, 2006, and the first day of each month thereafter, Heska shall pay monthly installments of \$9,259.26; and
- (c) On the Maturity Date, the entire unpaid principal balance of each Equipment Note, and all unpaid interest accrued thereon, shall in any event be due and payable.

Section 2.5 Term Loan B Advances. The Lender has previously made advances to Diamond in the amount of \$2,250,000 (the "Term Loan B Advances"). As of December 28, 2005, the outstanding principal balance of the Term Loan B Advances was \$904,738.00. The Borrowers' obligation to pay the Term Loan B Advances shall be evidenced by the Term Loan B Note and shall be secured by the Collateral as provided in Article III and the Mortgaged Property as defined in each of the Factory Mortgage and the Farm Mortgage.

Section 2.6 Payment of Term Loan B Note. The outstanding principal balance of the Term Loan B Note shall be due and payable as follows:

- (a) On June 1, 2000 and the first day of each month thereafter, in monthly installments of \$17,658; and
- (b) On the Maturity Date, the entire unpaid principal balance of the Term Loan B Note, and all unpaid interest accrued thereon, shall in any event be due and payable.

Section 2.7 Spread. The spread (the "Spread") means the percentage set forth in the table below opposite the applicable prior-fiscal-year Net Income of the Borrowers, which percentage shall change annually effective as of the first day of the month following the month in which the Borrowers delivers to the Lender their audited financial statements for the prior fiscal year; provided, however, that so long as no Default Period then exists, if Heska raises Additional Capital of not less than [***], the "Spread" shall be decreased by 0.75% below the otherwise-applicable rate, effective as of the first day of the month following the month in which such Additional Capital is raised; and provided further that if Heska does not raise at least [***] of Additional Capital on or before January 1, 2006, the "Spread" shall be increased

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by 0.25% above the otherwise-applicable rate, effective as of January 1, 2006; and provided further that if Heska does not raise at least [***] of Additional Capital on or before July 1, 2006, the "Spread" shall be increased by 0.75% (including, and not in addition to, the 0.25% increase described in the proviso above) above the otherwise-applicable rate, effective as of July 1, 2006; and provided further that in no case shall any decrease in the Spread occur during the Default Period:

<u>Prior Fiscal Year Net Income</u>	<u>Spread</u>
Less than \$0	2.75%
Greater than or equal to \$0 but less than \$2,500,000	1.75%
Greater than or equal to \$2,500,000	0.75%

Section 2.8 Interest; Minimum Interest Charge; Default Interest; Participations; Usury. Interest accruing on the Notes shall be due and payable in arrears on the first day of each month.

- (a) **Revolving Note**. Except as set forth in Sections 2.8(e), 2.8(f) and 2.8(g), the outstanding principal balance of the Revolving Note shall bear interest at the Revolving Floating Rate.
- (b) **Equipment Note**. Except as set forth in Sections 2.8(e), 2.8(f) and 2.8(g), the outstanding principal balance of the Equipment Note shall bear interest at the Term Floating Rate.

(c) **Term Loan B Note.** Except as set forth in Sections 2.8(e), 2.8(f) and 2.8(g), the outstanding principal balance of the Term Loan B Note shall bear interest at the Term Floating Rate.

(d) **Minimum Interest Charge.** Notwithstanding Sections 2.8(a), 2.8(b), 2.8(c) and 2.8(e), the Borrowers shall pay to the Lender interest of not less than \$100,000 per calendar year (the "Minimum Interest Charge") during the term of this Agreement, and the Borrowers shall pay any deficiency between the Minimum Interest Charge and the amount of interest otherwise calculated under Sections 2.8(a), 2.8(b), or 2.8(c) on the date and in the manner provided in Section 2.10; provided, however, that if the period for which the Minimum Interest Charge is being calculated is shorter than one year, such amount shall be prorated on a per diem basis for such shorter period.

(e) **Default Interest Rate.** At any time during any Default Period, in the Lender's sole discretion and without waiving any of its other rights and remedies, the principal of the Advances outstanding from time to time shall bear interest at the Default Rate, effective for any periods designated by the Lender from time to time during that Default Period.

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(f) **Participations.** If any Person shall acquire a participation in the Advances under this Agreement, the Borrowers shall be obligated to the Lender to pay the full amount of all interest calculated under this Section 2.8, along with all other fees, charges and other amounts due under this Agreement, regardless if such Person elects to accept interest with respect to its participation at a lower rate than the Revolving Floating Rate or the Term Floating Rate, or otherwise elects to accept less than its prorata share of such fees, charges and other amounts due under this Agreement.

(g) **Usury.** In any event no rate change shall be put into effect which would result in a rate greater than the highest rate permitted by law.

Section 2.9 Fees.

(a) **Unused Line Fee.** For the purposes of this Section 2.9(a), "Unused Amount" means the Maximum Line reduced by (i) outstanding Revolving Advances and (ii) the L/C Amount. The Borrowers agree to pay to the Lender an unused line fee at the rate of one-quarter of one percent (0.25%) per annum on the average daily Unused Amount from the date of this Agreement to and including the Termination Date, due and payable monthly in arrears on the first day of the month and on the Termination Date.

(b) **Audit Fees.** The Borrowers hereby agree to pay the Lender, on demand, audit fees in connection with any audits or inspections conducted by the Lender of any Collateral or any Borrower's operations or business at the rates established from time to time by the Lender as its audit fees (which fees are currently \$100 per hour per auditor), together with all actual out-of-pocket costs and expenses incurred in conducting any such audit or inspection, such audits shall be conducted, at the least, on a quarterly basis.

(c) **Letter of Credit Fees.** Each Borrower agrees to pay the Lender a fee with respect to each Letter of Credit issued for such Borrower's account, if any, accruing on a daily basis and computed at the annual rate of two and one-half percent (2.5%) of the aggregate amount that may then be drawn on all outstanding Letters of Credit issued for such Borrower's account, assuming compliance with all conditions for drawing thereunder (the "Aggregate Face Amount"), from and including the date of issuance of such Letter of Credit until such date as such Letter of Credit shall terminate by its terms or be returned to the Lender, due and payable monthly in arrears on the first day of each month and on the Termination Date; provided, however that during Default Periods, in the Lender's sole discretion and without waiving any of its other rights and remedies, such fee shall increase to five and one-half percent (5.5%) of the Aggregate Face Amount. The foregoing fee shall be in addition to any and all fees, commissions and charges imposed by Lender with respect to or in connection with such Letter of Credit.

(d) **Letter of Credit Administrative Fees.** Each Borrower shall pay all administrative fees charged by the Lender in connection with the honoring of drafts under any Letter of Credit issued for such Borrower's account, amendments thereto, transfers thereof and all other activity with respect to the Letters of Credit at the then-current rates published by the Lender for such services rendered on behalf of customers of the Lender generally.

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(e) **Foreign Receivables Eligibility Program Fee.** The Borrowers agree to pay to the Lender during the Foreign Accounts Eligibility Period, a monthly fee in an amount equal to one-twelfth of two-and-one-half percent (2.50%) of the FREP Sublimit, due and payable monthly in advance on the first day of the month.

(f) **Amendment Fee.** The Borrowers shall pay the Lender as of the date hereof a fully earned, non-refundable fee in the amount of \$10,000 in consideration of the Lender's execution and delivery of this Agreement.

Section 2.10 Computation of Interest and Fees; When Interest Due and Payable. Interest accruing on the outstanding principal balance of the Advances and fees hereunder outstanding from time to time shall be computed on the basis of actual number of days elapsed in a year of 360 days. Interest shall be payable in arrears on the first day of each month and on the Termination Date.

Section 2.11 Capital Adequacy. If any Related Lender determines at any time that its Return has been reduced as a result of any Rule Change, such Related Lender may require any Borrower to pay it the amount necessary to restore its Return to what it would have been had there been no Rule Change. For purposes of this Section 2.11:

(a) "Capital Adequacy Rule" means any law, rule, regulation, guideline, directive, requirement or request regarding capital adequacy, or the interpretation or administration thereof by any governmental or regulatory authority, central bank or comparable agency, whether or not having the force of law, that applies to any Related Lender. Such rules include rules requiring financial institutions to maintain total capital in amounts based upon percentages of outstanding loans, binding loan commitments and letters of credit.

(b) “L/C Rule” means any law, rule, regulation, guideline, directive, requirement or request regarding letters of credit, or the interpretation or administration thereof by any governmental or regulatory authority, central bank or comparable agency, whether or not having the force of law, that applies to any Related Lender. Such rules include rules imposing taxes, duties or other similar charges, or mandating reserves, special deposits or similar requirements against assets of, deposits with or for the account of, or credit extended by any Related Lender, on letters of credit.

(c) “Related Lender” includes (but is not limited to) the Lender, any parent corporation of the Lender and any assignee of any interest of the Lender hereunder and any participant in the loans made hereunder.

(d) “Return” for any period, means the return as determined by a Related Lender on the Advances and Letters of Credit based upon its total capital requirements and a reasonable attribution formula that takes account of the Capital Adequacy Rules and the L/C Rules then in effect, costs of issuing or maintaining any Letter of Credit and amounts received or receivable under this Agreement or the Notes with respect to any Advance or Letter of Credit. Return may be calculated for each calendar quarter and for

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the shorter period between the end of a calendar quarter and the date of termination of whole of this Agreement.

(e) “Rule Change” means any change in any Capital Adequacy Rule or L/C Rule occurring after the date of this Agreement, but the term does not include any changes in applicable requirements that at the Closing Date are scheduled to take place under the existing capital Adequacy Rules or L/C Rules or any increases in the capital that any Related Lender is required to maintain to the extent that the increases are required due to a regulatory authority’s assessment of the financial condition of such Related Lender.

The Lender will promptly notify the Borrowers of any event of which it has knowledge, occurring after the date hereof, which will entitle the Lender to compensation pursuant to this Section 2.11. Certificates of any Related Lender sent to any Borrower from time to time claiming compensation under this Section 2.11, stating the reason therefor and setting forth in reasonable detail the calculation of the additional amount or amounts to be paid to the Related Lender hereunder to restore its Return shall be conclusive absent manifest error. In determining such amounts, the Related Lender may use any reasonable averaging and attribution methods.

Section 2.12 Voluntary Prepayment; Reduction of the Maximum Line; Termination of the Credit Facility by the Borrowers. Except as otherwise provided herein, each Borrower may prepay the Revolving Advances made to it in whole at any time or from time to time in part. Diamond may prepay the Equipment Advances (other than in accordance with Section 2.4) or prepay the Term Loan B Advances (other than in accordance with Section 2.6), or the Borrowers may terminate the Credit Facility or reduce the Maximum Line at any time if it (i) gives the Lender at least 30 days’ prior written notice and (ii) pays the Lender the prepayment, termination or line reduction fees in accordance with Section 2.13. Any prepayment of the Equipment Advances (other than in accordance with Section 2.4), any prepayment of the Term Loan B Advances (other than in accordance with Section 2.6), or reduction in the Maximum Line must be in an amount not less than \$250,000 or an integral multiple thereof. If the Borrowers reduce the Maximum Line to zero, all Obligations shall be immediately due and payable. Any partial prepayments of the Equipment Note (other than in accordance with Section 2.4), and any partial prepayments of the Term Loan B Note (other than in accordance with Section 2.6), shall be applied to principal payments due and owing in inverse order of their maturities. Upon termination of the Credit Facility and payment and performance of all Obligations, the Lender shall release or terminate the Security Interest and the Security Documents to which the Borrowers are entitled by law.

Section 2.13 Termination, Line Reduction and Prepayment Fees; Waiver of Termination, Prepayment and Line Reduction Fees.

(a) **Termination and Line Reduction Fees**. If the Credit Facility is terminated for any reason as of a date other than the Maturity Date, or the Borrowers reduce the Maximum Line, the Borrowers shall pay the Lender a fee in an amount equal to the Prepayment Factor multiplied by the Maximum Line (or the reduction, as the case may be).

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(b) **Prepayment Fees**. If the Equipment Note is prepaid for any reason except in accordance with Section 2.4, the Borrowers shall pay to the Lender a fee in an amount equal to the Prepayment Factor multiplied by the amount prepaid. If the Term Loan B Note is prepaid for any reason except in accordance with Section 2.6, the Borrowers shall pay to the Lender a fee in an amount equal to one percent (1%) of the amount prepaid.

(c) **Waiver of Termination and Line Reduction Fees**. The Borrowers will not be required to pay the termination or line reduction fees otherwise due under this Section 2.13 if such termination or line reduction is made (i) because of refinancing of the Borrowers by another division of the Lender, (ii) within 60 days after any demand for payment upon any Borrower in accordance with Section 2.11, or (iii) within 60 days after any Discretionary Reduction Date.

Section 2.14 Mandatory Prepayment. Without notice or demand, if the outstanding principal balance of the Revolving Advances made to a Borrower shall at any time exceed such Borrower’s Borrowing Base, such Borrower shall immediately (or, to the extent such condition is a result of a Discretionary Reduction, within 5 Business Days) prepay the Revolving Advances to the extent necessary to eliminate such excess. Any payment received by the Lender under Section 2.12 may be applied to the Obligations, in such order and in such amounts as the Lender, in its discretion, may from time to time determine; provided that any prepayment under Section 2.12 which a Borrower designates as a payment of the Revolving Advances, shall be applied to such Borrower’s Revolving Advances; provided, further, that any prepayment under Section 2.12 which a Borrower designates as a partial prepayment of the Equipment Note or the Term Loan B Note, shall be applied to principal installments of the Equipment Note or the Term Loan B Note respectively, in inverse order of maturity.

Section 2.15 Payment. All payments to the Lender shall be made in immediately available funds and shall be applied to the Obligations upon receipt by the Lender. The Lender may hold all payments not constituting immediately available funds for three (3) days before applying them to the Obligations. Notwithstanding anything in Section 2.2, each Borrower hereby authorizes the Lender, in its discretion at any time or from time to time without

such Borrower's request and even if the conditions set forth in Section 4.2 would not be satisfied, to make a Revolving Advance in an amount equal to the portion of the Obligations from time to time due and payable.

Section 2.16 Payment on Non-Banking Days. Whenever any payment to be made hereunder shall be stated to be due on a day which is not a Banking Day, such payment may be made on the next succeeding Banking Day, and such extension of time shall in such case be included in the computation of interest on the Advances or the fees hereunder, as the case may be.

Section 2.17 Liability Records. The Lender may maintain from time to time, at its discretion, liability records as to the Obligations. All entries made on any such record shall be presumed correct until a Borrower establishes the contrary. Upon the Lender's demand, each Borrower will admit and certify in writing the exact principal balance of the Obligations that such Borrower then asserts to be outstanding. Any billing statement or accounting rendered by

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the Lender shall be conclusive and fully binding on the Borrowers unless the Borrowers give the Lender specific written notice of exception within 30 days after receipt.

Section 2.18 Issuance of Letters of Credit.

(a) Upon any Borrower's Request the Lender shall issue, from time to time until the Termination Date, one or more documentary or standby letters of credit (each, a "Letter of Credit") for such Borrower's account, provided that:

(i) The Lender shall have no obligation to issue any Letter of Credit for the benefit of a Borrower if (A) a Default Period exists, or (B) the face amount of the Letter of Credit to be issued would exceed the lesser of:

- (1) \$1,000,000 less the Aggregate L/C Amount, or
- (2) such Borrower's Availability.

Each Letter of Credit, if any, shall be issued pursuant to a separate L/C Application entered by the applicable Borrower and the Lender, completed in a manner satisfactory to the Lender. The terms and conditions set forth in each such L/C Application shall supplement the terms and conditions hereof, but if the terms of any such L/C Application and the terms of this Agreement are inconsistent, the terms hereof shall control.

(b) No Letter of Credit shall be issued with an expiry date later than the Maturity Date.

(c) Any request for the issuance of a Letter of Credit under this Section 2.18 shall be deemed to be a representation by the requesting Borrower that the statements set forth in Section 4.2 hereof are correct as of the time of the request.

Section 2.19 Payment of Amounts Drawn Under Letters of Credit. Each Borrower agrees to pay to the Lender any and all amounts required to be paid under the applicable L/C Application, when and as required to be paid thereby, and the amounts designated below, when and as designated:

(a) Each Borrower hereby agrees to pay the Lender on the day a draft is honored under any Letter of Credit a sum equal to all amounts drawn under such Letter of Credit plus any and all reasonable charges and expenses that the Lender may pay or incur relative to such draw, plus interest on all such amounts, charges and expenses as set forth below (all such amounts are hereinafter referred to as the "Obligation of Reimbursement").

(b) Each Borrower hereby agrees to pay the Lender on demand interest on all amounts, charges and expenses payable by such Borrower to the Lender under this Section 2.19, accrued from the date any such draft, charge or expense is paid by the Lender until payment in full by such Borrower at the Revolving Floating Rate.

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If a Borrower fails to pay to the Lender promptly the amount of its Obligation of Reimbursement in accordance with the terms hereof and the L/C Application pursuant to which such Letter of Credit was issued, the Lender is hereby irrevocably authorized and directed, in its sole discretion, to make a Revolving Advance in an amount sufficient to discharge the Obligation of Reimbursement, including all interest accrued thereon but unpaid at the time of such Revolving Advance, and such Revolving Advance shall be evidenced by the Revolving Note and shall bear interest as provided in Section 2.8 hereof.

Section 2.20 Special Account. If this Credit Facility is terminated for any reason whatsoever, while any Letter of Credit is outstanding for any Borrower's account, such Borrower shall thereupon pay the Lender in immediately available funds for deposit in the Special Account an amount equal to the maximum aggregate amount available to be drawn under all Letters of Credit then outstanding for such Borrower's account, assuming compliance with all conditions for drawing thereunder. The Special Account shall be maintained for the Lender by any financial institution acceptable to the Lender. Any interest earned on amounts deposited in the Special Account shall be credited to the Special Account. Amounts on deposit in the Special Account may be applied by the Lender at any time or from time to time to such Borrower's Obligation of Reimbursement or any other Obligations, in the Lender's sole discretion, and shall not be subject to withdrawal by any Borrower so long as the Lender maintains a security interest therein. The Lender agrees to transfer any balance in the Special Account to such Borrower at such time as the Lender is required to release its security interest in the Special Account under applicable law.

Section 2.21 Obligations Absolute. The obligations of each Borrower arising under Section 2.18 shall be absolute, unconditional and irrevocable, and shall be paid strictly in accordance with the terms of this Agreement, under all circumstances whatsoever, including (without limitation) the following circumstances:

- (a) any lack of validity or enforceability of any Letter of Credit or any other agreement or instrument relating to any Letter of Credit (collectively the "Related Documents");
- (b) any amendment or waiver of or any consent to departure from all or any of the Related Documents;
- (c) the existence of any claim, setoff, defense or other right which any Borrower may have at any time, against any beneficiary or any transferee of any Letter of Credit (or any persons or entities for whom any such beneficiary or any such transferee may be acting), or other person or entity, whether in connection with this Agreement, the transactions contemplated herein or in the Related Documents or any unrelated transactions;
- (d) any statement or any other document presented under any Letter of Credit proving to be forged, fraudulent, invalid or insufficient in any respect or any statement therein being untrue or inaccurate in any respect whatsoever;

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- (e) payment by or on behalf of the Lender under any Letter of Credit against presentation of a draft or certificate which does not strictly comply with the terms of such Letter of Credit; or
- (f) any other circumstance or happening whatsoever, whether or not similar to any of the foregoing.

ARTICLE III

Security Interest; Occupancy; Setoff

Section 3.1 **Grant of Security Interest.** Each Borrower hereby pledges, assigns and grants to the Lender a security interest (collectively referred to as the "Security Interest") in the Collateral, as security for the payment and performance of the Obligations. Upon request by the Lender, each Borrower will grant the Lender a security interest in all commercial tort claims it may have against any Person.

Section 3.2 **Notification of Account Debtors and Other Obligors.** The Lender may during any Default Period notify any account debtor or other person obligated to pay the amount due that such right to payment has been assigned or transferred to the Lender for security and shall be paid directly to the Lender. Each Borrower will join in giving such notice if the Lender so requests. At any time after any Borrower or the Lender gives such notice to an account debtor or other obligor, the Lender may, but need not, in the Lender's name or in any Borrower's name, (a) demand, sue for, collect or receive any money or property at any time payable or receivable on account of, or securing, any such right to payment, or grant any extension to, make any compromise or settlement with or otherwise agree to waive, modify, amend or change the obligations (including collateral obligations) of any such account debtor or other obligor; and (b) as each Borrower's agent and attorney-in-fact, notify the United States Postal Service to change the address for delivery of such Borrower's mail to any address designated by the Lender, otherwise intercept such Borrower's mail, and receive, open and dispose of such Borrower's mail, applying all Collateral as permitted under this Agreement and holding all other mail for such Borrower's account or forwarding such mail to such Borrower's last known address.

Section 3.3 **Assignment of Insurance.** As additional security for the payment and performance of the Obligations, each Borrower hereby assigns to the Lender any and all monies (including, without limitation, proceeds of insurance and refunds of unearned premiums) due or to become due under, and all other rights of such Borrower with respect to, any and all policies of insurance now or at any time hereafter covering the Collateral, to the extent such rights may be assigned in accordance with such policies, or any evidence thereof or any business records or valuable papers pertaining thereto, and such Borrower hereby directs the issuer of any such policy to pay all such monies directly to the Lender. At any time, after and during the continuance of an Event of Default, the Lender may (but need not), in the Lender's name or in any Borrower's name, execute and deliver proof of claim, receive all such monies, endorse checks and other instruments representing payment of such monies, and adjust, litigate, compromise or release any claim against the issuer of any such policy.

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Section 3.4 **Occupancy**

- (a) Each Borrower hereby irrevocably grants to the Lender the right to take exclusive possession of the Premises at any time during a Default Period.
- (b) The Lender may use the Premises only to hold, process, manufacture, sell, use, store, liquidate, realize upon or otherwise dispose of goods that are Collateral and for other purposes that the Lender may in good faith deem to be related or incidental purposes.
- (c) The Lender's right to hold the Premises shall cease and terminate upon the earlier of (i) payment in full and discharge of all Obligations and termination of the Commitment, and (ii) final sale or disposition of all goods constituting Collateral and delivery of all such goods to purchasers.
- (d) The Lender shall not be obligated to pay or account for any rent or other compensation for the possession, occupancy or use of any of the Premises; provided, however, that if the Lender does pay or account for any rent or other compensation for the possession, occupancy or use of any of the Premises, the Borrowers shall reimburse the Lender promptly for the full amount thereof. In addition, the Borrowers will pay, or reimburse the Lender for, all taxes, fees, duties, imposts, charges and expenses at any time incurred by or imposed upon the Lender by reason of the execution, delivery, existence, recordation, performance or enforcement of this Agreement or the provisions of this Section 3.4.

Section 3.5 **License.** Each Borrower hereby grants to the Lender a non-exclusive, worldwide and royalty-free license to use or otherwise exploit all trademarks, franchises, trade names, copyrights and patents of such Borrower for the purpose of selling, leasing or otherwise disposing of any or all Collateral during any Default Period. Notwithstanding the foregoing, such grant shall not constitute an assignment of any Intellectual Property License to the extent granting such a license is prohibited by or would constitute a default under any such Intellectual Property License (but only to the extent such prohibition is enforceable under applicable law).

Section 3.6 Financing Statement. The Borrowers authorize the Lender to file from time to time where permitted by law, such financing statements against collateral described as 'all personal property' or describing specific items of collateral including commercial tort claims as the Lender deems necessary or useful to perfect the Security Interest. A carbon, photographic or other reproduction of this Agreement or of any financing statements signed by the Borrower is sufficient as a financing statement and may be filed as a financing statement in any state to perfect the security interests granted hereby. For this purpose, the following information is set forth:

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Name and address of Debtors:

Heska Corporation
3760 Rocky Mountain Avenue
Loveland, Colorado 80538
Organizational Identification No. 2733906

Diamond Animal Health, Inc.
2538 43rd Street SE
Des Moines, Iowa 50317
Organizational Identification No. 170088

Name and address of Secured Party:

Wells Fargo Bank, National Association
MAC C7300-210
1740 Broadway
Denver, Colorado 80274

Section 3.7 Setoff. Each Borrower agrees that the Lender may at any time or from time to time during any Default Period, at its sole discretion and without demand and without notice to anyone, setoff any liability owed to such Borrower by the Lender, whether or not due, against any Obligation, whether or not due. In addition, whether or not a Default Period exists, each other Person holding a participating interest in any Obligations shall have the right to appropriate or setoff any deposit or other liability then owed by such Person to such Borrower, whether or not due, and apply the same to the payment of said participating interest, as fully as if such Person had lent directly to such Borrower the amount of such participating interest.

Section 3.8 Security Interest in Special Account. Each Borrower hereby pledges, and grants to the Lender a security interest in, all funds held in the Special Account from time to time and all proceeds thereof, as security for the payment of all Obligations.

ARTICLE IV

Conditions of Lending

Section 4.1 Conditions Precedent to Effectiveness. This Agreement shall be effective upon the Lender's receipt of all of the following, each properly executed by the appropriate party and in form and substance satisfactory to the Lender:

- (a) This Agreement.
- (b) A certificate of each Borrower's Chief Financial Officer certifying that no action of any Borrower's directors is necessary to authorize execution of this Agreement.
- (c) Such other documents as the Lender in its sole discretion may require.

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Section 4.2 Conditions Precedent to All Advances and Letters of Credit. The Lender's obligation to make each Advance or to issue each Letter of Credit shall be subject to the further conditions precedent that:

- (a) the representations and warranties contained in Article V hereof are correct on and as of such date of such Advance as though made on and as of such date, except to the extent that such representations and warranties relate solely to an earlier date; and
- (b) no event has occurred and is continuing, or would result from such Advance or the issuance of such Letter of Credit, as the case may be, which constitutes a Default or an Event of Default.

ARTICLE V

Representations and Warranties

Each Borrower represents and warrants to the Lender as follows:

Section 5.1 Corporate Existence and Power; Name; Chief Executive Office; Inventory and Equipment Locations; Tax Identification Number. Diamond is a corporation, duly organized, validly existing and in good standing under the laws of the State of Iowa, Heska is a corporation, duly organized, validly existing and in good standing under the laws of the State of Delaware. Each Borrower is duly licensed or qualified to transact business in all jurisdictions where the character of the property owned or leased or the nature of the business transacted by it makes such licensing or qualification necessary.

No dissolution or termination of any Borrower has occurred, and no notice of dissolution or articles of termination have been filed with respect to any Borrower. Each Borrower has all requisite corporate power and authority, to conduct its business, to own its properties and to execute and deliver, and to perform all of its obligations under the Loan Documents. Since 1994, each Borrower has done business solely under the names set forth in Schedule 5.1 hereto. Each Borrower's chief executive office and principal place of business is located at the address set forth under the name of such Borrower in Schedule 5.1 hereto, and all of such Borrower's records relating to its business or the Collateral are kept at that location. All Inventory and Equipment is located at that location or at one of the other locations set forth in Schedule 5.1 hereto. Each Borrower's tax identification number is correctly set forth in Section 3.6 hereto.

Section 5.2 Authorization of Borrowing; No Conflict as to Law or Agreements. The execution, delivery and performance by each Borrower of the Loan Documents and the borrowings from time to time hereunder have been duly authorized by all necessary corporate action and do not and will not (i) require any consent or approval of such Borrower's Owners; (ii) require any authorization, consent or approval by, or registration, declaration or filing with, or notice to, any governmental department, commission, board, bureau, agency or instrumentality, domestic or foreign, or any third party, except such authorization, consent, approval, registration, declaration, filing or notice as has been obtained, accomplished or given prior to the date hereof; (iii) violate any provision of any law, rule or regulation (including, without limitation, Regulation X of the Board of Governors of the Federal Reserve System) or of

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any order, writ, injunction or decree presently in effect having applicability to such Borrower or of such Borrower's articles of incorporation and bylaws; (iv) result in a breach of or constitute a default under any indenture or loan or credit agreement or any other material agreement, lease or instrument to which such Borrower is a party or by which it or its properties may be bound or affected; or (v) result in, or require, the creation or imposition of any mortgage, deed of trust, pledge, lien, security interest or other charge or encumbrance of any nature (other than the Security Interest) upon or with respect to any of the properties now owned or hereafter acquired by such Borrower.

Section 5.3 Legal Agreements.

(a) Immediately prior to execution of this Agreement, the Former Credit Agreement constituted the legal, valid and binding obligations of each Borrower, enforceable against each Borrower in accordance with its terms, subject to general principles of equity and the effects of bankruptcy and insolvency laws applicable to creditors generally. No Borrower has any claim, defense or offset to enforcement of the Former Credit Agreement.

(b) This Agreement constitutes and, upon due execution by each Borrower, the other Loan Documents will constitute the legal, valid and binding obligations of each Borrower, enforceable against such Borrower in accordance with their respective terms, subject to general principles of equity and the effects of bankruptcy and insolvency laws applicable to creditors generally.

Section 5.4 Subsidiaries. No Borrower has any Subsidiaries except as set forth in Schedule 5.4.

Section 5.5 Financial Condition; No Adverse Change. Heska has heretofore furnished to the Lender its consolidated and consolidating financial statements and those statements fairly present the Borrowers' financial condition on the dates thereof and the results of its operations and cash flows for the periods then ended and were prepared in accordance with generally accepted accounting principles (except for the absence of footnotes and subject to normal year-end adjustments with respect to unaudited financial statements). Since the date of the most recent financial statements, to the date hereof, there has been no material adverse change in any Borrower's business, properties or condition (financial or otherwise).

Section 5.6 Litigation. Except as set forth in Schedule 5.6 hereto, there are no actions, suits or proceedings pending or, to any Borrower's knowledge, threatened against or affecting any Borrower or the properties of any Borrower before any court or governmental department, commission, board, bureau, agency or instrumentality, domestic or foreign, which, if determined adversely to such Borrower, would have a material adverse effect on the financial condition, properties or operations of such Borrower.

Section 5.7 Regulation U. No Borrower is engaged in the business of extending credit for the purpose of purchasing or carrying margin stock (within the meaning of Regulation U of the Board of Governors of the Federal Reserve System), and no part of the proceeds of any

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Advance will be used to purchase or carry any margin stock or to extend credit to others for the purpose of purchasing or carrying any margin stock.

Section 5.8 Taxes. Each Borrower and its Affiliates have paid or caused to be paid to the proper authorities when due all federal, state and local taxes required to be withheld by each of them (other than (a) any such tax whose amount, applicability or validity is being contested in good faith by appropriate proceedings and for which proper reserves have been made, or (b) any such taxes in an aggregate amount among all Borrowers less than \$25,000 at any given time). Each Borrower and its Affiliates have filed all federal, state and local tax returns which to the knowledge of the officers of such Borrower or any Affiliate, as the case may be, are required to be filed, and each Borrower and its Affiliates have paid or caused to be paid to the respective taxing authorities all taxes as shown on said returns or on any assessment received by any of them to the extent such taxes have become due (other than (a) any such tax whose amount, applicability or validity is being contested in good faith by appropriate proceedings and for which proper reserves have been made, or (b) any such taxes in an aggregate amount among all Borrowers less than \$25,000 at any given time).

Section 5.9 Titles and Liens. Each Borrower has good and absolute title to all Collateral described in the collateral reports provided to the Lender and all other Collateral, properties and assets (other than assets identified as being subject to capital leases) reflected in the latest financial statements referred to in Section 5.5 and all proceeds thereof, free and clear of all mortgages, security interests, liens, adverse claims and encumbrances, except for Permitted Liens. No financing statement naming any Borrower as debtor is on file in any office except to perfect only Permitted Liens.

Section 5.10 Plans. Except as disclosed to the Lender in writing prior to the date hereof, no Borrower nor any Affiliates of any Borrower maintains or has maintained any Plan. To the best of its knowledge, no Borrower nor any Affiliate of any Borrower has received any notice or has any knowledge to the effect that it is not in full compliance with any of the requirements of ERISA, except as set forth on Schedule 5.10. No Reportable Event or

other fact or circumstance which may have an adverse effect on the Plan's tax qualified status exists in connection with any Plan. No Borrower nor any Affiliate of any Borrower has:

- (a) Any accumulated funding deficiency within the meaning of ERISA; or
- (b) Any liability or knows of any fact or circumstances which could result in any liability to the Pension Benefit Guaranty Corporation, the Internal Revenue Service, the Department of Labor or any participant in connection with any Plan (other than accrued benefits which or which may become payable to participants or beneficiaries of any such Plan).

Section 5.11 Default. Each Borrower is in compliance with all provisions of all agreements, instruments, decrees and orders to which it is a party or by which it or its property is bound or affected, the breach or default of which could have a material adverse effect on any Borrower's financial condition, properties or operations.

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Section 5.12 Environmental Matters.

- (a) Definitions. As used in this Agreement, the following terms shall have the following meanings:

- (i) "Environmental Law" means any federal, state, local or other governmental statute, regulation, law or ordinance dealing with the protection of human health and the environment.

- (ii) "Hazardous Substances" means pollutants, contaminants, hazardous substances, hazardous wastes, petroleum and fractions thereof, and all other chemicals, wastes, substances and materials listed in, regulated by or identified in any Environmental Law.

- (b) To each Borrower's best knowledge, except as previously disclosed to Lender, there are not present in, on or under the Premises any Hazardous Substances in such form or quantity as to create any liability or obligation for any Borrower or for the Lender under common law of any jurisdiction or under any Environmental Law, and no Hazardous Substances have ever been stored, buried, spilled, leaked, discharged, emitted or released in, on or under the Premises in such a way as to create any such liability.

- (c) Except as set forth in Schedule 5.12, to each Borrower's best knowledge, no Borrower has disposed of Hazardous Substances in such a manner as to create any liability under any Environmental Law.

- (d) Except as previously disclosed to Lender, there are not and there never have been any requests, claims, notices, investigations, demands, administrative proceedings, hearings or litigation, relating in any way to the Premises or any Borrower, alleging liability under, violation of, or noncompliance with any Environmental Law or any license, permit or other authorization issued pursuant thereto, which could create liability to any Borrower in excess of \$25,000. To each Borrower's best knowledge, no such matter is threatened or impending.

- (e) To each Borrower's best knowledge, except as previously disclosed to Lender, each Borrower's businesses are and have in the past always been conducted in accordance with all Environmental Laws and all licenses, permits and other authorizations required pursuant to any Environmental Law and necessary for the lawful and efficient operation of such businesses are in the Borrowers' possession and are in full force and effect. Except as set forth in Schedule 5.12, to each Borrower's best knowledge, there is no threat that any permit required under any Environmental Law will be withdrawn, terminated, limited or materially changed.

- (f) To each Borrower's best knowledge, except as previously disclosed to Lender, the Premises are not and never have been listed on the National Priorities List, the Comprehensive Environmental Response, Compensation and Liability Information System or any similar federal, state or local list, schedule, log, inventory or database.

- (g) Except as set forth in Schedule 5.12, each Borrower has delivered to Lender all environmental assessments, audits, reports, permits, licenses and other

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documents describing or relating in any way to the Premises or such Borrower's businesses to the extent in such Borrower's possession or control.

Section 5.13 Submissions to Lender. All financial and other information provided to the Lender by or on behalf of each Borrower in connection with such Borrower's request for the credit facilities contemplated hereby were true and correct in all material respects as of the date given and, as to projections, valuations or proforma financial statements, presented, at the time given, a good faith opinion as to such projections, valuations and proforma condition and results. It is recognized by the Lender that projections and forecasts provided by or on behalf of the Borrowers, although reflecting the Borrowers' good faith projections or forecasts based on methods and data which the Borrowers believe to be reasonable and accurate, are not to be viewed as facts and that actual results during the periods covered by any such projections and forecasts may (and are likely to) differ from the projected or forecasted results. Notwithstanding the foregoing, it is recognized by the Borrowers that the Lender will rely on, among other things, the Borrowers' projections in setting financial covenants set forth in Articles VI and VII hereof, and nothing in this Section 5.13 shall be construed as a waiver of the Lender's right to rely on such covenants or to exercise its remedies in case of a breach of such covenants.

Section 5.14 Financing Statements. Each Borrower has provided to the Lender signed financing statements sufficient when filed to perfect the Security Interest and the other security interests created by the Security Documents. When such financing statements are filed in the offices noted therein, the Lender will have a valid and perfected security interest in all Collateral and all other collateral described in the Security Documents which is capable of being perfected by filing financing statements. None of the Collateral or other collateral covered by the Security Documents is or will become a fixture on real estate, unless a sufficient fixture filing is in effect with respect thereto.

Section 5.15 Rights to Payment. To the best of each Borrower's knowledge, except as disclosed to Lender, each right to payment and each instrument, document, chattel paper and other agreement constituting or evidencing Collateral or other collateral covered by the Security Documents is (or, in the case of all future Collateral or such other collateral, will be when arising or issued) the valid, genuine and legally enforceable obligation, subject to no defense, setoff or counterclaim, of the account debtor or other obligor named therein or in such Borrower's records pertaining thereto as being obligated to pay such obligation.

Section 5.16 Financial Solvency. Both before and after giving effect to all of the transactions contemplated in the Loan Documents, no Borrower, and no Affiliate of any Borrower:

- (a) was or will be insolvent, as that term is used and defined in Section 101(32) of the United States Bankruptcy Code and Section 2 of the Uniform Fraudulent Transfer Act;
- (b) has unreasonably small capital or is engaged or about to engage in a business or a transaction for which any remaining assets of such Borrower or such Affiliate are unreasonably small;

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- (c) by executing, delivering or performing its obligations under the Loan Documents or other documents to which it is a party or by taking any action with respect thereto, intends to, nor believes that it will, incur debts beyond its ability to pay them as they mature;
- (d) by executing, delivering or performing its obligations under the Loan Documents or other documents to which it is a party or by taking any action with respect thereto, intends to hinder, delay or defraud either its present or future creditors; and
- (e) at this time contemplates filing a petition in bankruptcy or for an arrangement or reorganization or similar proceeding under any law of any jurisdiction, or, to the best knowledge of any Borrower, is the subject of any actual, pending or threatened bankruptcy, insolvency or similar proceedings under any law of any jurisdiction.

ARTICLE VI

Borrower's Affirmative Covenants

So long as the Obligations shall remain unpaid, or the Credit Facility shall remain outstanding, each Borrower will comply with the following requirements, unless the Lender shall otherwise consent in writing:

Section 6.1 Reporting Requirements. Heska will deliver, or cause to be delivered, to the Lender each of the following, which shall be in form and detail acceptable to the Lender:

- (a) as soon as available, and in any event within 90 days after the end of each fiscal year of Heska, Heska's audited financial statements with the unqualified opinion of independent certified public accountants selected by Heska and acceptable to the Lender, which annual financial statements shall include Heska's balance sheet as at the end of such fiscal year and the related statements of Heska's income, retained earnings and cash flows for the fiscal year then ended, prepared on a consolidating and consolidated basis to include any Affiliates, all in reasonable detail and prepared in accordance with GAAP, together with (i) copies of all management letters prepared by such accountants and (ii) a certificate of Heska's chief financial officer stating that to the best of his knowledge such financial statements have been prepared in accordance with GAAP and whether or not such officer has knowledge of the occurrence of any Default or Event of Default hereunder and, if so, stating in reasonable detail the facts with respect thereto;
- (b) within 5 business days of filing with the United States Securities and Exchange Commission, a copy of each of Heska's annual or quarterly reports on forms 10K or 10Q;
- (c) as soon as available and in any event within 20 days after the end of each month (or, in the case of months that coincide with the end of the Borrowers' fiscal quarter, within 30 days after the end of such month), an unaudited/internal balance sheet and statement of income and retained earnings of Heska as at the end of and for such month and for the year to date period then ended, prepared on a consolidated and consolidating basis in accordance with GAAP, subject to year-end audit adjustments; and

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accompanied by a certificate of Heska's chief financial officer or principal accounting officer, substantially in the form of Exhibit B hereto, stating (i) that to the best of his knowledge such financial statements have been prepared in accordance with GAAP and fairly represent each Borrower's financial condition and the results of its operations, subject to year-end audit adjustments, (ii) whether or not such officer has knowledge of the occurrence of any Default or Event of Default hereunder not theretofore reported and remedied and, if so, stating in reasonable detail the facts with respect thereto, and (iii) all relevant facts in reasonable detail to evidence, and the computations as to, whether or not each Borrower is in compliance with the requirements set forth in Sections 6.12, 6.13, 6.14, 6.15, and 7.10;

- (d) weekly, or more frequently if the Lender so requires, sales journals, collection reports, and credit memos of each Borrower;
- (e) Monthly within 20 days after the end of each month, agings of each Borrower's accounts receivable and its accounts payable, an inventory certification report, and a calculation of each Borrower's Accounts, Eligible Accounts, Inventory and Eligible Inventory as at the end of such month or shorter time period;
- (f) at least 30 days before the beginning of each fiscal year of Heska, the projected balance sheets and income statements for each month of such year, each in reasonable detail, representing each Borrower's good faith projections and certified by such Borrower's chief financial

officer as being the most accurate projections available and identical to the projections used by such Borrower for internal planning purposes, together with such supporting schedules and information as the Lender may in its discretion require;

(g) immediately after the commencement thereof, notice in writing of all litigation and of all proceedings before any governmental or regulatory agency affecting any Borrower of the type described in Section 5.12 or which seek a monetary recovery against any Borrower in excess of \$50,000;

(h) as promptly as practicable (but in any event not later than five business days) after an officer of any Borrower obtains knowledge of the occurrence of any breach, default or event of default under any Security Document or any event which constitutes a Default or Event of Default hereunder, notice of such occurrence, together with a detailed statement by a responsible officer of such Borrower of the steps being taken by such Borrower to cure the effect of such breach, default or event;

(i) as soon as possible and in any event within 30 days after any Borrower knows or has reason to know that any Reportable Event with respect to any Plan has occurred, the statement of such Borrower's chief financial officer setting forth details as to such Reportable Event and the action which such Borrower proposes to take with respect thereto, together with a copy of the notice of such Reportable Event to the Pension Benefit Guaranty Corporation;

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(j) as soon as possible, and in any event within 10 days after any Borrower fails to make any quarterly contribution required with respect to any Plan under Section 412(m) of the Internal Revenue Code of 1986, as amended, the statement of such Borrower's chief financial officer setting forth details as to such failure and the action which such Borrower proposes to take with respect thereto, together with a copy of any notice of such failure required to be provided to the Pension Benefit Guaranty Corporation;

(k) promptly upon knowledge thereof, notice of any loss of or material damage to any Collateral or other collateral covered by the Security Documents or of any substantial adverse change in the Collateral or such other collateral or the prospect of payment thereof, in each case involving a loss, damage or change of \$50,000 or more;

(l) promptly upon their distribution, copies of all financial statements, reports and proxy statements which any Borrower shall have sent to its stockholders;

(m) promptly after the sending or filing thereof, copies of all regular and periodic reports which any Borrower shall file with the Securities and Exchange Commission or any national securities exchange;

(n) promptly upon filing, copies of the state and federal tax returns and all schedules thereto of each Borrower;

(o) promptly upon knowledge thereof, notice of any Borrower's violation of any law, rule or regulation, the non-compliance with which could materially and adversely affect any Borrower's business or its financial condition; and

(p) from time to time, with reasonable promptness, any and all receivables schedules, collection reports, deposit records, equipment schedules, copies of invoices to account debtors, shipment documents and delivery receipts for goods sold, and such other material, reports, records or information as the Lender may request.

(q) Promptly upon knowledge thereof, each Borrower will deliver to the Lender notice of any commercial tort claims it may bring against any person, including the name and address of each defendant, a summary of the facts, an estimate of such Borrower's damages, copies of any complaint or demand letter submitted by such Borrower, and such other information as the Lender may request.

Section 6.2 Books and Records; Inspection and Examination. Each Borrower will keep accurate books of record and account for itself pertaining to the Collateral and pertaining to such Borrower's business and financial condition and such other matters as the Lender may from time to time request in which true and complete entries will be made in accordance with GAAP and, upon the Lender's request, will permit any officer, employee, attorney or accountant for the Lender to audit, review, make extracts from or copy any and all corporate and financial books and records of such Borrower at all times during ordinary business hours, to send and discuss with account debtors and other obligors requests for verification of amounts owed to such Borrower, and to discuss such Borrower's affairs with any of its Directors, officers, employees or agents. Each Borrower will permit the Lender, or its employees, accountants, attorneys or agents,

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to examine and inspect any Collateral, other collateral covered by the Security Documents or any other property of such Borrower at any time during ordinary business hours. The Borrowers hereby irrevocably authorize all accountants and third parties to disclose and deliver to the Lender, at the Borrowers' expense, all financial information, books and records, work papers, management reports and other information in their possession regarding the Borrowers.

Section 6.3 Account Verification. The Lender may at any time and from time to time send or require any Borrower to send requests for verification of accounts or notices of assignment to account debtors and other obligors. The Lender may also at any time and from time to time telephone account debtors and other obligors to verify accounts.

Section 6.4 Compliance with Laws.

(a) Each Borrower will (i) comply with the requirements of applicable laws and regulations, the non-compliance with which would materially and adversely affect its business or its financial condition and (ii) use and keep the Collateral, and require that others use and keep the Collateral, only for lawful purposes, without violation of any federal, state or local law, statute or ordinance.

(b) Without limiting the foregoing undertakings, each Borrower specifically agrees that it will comply in all material respects with all applicable Environmental Laws and obtain and comply with all permits, licenses and similar approvals required by any Environmental Laws, and will not generate, use, transport, treat, store or dispose of any Hazardous Substances in such a manner as to create any material liability or obligation under the common law of any jurisdiction or any Environmental Law.

Section 6.5 Payment of Taxes and Other Claims; Payment of Past-Due Accounts. Each Borrower will pay or discharge, when due, (a) all taxes, assessments and governmental charges levied or imposed upon it or upon its income or profits, upon any properties belonging to it (including, without limitation, the Collateral) or upon or against the creation, perfection or continuance of the Security Interest, prior to the date on which penalties attach thereto, (b) all federal, state and local taxes required to be withheld by it, and (c) all lawful claims for labor, materials and supplies which, if unpaid, might by law become a lien or charge upon any properties of such Borrower; provided, that no Borrower shall be required to pay any such tax, assessment, charge or claim whose amount, applicability or validity is being contested in good faith by appropriate proceedings and for which proper reserves have been made. No Borrower shall have any Past Due Payables.

Section 6.6 Maintenance of Properties.

(a) Each Borrower will keep and maintain the Collateral, the other collateral covered by the Security Documents and all of its other properties necessary or useful in its business in good condition, repair and working order (normal wear and tear excepted) and will from time to time replace or repair any worn, defective or broken parts; provided, however, that nothing in this Section 6.6 shall prevent any Borrower from discontinuing the operation and maintenance of any of its properties if such

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discontinuance is, in such Borrower's judgment, desirable in the conduct of such Borrower's business and not disadvantageous in any material respect to the Lender.

(b) Each Borrower will defend the Collateral against all claims or demands of all persons (other than the Lender) claiming the Collateral or any interest therein.

(c) Each Borrower will keep all Collateral and other collateral covered by the Security Documents free and clear of all security interests, liens and encumbrances except Permitted Liens.

Section 6.7 Insurance. Each Borrower will obtain and at all times maintain insurance with insurers believed by such Borrower to be responsible and reputable, in such amounts and against such risks as may from time to time be reasonably required by the Lender, but in all events in such amounts and against such risks as is usually carried by companies engaged in similar business and owning similar properties in the same general areas in which such Borrower operates. Without limiting the generality of the foregoing, each Borrower will at all times keep all tangible Collateral insured against risks of fire (including so-called extended coverage), theft, collision (for Collateral consisting of motor vehicles) and such other risks and in such amounts as the Lender may reasonably request, with any loss payable to the Lender to the extent of its interest, and all policies of such insurance shall contain a lender's loss payable endorsement for the Lender's benefit acceptable to the Lender. All policies of liability insurance required hereunder shall name the Lender as an additional insured.

Section 6.8 Preservation of Existence. Each Borrower will preserve and maintain its existence and all of its rights, privileges and franchises necessary or desirable in the normal conduct of its business and shall conduct its business in an orderly, efficient and regular manner.

Section 6.9 Delivery of Instruments, etc. Upon request by the Lender, each Borrower will promptly deliver to the Lender in pledge all instruments, documents and chattel papers constituting Collateral, duly endorsed or assigned by such Borrower.

Section 6.10 Collateral Accounts.

(a) If, notwithstanding the instructions to debtors to make payments to the Lockbox, any Borrower receives any payments on Receivables, such Borrower shall deposit such payments into such Borrower's Collateral Account. Until so deposited, such Borrower shall hold all such payments in trust for and as the property of the Lender and shall not commingle such payments with any of its other funds or property; provided, however, that the foregoing shall not be construed to allow the Lender to withhold any such payments after full payment and discharge of all Obligations.

(b) Amounts deposited in any Collateral Account shall not bear interest and shall not be subject to withdrawal by any Borrower, except after full payment and discharge of all Obligations; provided, however, that if the Borrowers' only outstanding Obligations are principal owing under the Equipment Note and the Term Loan B Note, and if no such principal amount is due, the Lender agrees to remit such amounts to such Borrower's demand deposit account maintained with Wells Fargo Bank.

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(c) All deposits in any Collateral Account shall constitute proceeds of Collateral and shall not constitute payment of the Obligations. The Lender shall from time to time within one Banking Day, apply deposited funds in each Collateral Account to the payment of the Obligations, in any order or manner of application satisfactory to the Lender, by transferring such funds to the Lender's general account.

(d) All items deposited in any Collateral Account shall be subject to final payment. If any such item is returned uncollected, the applicable Borrower will immediately pay the Lender, or, for items deposited in a Collateral Account, the bank maintaining such account, the amount of that item, or such bank at its discretion may charge any uncollected item to any commercial account or other account belonging to the Borrower to whom the item was payable.

Section 6.11 Performance by the Lender. If any Borrower at any time fails to perform or observe any of the foregoing covenants contained in this Article VI or elsewhere herein, and if such failure shall continue for a period of ten calendar days after the Lender gives such Borrower written notice

thereof (or in the case of the agreements contained in Sections 6.5, 6.7 and 6.10, immediately upon the occurrence of such failure, without notice or lapse of time), the Lender may, but need not, perform or observe such covenant on behalf and in the name, place and stead of such Borrower (or, at the Lender's option, in the Lender's name) and may, but need not, take any and all other actions which the Lender may reasonably deem necessary to cure or correct such failure (including, without limitation, the payment of taxes, the satisfaction of security interests, liens or encumbrances, the performance of obligations owed to account debtors or other obligors, the procurement and maintenance of insurance, the execution of assignments, security agreements and financing statements, and the endorsement of instruments); and such Borrower shall thereupon pay to the Lender on demand the amount of all monies expended and all costs and expenses (including reasonable attorneys' fees and legal expenses) incurred by the Lender in connection with or as a result of the performance or observance of such agreements or the taking of such action by the Lender, together with interest thereon from the date expended or incurred at the Revolving Floating Rate. To facilitate the Lender's performance or observance of such covenants of the Borrowers, each Borrower hereby irrevocably appoints the Lender, or the Lender's delegate, acting alone, as such Borrower's attorney in fact (which appointment is coupled with an interest) with the right (but not the duty) from time to time to create, prepare, complete, execute, deliver, endorse or file in the name and on behalf of such Borrower any and all instruments, documents, assignments, security agreements, financing statements, applications for insurance and other agreements and writings required to be obtained, executed, delivered or endorsed by such Borrower under this Section 6.11.

Section 6.12 **Minimum Capital.** Heska will maintain, on a consolidated basis, as of each date listed below, its Capital at an amount not less than the amount set forth opposite such date (amounts in parentheses denote negative numbers):

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[***] – Certain information on this page have been omitted and filed separately with the Securities and Exchange Commission. Confidential treatment has been requested with respect to the omitted portions.

Date	Minimum Capital
November 30, 2005	[***]
December 31, 2005	[***]
January 1, 2006	[***]
February 28, 2006	[***]
March 31, 2006	[***]
April 30, 2006	[***]
May 31, 2006	[***]
June 30, 2006	[***]
July 31, 2006	[***]
August 31, 2006	[***]
September 30, 2006	[***]
October 31, 2006	[***]
November 30, 2006	[***]
December 31, 2006	[***]
January 31, 2007 and the last day of each month thereafter	[***]

Amounts corresponding to dates after December 31, 2005 shall be adjusted upward or downward, respectively, on a dollar-for-dollar basis, by the amount the Borrowers' aggregate actual Capital on December 31, 2005 per the Borrowers' audited financial statements exceeds or falls short of [***].

In addition to the foregoing, if Heska makes [***] during the fiscal year ending December 31, 2006, as contemplated by Section 7.4(a)(ix), to the extent [***] is expensed in accordance with GAAP, the Minimum Capital amounts listed above occurring [***] shall be adjusted downward on a dollar-for-dollar basis by the amount of such expense, not to exceed \$1,000,000.

Section 6.13 **Minimum Net Income.** Heska will achieve, on a consolidated basis, during each period described below, Net Income in an amount not less than the amount set forth opposite such period (amounts in parentheses denote negative numbers):

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[***] – Certain information on this page have been omitted and filed separately with the Securities and Exchange Commission. Confidential treatment has been requested with respect to the omitted portions.

Period	Minimum Net Income
Twelve months ending December 31, 2005	[***]
Three months ending March 31, 2006	[***]
Six months ending June 30, 2006	[***]
Nine months ending September 30, 2006	[***]
Twelve months ending December 31, 2006	[***]

In addition to the foregoing, if Heska makes [***] during the fiscal year ending December 31, 2006, as contemplated by Section 7.4(a)(ix), to the extent [***] is expensed in accordance with GAAP, the Minimum Capital amounts listed above occurring [***] shall be adjusted downward on a dollar-for-dollar basis by the amount of such expense, not to exceed \$1,000,000.

Section 6.14 **Minimum Liquidity.** Heska will maintain, on a consolidated basis, as of the last day of each month, its Liquidity at an amount not less than \$1,500,000.

Section 6.15 **Minimum Individual Book Net Worth.** Each Borrower shall at all times maintain its Book Net Worth, calculated without regard to any Subsidiary or other Affiliate, as shown on the "Total stockholders' equity" line for each Borrower in Exhibit C, at an amount greater than zero.

Section 6.16 New Covenants. On or before November 30, 2006, the Borrowers and the Lender shall agree on new covenant levels for Sections 6.12, 6.13, 6.14, 7.4(a)(v) and 7.10 for periods after such date. The new covenant levels will be based on (i) the Borrowers' projections for such periods and (ii) the year to date financial results of Heska, on a consolidated basis, and such new covenant levels shall be no less stringent than the present levels. An Event of Default shall occur if the new covenants are not agreed to by the above date.

ARTICLE VII

Negative Covenants

So long as the Obligations shall remain unpaid, or the Credit Facility shall remain outstanding, each Borrower agrees that, without the Lender's prior written consent:

Section 7.1 Liens. Such Borrower will not create, incur or suffer to exist any mortgage, deed of trust, pledge, lien, security interest, adverse claim, assignment or transfer (collectively, "Liens") upon or of any of its assets, now owned or hereafter acquired, to secure any indebtedness; excluding, however, from the operation of the foregoing, the following (collectively, "Permitted Liens"):

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(a) in the case of any of such Borrower's property which is not Collateral or other collateral described in the Security Documents, mortgages, deeds of trust, covenants, restrictions, rights, easements and minor irregularities in title which do not materially interfere with such Borrower's business or operations as presently conducted;

(b) Liens in existence on the date hereof and listed in Schedule 7.1 hereto;

(c) the Security Interest and Liens and security interests created by the Security Documents;

(d) purchase money Liens given, simultaneously with or within one hundred twenty (120) days after the acquisition or construction of real property or tangible personal property (including vendor's rights under purchase contracts under an agreement whereby title is retained for the purpose of securing the purchase price thereof and lessors' liens under capitalized lease obligations) or any Lien given to a financial institution financing the acquisition or construction of the real property or tangible personal property, on real property or tangible personal property hereafter acquired or constructed and not heretofore owned by any Borrower; provided, however, that in each such case such Lien (i) does not exceed the amount paid for such acquisition or construction, and (ii) is limited to such acquired or constructed real or tangible personal property;

(e) carriers', mechanics', materialmen's, suppliers', and other like Liens and charges arising in the ordinary course of business securing obligations that are not incurred in connection with the obtaining of any advance or credit and which are not overdue, or are being contested in good faith by appropriate proceedings;

(f) Liens arising in connection with worker's compensation, unemployment insurance and progress payments under government contracts and liens securing the performance of bids, tenders, leases, contracts (other than for the repayment of borrowed money), statutory obligations, surety customs and appeal bonds and other obligations of like nature, incurred, in each case, in the ordinary course of business;

(g) judgment liens in existence in an amount not more than \$100,000;

(h) zoning restrictions, easements, licenses, encumbrances, reservations, provisions, covenants, conditions, waivers, restrictions on the use of property or minor irregularities of title (and with respect to leasehold interests, mortgages, obligations, liens and other encumbrances incurred, created, assumed or permitted to exist and arising by, through or under a landlord or owner of the leased property, with or without consent of the lessee) as normally exist with respect to similar properties which do not in the aggregate materially impair the use thereof in the operation of any Borrower's business;

(i) any preexisting Lien (whether or not assumed) on any real property or tangible personal property hereafter acquired by any Borrower; provided, however, that in each such case such Lien is limited to such acquired real or tangible personal property; provided, further, that proceeds from a Term Advance are not used to acquire such real property or tangible personal property;

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(j) extensions, renewals and replacements of the Liens referred to in clause (b), (d) or (i) above; provided, any such extension, renewal or replacement liens shall be limited to the property or assets covered by the Lien extended, renewed or replaced;

(k) leases, subleases, licenses and sublicenses to third parties of patents, patent applications, trademarks and copyrights, in each case in the ordinary course of its business as currently conducted;

(l) Liens of brokers under brokerage agreements entered into in the ordinary course of business as presently conducted;

(m) Diamond's grant of a security interest in the Farm Mortgaged Property to secure existing indebtedness payable to Agri Laboratories, Ltd. or to secure new indebtedness for borrowed money described in Section 7.2(g), in each case on terms acceptable to the Lender in its reasonable discretion; and

(n) Diamond's grant of a security interest in the Factory Mortgaged Property to secure new indebtedness for borrowed money described in Section 7.2(h).

Section 7.2 Indebtedness. Such Borrower will not incur, create, assume or permit to exist any indebtedness or liability on account of deposits or advances or any indebtedness for borrowed money or letters of credit issued on such Borrower's behalf, or any other indebtedness or liability evidenced by

notes, bonds, debentures or similar obligations, except:

- (a) indebtedness arising hereunder;
- (b) indebtedness of such Borrower in existence on the date hereof and listed in Schedule 7.2 hereto;
- (c) indebtedness of such Borrower (i) relating to liens of such Borrower permitted in accordance with Section 7.1, (ii) arising out of guaranties of such Borrower permitted under Section 7.3, (iii) arising for such Borrower as a result of an investment in or loan to such Borrower by another Borrower in accordance with Section 7.4, or (iv) in the case of Heska, at all times on or before January 31, 2006, indebtedness to Heska Holding AG in an amount not to exceed \$1,500,000, and thereafter, zero.
- (d) unsecured trade debt incurred, and cash advances received from customers, in each case in the ordinary course of business;
- (e) indebtedness of any Person existing at the time such Person is merged with or into such Borrower, to the extent the Lender consents to such merger in accordance with Section 7.7, and provided that such Debt is not incurred in connection with or in contemplation of such merger;
- (f) extensions, renewals and replacements of the debt referred to in clause (b) or (c) above; provided that any such extension, renewal or replacement shall be in an

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amount not greater than, and on terms no less favorable to such Borrower (other than interest rate increases) than, the amount extended, renewed or replaced;

(g) Diamond's incurrence of indebtedness of not less than [***] nor more than [***] secured by the Farm Mortgaged Property, in each case on terms acceptable to the Lender in its reasonable discretion, but in no event on terms less favorable to the Borrowers than the terms of the Term Loan B Note; and upon receipt of proceeds of such indebtedness, the Lender will release its security interest in the Farm Mortgaged Property;

(h) Diamond's incurrence of indebtedness not less than [***] nor more than [***] secured by the Factory Mortgaged Property in connection with a refinancing of the Term Loan B Note, provided that (a) the proceeds of such indebtedness are sufficient to repay, and in fact are used to repay, the Term Loan B Note in its entirety, with the balance of such proceeds (if any) being deposited in Diamond's Collateral Account for repayment of Revolving Advances, and (b) the terms of such indebtedness are acceptable to the Lender in its reasonable discretion, but in no event on terms less favorable to the Borrowers than the terms of the Term Loan B Note. In the case of such a refinancing, the Lender agrees that it will release its security interest in the Factory Mortgaged Property upon receipt of the proceeds of such permitted refinancing;

- (i) other Debt in an amount not to exceed \$100,000; and
- (j) capital leases to the extent the entry into such leases does not cause a Default or Event of Default hereunder.

Section 7.3 Guaranties. Such Borrower will not assume, guarantee, endorse or otherwise become directly or contingently liable in connection with any obligations of any other Person, except:

- (a) the endorsement of negotiable instruments by such Borrower for deposit or collection or similar transactions in the ordinary course of business;
- (b) guaranties, endorsements and other direct or contingent liabilities in connection with the obligations of other Persons, in existence on the date hereof and listed in Schedule 7.2 hereto; and
- (c) guaranties of the obligations of one Borrower given by another Borrower.

Section 7.4 Investments and Subsidiaries.

(a) Such Borrower will not purchase or hold beneficially any stock or other securities or evidences of indebtedness of, make or permit to exist any loans or advances to, or make any investment or acquire any interest whatsoever in, any other Person, including specifically but without limitation any partnership or joint venture, except:

- (i) investments in direct obligations of the United States of America or any agency or instrumentality thereof whose obligations constitute full faith

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and credit obligations of the United States of America having a maturity of one year or less, commercial paper issued by U.S. corporations rated "A-1" or "A-2" by Standard & Poors Corporation or "P-1" or "P-2" by Moody's Investors Service or certificates of deposit or bankers' acceptances having a maturity of one year or less issued by members of the Federal Reserve System having deposits in excess of \$100,000,000 (which certificates of deposit or bankers' acceptances are fully insured by the Federal Deposit Insurance Corporation);

- (ii) advances or loans to such Borrower's officers and employees not exceeding at any one time an aggregate of \$200,000;
- (iii) advances in the form of progress payments, prepaid rent not exceeding two months or security deposits;

(iv) unless a Default Period exists or would exist immediately after or as a result of any such loan, advance or capital contribution, loans, advances or capital contributions by Heska to any Subsidiary that is also a Borrower;

(v) unless a Default Period exists or would exist immediately after or as a result of any such advance or contribution, advances or contributions during the fiscal year ending December 31, 2006, by Heska to any Subsidiary that is not a Borrower; provided, however, that (A) both before and after such advance or contribution Heska's Tangible Net Worth must equal or exceed \$100,000 and (B) all contributions and advances made in reliance on this subsection (v) shall not exceed \$700,000 in the aggregate during the fiscal year ending December 31, 2006;

(vi) investments, including investments in Subsidiaries, existing on the date hereof and listed in Schedule 7.4;

(vii) investments in the following items arising in the ordinary course of business: (A) prepaid expenses and negotiable instruments held for collection; (B) Accounts (and Investments obtained in exchange or settlement of Accounts for which such Borrower has determined that collection is not likely); and (C) lease, utility and worker's compensation, performance and other similar deposits;

(viii) unless a Default Period exists or would exist immediately after or as a result of any such loan or advance, loans or advances by any Subsidiary that is also a Borrower to Heska; provided, however, that both before and after such loan or advance both Heska's Tangible Net Worth and such Subsidiary's Tangible Net Worth must equal or exceed \$100,000; and

(ix) unless (A) a Default Period exists or would exist immediately after or as a result of any such purchase or investment, or (B) Heska, on a consolidated basis, achieves Net Income of less than (\$500,000) during the fiscal year ending December 31, 2005, a purchase of intellectual property rights concerning immunodiagnostic technology or an investment in an equity position in a company in the immunodiagnostic industry, not to exceed \$1,000,000, which

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purchase or investment shall occur during the fiscal year ending December 31, 2006.

(b) Such Borrower will not create or permit to exist any Subsidiary; provided, however, that so long as no Default Period exists, upon written request by such Borrower, the Lender shall not withhold its consent to the creation of (i) any domestic subsidiary provided such Borrower causes such subsidiary to deliver to the Lender a guaranty, a security agreement, and UCC financing statements and other documents requested by the Lender to create a first priority security interest on behalf of the Lender, or to perfect such security interest, in all assets of such subsidiary, or (ii) any foreign subsidiary.

Section 7.5 Dividends. Such Borrower will not declare or pay any dividends (other than dividends payable solely in stock of such Borrower) on any class of its stock or make any payment on account of the purchase, redemption or other retirement of any shares of such stock or make any distribution in respect thereof, either directly or indirectly; provided, however, that so long as no Default Period then exists or would occur immediately following or as a result of such action, (A) any Borrower that is a Subsidiary of Heska may pay dividends to Heska so long as such Subsidiary's Tangible Net Worth both before and after such dividend equals or exceeds \$100,000; and (B) Heska may repurchase capital stock of Heska held by any employee provided Heska is required to do so pursuant to any employee equity subscription agreement, stock ownership plan or stock option agreement in effect from time to time; and provided further that the aggregate price paid for all such repurchased, redeemed, acquired or retired capital shall not exceed \$100,000 during any fiscal year. Notwithstanding the foregoing, the exercise of stock options for the purchase of Heska's capital stock shall not, by means of any deemed repurchase of shares as a result of a cashless exercise or otherwise, cause a breach of this Section 7.5.

Section 7.6 Sale or Transfer of Assets; Suspension of Business Operations. Such Borrower will not sell, lease, assign, transfer or otherwise dispose of (i) the stock of any Subsidiary, (ii) all or a substantial part of its assets, or (iii) any Collateral or any interest therein (whether in one transaction or in a series of transactions) to any other Person other than (A) sale of Inventory in the ordinary course of business; (B) licenses and sublicenses to third parties of patents, patent applications, trademarks and copyrights, in each case in the ordinary course of its business as currently conducted; (C) the sale of used equipment, provided that the aggregate amount of any such sales of equipment shall not exceed \$100,000 during any year, unless the proceeds of such sales are delivered to the Lender for application against the Obligations; (D) sales or other dispositions of Investments permitted by Section 7.4; (E) sales of defaulted receivables to a collection agency in the ordinary course of business; and (F) other sales of assets with book value of not more than \$100,000 during any fiscal year, for fair and reasonable consideration, to the extent such sale could not reasonably be expected to have a material adverse effect. Such Borrower will not in any manner transfer any property without prior or present receipt of full and adequate consideration.

Section 7.7 Consolidation and Merger; Asset Acquisitions. Such Borrower will not consolidate with or merge into any Person, or permit any other Person to merge into it, or acquire (in a transaction analogous in purpose or effect to a consolidation or merger) all or substantially all the assets of any other Person; provided, however, that the Lender will not unreasonably withhold its consent to any merger or acquisition.

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Section 7.8 Restrictions on Nature of Business. Such Borrower will not engage in any line of business materially different from that presently engaged in by such Borrower and/or lines of business reasonably related or supplementing thereto and will not purchase, lease or otherwise acquire assets not related to its business.

Section 7.9 Accounting. Such Borrower will not adopt any material change in accounting principles other than as required by GAAP, the SEC, or NASDAQ. Such Borrower will not adopt, permit or consent to any change in its fiscal year.

Section 7.10 Capital Expenditures. The Borrowers, together with any Affiliates, will not incur or contract to incur, in the aggregate, Capital Expenditures in the aggregate during the fiscal year-to-date period ending on any date described below in excess of the amount set forth opposite such period:

Date	Maximum Capital Expenditures
------	------------------------------

November 30, 2005	[***]
December 31, 2005	[***]
January 1, 2006	[***]
February 28, 2006	[***]
March 31, 2006	[***]
April 30, 2006	[***]
May 31, 2006	[***]
June 30, 2006	[***]
July 31, 2006	[***]
August 31, 2006	[***]
September 30, 2006	[***]
October 31, 2006	[***]
November 30, 2006	[***]
December 31, 2006	[***]

Section 7.11 Discounts, etc. Such Borrower will not, following and during the continuance of an Event of Default, if requested by the Lender, grant any discount, credit or allowance to any customer of such Borrower or accept any return of goods sold, or modify, amend, subordinate, cancel or terminate the obligation of any account debtor or other obligor of such Borrower.

Section 7.12 Defined Benefit Pension Plans. Such Borrower will not adopt, create, assume or become a party to any defined benefit pension plan, unless disclosed to the Lender pursuant to Section 5.10.

Section 7.13 Other Defaults. Such Borrower will not permit any breach, default or event of default to occur under any note, loan agreement, indenture, lease, mortgage, contract for deed, security agreement or other contractual obligation binding upon such Borrower if the effect of such breach, default or event of default is to permit the lender thereof to accelerate the payment of \$100,000 or more; provided, however, that such Borrower shall not be in breach hereunder so long as such breach, default or event of default is being contested in good faith by

appropriate proceedings, for which proper reserves have been made, and the Lender has been given written notice of such content.

Section 7.14 Place of Business; Name. Such Borrower will not transfer its chief executive office or principal place of business, or move, relocate, close or sell any business location. Such Borrower will not permit any tangible Collateral or any records pertaining to the Collateral to be located in any state or area in which, in the event of such location, a financing statement covering such Collateral would be required to be, but has not in fact been, filed in order to perfect the Security Interest. Such Borrower will not change its name. Upon written request by any Borrower, after delivery by such Borrower of (a) financing statements, financing statement amendments, and other documents requested by the Lender for the purpose of perfecting or maintaining priority or perfection of the Security Interest and the other security interests evidenced by the Security Documents, and (b) searches and other proof requested by the Lender to evidence such priority and perfection, the Lender shall grant its consent to (x) a relocation of business locations or Collateral within the United States or (y) a change of any Borrower's name.

Section 7.15 Organizational Documents. Such Borrower will not become an S Corporation within the meaning of the Internal Revenue Code of 1986, as amended.

Section 7.16 Financing Statements. No Borrower will amend any financing statements showing the Lender as Secured Party or Assignee, or any other financing statements that are filed in favor of the Lender, except as permitted by law. Any authorization by the Lender to any Person to amend any such financing statements shall be in writing.

ARTICLE VIII

Events of Default, Rights and Remedies

Section 8.1 Events of Default. "Event of Default", wherever used herein, means any one of the following events:

- (a) default in the payment of the Obligations (other than the Obligations specified in Section 8.1(b)) when they become due and payable;
- (b) default in the payment of any fees, commissions, costs or expenses required to be paid by any Borrower under this Agreement or any other Loan Document within 5 Business Days of the date they become due and payable;
- (c) default in the performance, or breach, of the covenants contained in Section 6.4(a) or Section 6.6(a) of this Agreement if such default remains unremedied 15 Business Days after its occurrence; or default in the performance, or breach, of any other covenant or agreement of any Borrower contained in this Agreement or any other Loan Document;
- (d) Any Borrower or any Guarantor shall be or become insolvent, or admit in writing its or his inability to pay its or his debts as they mature, or make an assignment for the benefit of creditors; or any Borrower or any Guarantor shall apply for or consent

to the appointment of any receiver, trustee, or similar officer for it or him or for all or any substantial part of its or his property; or such receiver, trustee or similar officer shall be appointed without the application or consent of such Borrower or such Guarantor, as the case may be; or any Borrower or any Guarantor shall institute (by petition, application, answer, consent or otherwise) any bankruptcy, insolvency, reorganization, arrangement, readjustment of debt, dissolution, liquidation or similar proceeding relating to it or him under the laws of any jurisdiction; or any such

proceeding shall be instituted (by petition, application or otherwise) against any Borrower or any such Guarantor; or any judgment, writ, warrant of attachment or execution or similar process shall be issued or levied against a substantial part of the property of any Borrower or any Guarantor;

(e) A petition shall be filed by or against any Borrower or any Guarantor under the United States Bankruptcy Code naming such Borrower or such Guarantor as debtor;

(f) Any representation or warranty made by any Borrower in this Agreement, by any Guarantor in any guaranty delivered to the Lender, or by any Borrower (or any of its officers) or any Guarantor in any agreement, certificate, instrument or financial statement or other statement contemplated by or made or delivered pursuant to or in connection with this Agreement or any such guaranty shall prove to have been incorrect in any material respect when deemed to be effective;

(g) The rendering against any Borrower of a final judgment, decree or order for the payment of money in excess of \$100,000 and the continuance of such judgment, decree or order unsatisfied and in effect for any period of 30 consecutive days without a stay of execution;

(h) A default under any bond, debenture, note or other evidence of indebtedness of any Borrower owed to any Person other than the Lender, or under any indenture or other instrument under which any such evidence of indebtedness has been issued or by which it is governed, or under any lease of any of the Premises, and the expiration of the applicable period of grace, if any, specified in such evidence of indebtedness, indenture, other instrument or lease, if the effect of such default is to permit the lender thereof to accelerate the payment of indebtedness \$100,000 or more;

(i) Any Reportable Event, which the Lender determines in good faith might constitute grounds for the termination of any Plan or for the appointment by the appropriate United States District Court of a trustee to administer any Plan, shall have occurred and be continuing 30 days after written notice to such effect shall have been given to such Borrower by the Lender; or a trustee shall have been appointed by an appropriate United States District Court to administer any Plan; or the Pension Benefit Guaranty Corporation shall have instituted proceedings to terminate any Plan or to appoint a trustee to administer any Plan; or any Borrower shall have filed for a distress termination of any Plan under Title IV of ERISA; or any Borrower shall have failed to make any quarterly contribution required with respect to any Plan under Section 412(m) of the Internal Revenue Code of 1986, as amended, which the Lender determines in good faith may by itself, or in combination with any such failures that the Lender may

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determine are likely to occur in the future, result in the imposition of a lien on such Borrower's assets in favor of the Plan;

(j) An event of default shall occur under any Security Document or under any other security agreement, mortgage, deed of trust, assignment or other instrument or agreement securing any obligations of any Borrower hereunder or under any note;

(k) Except as permitted by Section 7.6 of this Agreement, any Borrower shall liquidate, dissolve, terminate or suspend its business operations or otherwise fail to operate its business in the ordinary course, or sell all or substantially all of its assets, without the Lender's prior written consent;

(l) Any Borrower shall fail to pay, withhold, collect or remit any tax or tax deficiency when assessed or due (other than any tax deficiency which is being contested in good faith and by proper proceedings and for which it shall have set aside on its books adequate reserves therefor) or notice of any state or federal tax liens shall be filed or issued (unless such lien is being contested in good faith and by proper proceedings and for which it shall have set aside on its books adequate reserves therefor);

(m) Default in the payment of any amount owed by any Borrower to the Lender, other than any indebtedness arising hereunder;

(n) Any Guarantor shall repudiate, purport to revoke or fail to perform any such Guarantor's obligations under such Guarantor's guaranty in favor of the Lender, or any Guarantor shall cease to exist;

(o) Any event or circumstance with respect to any Borrower shall occur such that the Lender shall believe in good faith that the prospect of payment of all or any part of the Obligations or the performance by any Borrower under the Loan Documents is impaired or any material adverse change in the business or financial condition of any Borrower shall occur; or

(p) Any Borrower shall take or participate in any action which would be prohibited under the provisions of any Subordination Agreement or make any payment on Subordinated Indebtedness (as defined in any Subordination Agreement) that any Person was not entitled to receive under the provisions of such Subordination Agreement.

Section 8.2 Rights and Remedies. During any Default Period, the Lender may exercise any or all of the following rights and remedies:

(a) the Lender may, by notice to the Borrowers, declare the Commitment to be terminated, whereupon the same shall forthwith terminate;

(b) the Lender may, by notice to the Borrowers, declare the Obligations to be forthwith due and payable, whereupon all Obligations shall become and be forthwith due and payable, without presentment, notice of dishonor, protest or further notice of any kind, all of which each Borrower hereby expressly waives;

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(c) the Lender may refuse to fund any requested Advance made by any Borrower;

(d) the Lender may, without notice to any Borrower and without further action, apply any and all money owing by the Lender to any Borrower to the payment of the Obligations;

(e) the Lender may exercise and enforce any and all rights and remedies available upon default to a secured party under the UCC, including, without limitation, the right to take possession of Collateral, or any evidence thereof, proceeding without judicial process or by judicial process (without a prior hearing or notice thereof, which each Borrower hereby expressly waives) and the right to sell, lease or otherwise dispose of any or all of the Collateral, and, in connection therewith, each Borrower will on demand assemble the Collateral and make it available to the Lender at a place to be designated by the Lender which is reasonably convenient to both parties;

(f) the Lender may exercise and enforce its rights and remedies under the Loan Documents; and

(g) the Lender may exercise any other rights and remedies available to it by law or agreement.

Notwithstanding the foregoing, upon the occurrence of an Event of Default described in subsections (d) or (e) of Section 8.1, the Obligations shall be immediately due and payable automatically without presentment, demand, protest or notice of any kind.

Section 8.3 Certain Notices. If notice to any Borrower of any intended disposition of Collateral or any other intended action is required by law in a particular instance, such notice shall be deemed commercially reasonable if given (in the manner specified in Section 9.5) at least ten calendar days before the date of intended disposition or other action.

ARTICLE IX

Miscellaneous

Section 9.1 Restatement of Former Credit Agreement. This Agreement is executed for the purpose of amending and restating the Former Credit Agreement.

Section 9.2 Release. Each Borrower hereby absolutely and unconditionally releases and forever discharges the Lender, the Participants and any and all parent corporations, subsidiary corporations, affiliated corporations, insurers, indemnitors, successors and assigns thereof, together with all of the present and former directors, officers, agents and employees of any of the foregoing, from any and all claims, demands or causes of action of any kind, nature or description relating to the transactions contemplated by this Agreement, whether arising in law or equity or upon contract or tort or under any state or federal law or otherwise, which such Borrower has had or has made claim to have against any such person for or by reason of any act, omission, matter, cause or thing whatsoever arising from the beginning of time to and including the date of this Agreement, whether such claims, demands and causes of action are matured or

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unmatured or known or unknown. For greater certainty, nothing herein shall constitute a release by any Borrower of any Person for any such claim, demand or cause of action arising after the date of this Agreement.

Section 9.3 No Waiver; Cumulative Remedies. No failure or delay by the Lender in exercising any right, power or remedy under the Loan Documents shall operate as a waiver thereof; nor shall any single or partial exercise of any such right, power or remedy preclude any other or further exercise thereof or the exercise of any other right, power or remedy under the Loan Documents. The remedies provided in the Loan Documents are cumulative and not exclusive of any remedies provided by law.

Section 9.4 Amendments, Etc. No amendment, modification, termination or waiver of any provision of any Loan Document or consent to any departure by any Borrower therefrom or any release of a Security Interest shall be effective unless the same shall be in writing and signed by the Lender, and then such waiver or consent shall be effective only in the specific instance and for the specific purpose for which given. No notice to or demand on any Borrower in any case shall entitle such Borrower to any other or further notice or demand in similar or other circumstances.

Section 9.5 Addresses for Notices, Etc. Except as otherwise expressly provided herein, all notices, requests, demands and other communications provided for under the Loan Documents shall be in writing and shall be (a) personally delivered, (b) sent by first class United States mail, (c) sent by overnight courier of national reputation, or (d) transmitted by telecopy, in each case addressed or telecopied to the party to whom notice is being given at its address or telecopier number as set forth below:

If to the Borrowers:

Heska Corporation
3760 Rocky Mountain Avenue
Loveland, Colorado 80538
Telecopier: 970-619-6003
Attention: Chief Financial Officer

Diamond Animal Health, Inc.
c/o Heska Corporation
3760 Rocky Mountain Avenue
Loveland, Colorado 80538
Telecopier: 970-619-6003
Attention: Chief Financial Officer

If to the Lender:

Wells Fargo Bank, National Association
MAC C7300-210
1740 Broadway

Telecopier: 303-863-4904
Attention: Tim Ulrich

or, as to each party, at such other address or telecopier number as may hereafter be designated by such party in a written notice to the other party complying as to delivery with the terms of this Section. All such notices, requests, demands and other communications shall be deemed to have been given on (a) the date received if personally delivered, (b) when deposited in the mail if delivered by mail, (c) the date sent if sent by overnight courier, or (d) the date of transmission if delivered by telecopy, except that notices or requests to the Lender pursuant to any of the provisions of Article II shall not be effective until received by the Lender.

Section 9.6 Further Documents. Each Borrower will from time to time execute and deliver or endorse any and all instruments, documents, conveyances, assignments, security agreements, financing statements and other agreements and writings that the Lender may reasonably request in order to secure, protect, perfect or enforce the Security Interest or the Lender's rights under the Loan Documents (but any failure to request or assure that any Borrower executes, delivers or endorses any such item shall not affect or impair the validity, sufficiency or enforceability of the Loan Documents and the Security Interest, regardless of whether any such item was or was not executed, delivered or endorsed in a similar context or on a prior occasion). All requests under Section 9-210 of the UCC (i) shall be made in a writing signed by a person authorized under Section 2.2, (ii) shall be personally delivered, sent by registered or certified mail, return receipt requested, or by overnight courier of national reputation (iii) shall be deemed to be sent when received by the Lender and (iv) shall otherwise comply with the requirements of Section 9-210. The Borrowers request that the Lender respond to all such requests which on their face appear to come from an authorized individual and releases the Lender from any liability for so responding. The Borrowers shall pay Lender the maximum amount allowed by law for responding to such requests.

Section 9.7 Collateral. This Agreement does not contemplate a sale of accounts, contract rights or chattel paper, and, as provided by law, each Borrower is entitled to any surplus and shall remain liable for any deficiency. The Lender's duty of care with respect to Collateral in its possession (as imposed by law) shall be deemed fulfilled if it exercises reasonable care in physically keeping such Collateral, or in the case of Collateral in the custody or possession of a bailee or other third person, exercises reasonable care in the selection of the bailee or other third person, and the Lender need not otherwise preserve, protect, insure or care for any Collateral. The Lender shall not be obligated to preserve any rights any Borrower may have against prior parties, to realize on the Collateral at all or in any particular manner or order or to apply any cash proceeds of the Collateral in any particular order of application.

Section 9.8 Costs and Expenses. Each Borrower, jointly and severally, agrees to pay on demand all costs and expenses, including (without limitation) reasonable attorneys' fees, incurred by the Lender in connection with the Obligations, this Agreement, the Loan Documents, and any other document or agreement related hereto or thereto, and the transactions contemplated hereby, including without limitation all such costs, expenses and fees incurred in connection with the negotiation, preparation, execution, amendment, administration, performance, collection and enforcement of the Obligations and all such documents and

agreements and the creation, perfection, protection, satisfaction, foreclosure or enforcement of the Security Interest.

Section 9.9 Indemnity. In addition to the payment of expenses pursuant to Section 9.8, each Borrower, jointly and severally, agrees to indemnify, defend and hold harmless the Lender, and any of its participants, parent corporations, subsidiary corporations, affiliated corporations, successor corporations, and all present and future officers, directors, employees, attorneys and agents of the foregoing (the "Indemnitees") from and against any of the following (collectively, "Indemnified Liabilities"):

- (i) any and all transfer taxes, documentary taxes, assessments or charges made by any governmental authority by reason of the execution and delivery of the Loan Documents or the making of the Advances;
- (ii) any claims, loss or damage to which any Indemnitee may be subjected if any representation or warranty contained in Section 5.12 proves to be incorrect in any respect or as a result of any violation of the covenant contained in Section 6.4(b); and
- (iii) any and all other liabilities, losses, damages, penalties, judgments, suits, claims, costs and expenses of any kind or nature whatsoever (including, without limitation, the reasonable fees and disbursements of counsel) in connection with the foregoing and any other investigative, administrative or judicial proceedings, whether or not such Indemnitee shall be designated a party thereto, which may be imposed on, incurred by or asserted against any such Indemnitee, in any manner related to or arising out of or in connection with the making of the Advances and the Loan Documents or the use or intended use of the proceeds of the Advances;

provided that no Borrower shall have any such obligation for any Indemnified Liabilities arising from any act or omission by an Indemnitee which constitutes gross negligence or willful misconduct. If any investigative, judicial or administrative proceeding arising from any of the foregoing is brought against any Indemnitee, upon such Indemnitee's request, each Borrower, or counsel designated by any such Borrower and satisfactory to the Indemnitee, will resist and defend such action, suit or proceeding to the extent and in the manner directed by the Indemnitee, at such Borrower's sole costs and expense. Each Indemnitee will use its best efforts to cooperate in the defense of any such action, suit or proceeding. If the foregoing undertaking to indemnify, defend and hold harmless may be held to be unenforceable because it violates any law or public policy, each Borrower shall nevertheless make the maximum contribution to the payment and satisfaction of each of the Indemnified Liabilities which is permissible under applicable law. Each Borrower's obligation under this Section 9.9 shall survive the termination of this Agreement and the discharge of such Borrower's other obligations hereunder.

Section 9.10 Participants. The Lender and its participants, if any, are not partners or joint venturers, and the Lender shall not have any liability or responsibility for any obligation, act or omission of any of its participants. All rights and powers specifically conferred upon the Lender may be transferred or delegated to any of the Lender's participants, successors or assigns.

Section 9.11 Execution in Counterparts. This Agreement and other Loan Documents may be executed in any number of counterparts, each of which when so executed and delivered shall be deemed to be an original and all of which counterparts, taken together, shall constitute but one and the same instrument.

Section 9.12 Binding Effect; Assignment; Complete Agreement; Exchanging Information. The Loan Documents shall be binding upon and inure to the benefit of the Borrowers and the Lender and their respective successors and assigns, except that no Borrower shall have the right to assign its rights thereunder or any interest therein without the Lender's prior written consent. This Agreement, together with the Loan Documents, comprises the complete and integrated agreement of the parties on the subject matter hereof and supersedes all prior agreements, written or oral, on the subject matter hereof. Without limiting the Lender's right to share information regarding any Borrower and its Affiliates with the Lender's participants (except that the Lender shall not share any information with a participant that is a competitor, or an affiliate of a competitor, of any such Borrower, in the area of researching, developing and manufacturing animal health products), accountants, lawyers and other advisors, the Lender, WFC Holdings Corporation, and all direct and indirect subsidiaries of WFC Holdings Corporation, may exchange any and all information they may have in their possession regarding any Borrower and its Affiliates, and each Borrower waives any right of confidentiality it may have with respect to such exchange of such information. To the extent permitted by law, each Borrower waives and will not assert against any assignee any claims, defenses or set-offs which such Borrower could assert against the Lender.

Section 9.13 Severability of Provisions. Any provision of this Agreement which is prohibited or unenforceable shall be ineffective to the extent of such prohibition or unenforceability without invalidating the remaining provisions hereof.

Section 9.14 Headings. Article and Section headings in this Agreement are included herein for convenience of reference only and shall not constitute a part of this Agreement for any other purpose.

Section 9.15 Governing Law; Jurisdiction, Venue; Waiver of Jury Trial. The Loan Documents shall be governed by and construed in accordance with the substantive laws (other than conflict laws) of the State of Colorado. The parties hereto hereby (i) consent to the personal jurisdiction of the state and federal courts located in the State of Colorado in connection with any controversy related to this Agreement; (ii) waive any argument that venue in any such forum is not convenient, (iii) agree that any litigation initiated by the Lender or any Borrower in connection with this Agreement or the other Loan Documents shall be venued in either the District Court for the City and County of Denver, Colorado, or the United States District Court, District of Colorado; and (iv) agree that a final judgment in any such suit, action or proceeding shall be conclusive and may be enforced in other jurisdictions by suit on the judgment or in any other manner provided by law. **THE PARTIES WAIVE ANY RIGHT TO TRIAL BY JURY IN ANY ACTION OR PROCEEDING BASED ON OR PERTAINING TO THIS AGREEMENT.**

Section 9.16 Retention of Borrowers' Records. The Lender shall have no obligation to maintain any electronic records or any documents, schedules, invoices, agings, or other papers

delivered to the Lender by the Borrowers or in connection with the Loan Documents for more than four months after receipt by the Lender.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed by their respective officers thereunto duly authorized as of the date first above written.

WELLS FARGO BANK, NATIONAL
ASSOCIATION

HESKA CORPORATION

By /s/ Tim Ulrich
Tim Ulrich, Vice President

By /s/ Jason Napolitano
Jason Napolitano, Chief Financial Officer

DIAMOND ANIMAL HEALTH, INC.

By /s/ Jason Napolitano
Jason Napolitano, Chief Financial Officer

	Table of Exhibits and Schedules
Exhibit A	Premises
Exhibit B	Compliance Certificate
Exhibit C	Consolidating Balance Sheets
Schedule 5.1	Trade Names, Chief Executive Office, Principal Place of Business, and Locations of Collateral
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Schedule 7.2	Permitted Indebtedness and Guaranties
Schedule 7.4	Investments

Exhibit A to Third Amended and Restated
Credit and Security Agreement

Premises

The Premises referred to in the Amended and Restated Credit and Security Agreement are described as follows:

Heska Corporation
3760 Rocky Mountain Avenue
Loveland, Colorado 80538

Diamond Animal Health, Inc.
2538 43rd Street SE
Des Moines, Iowa 50317

440 170th Avenue
Carlisle, Iowa

*[***] – Certain information in this exhibit have been omitted and filed separately with the Securities and Exchange Commission. Confidential treatment has been requested with respect to the omitted portions.*

Exhibit B to Third Amended and Restated
Credit and Security Agreement

Compliance Certificate

To: Wells Fargo Business Credit
Date: , 200
Subject: Heska Corporation
Financial Statements

In accordance with our Third Amended and Restated Credit and Security Agreement dated as of December 30, 2005 (the "Credit Agreement"), attached are the financial statements of Heska Corporation ("Heska") as of and for , 20 (the "Reporting Date") and the year-to-date period then ended (the "Current Financials"). All terms used in this certificate have the meanings given in the Credit Agreement.

I certify that, to the best of my knowledge, the Current Financials have been prepared in accordance with GAAP, subject to year-end audit adjustments, and fairly present the Borrowers' financial condition and the results of its operations as of the date thereof.

Events of Default. (Check one):

- The undersigned does not have knowledge of the occurrence of a Default or Event of Default under the Credit Agreement.
- The undersigned has knowledge of the occurrence of a Default or Event of Default under the Credit Agreement and attached hereto is a statement of the facts with respect to thereto.

I hereby certify to the Lender as follows:

- The Reporting Date does not mark the end of one of the Borrowers' fiscal quarters, hence I am completing all paragraphs below except paragraph 4.
- The Reporting Date marks the end of one of the Borrowers' fiscal quarters, hence I am completing all paragraphs below .

Financial Covenants. I further hereby certify as follows:

1. Accounts Payable. Pursuant to Section 6.5 of the Credit Agreement, as of the Reporting Date, Past Due Payables on a consolidated basis was \$ _____, which o satisfies o does not satisfy the requirement that the Borrowers have no Past Due Payables.

2. Spread. Pursuant to Section 2.7 of the Credit Agreement, as of the Reporting Date, Heska's prior-fiscal-year Net Income was, on a consolidated basis, \$ _____, which determines a base Spread of _____ % pursuant to the table below. Heska o has o has not raised at least [***] in Additional Capital as of the Reporting Date, leading to an o increase o decrease from the base Spread of _____ %, so that the applicable Spread is equal to _____ %.

<u>Prior Fiscal Year Net Income</u>	<u>Spread</u>
Less than \$0	2.75%
Greater than or equal to \$0 but less than \$2,500,000	1.75%
Greater than or equal to \$2,500,000	0.75%

3. Minimum Capital. Pursuant to Section 6.12 of the Credit Agreement, as of the Reporting Date, Heska's Capital was, on a consolidated basis, \$ _____, which o satisfies o does not satisfy the requirement that such amount be not less than \$ _____ on the Reporting Date, as set forth in the table below and adjusted, if applicable, in accordance with Section 6.12:

[***] – Certain information on this page have been omitted and filed separately with the Securities and Exchange Commission. Confidential treatment has been requested with respect to the omitted portions.

<u>Date</u>	<u>Minimum Capital</u>
November 30, 2005	[***]
December 31, 2005	[***]
January 1, 2006	[***]
February 28, 2006	[***]
March 31, 2006	[***]
April 30, 2006	[***]
May 31, 2006	[***]
June 30, 2006	[***]
July 31, 2006	[***]
August 31, 2006	[***]
September 30, 2006	[***]
October 31, 2006	[***]
November 30, 2006	[***]
December 31, 2006	[***]
January 31, 2007 and the last day of each month thereafter	[***]

4. Minimum Net Income. Pursuant to Section 6.13 of the Credit Agreement, as of the Reporting Date, Heska's Net Income was, on a consolidated basis, \$ _____, which o satisfies o does not satisfy the requirement that such amount be no less than \$ _____ on the Reporting Date, as set forth in the table below and adjusted, if applicable, in accordance with Section 6.13:

<u>Period</u>	<u>Minimum Net Income</u>
Twelve months ending December 31, 2005	[***]
Three months ending March 31, 2006	[***]
Six months ending June 30, 2006	[***]
Nine months ending September 30, 2006	[***]
Twelve months ending December 31, 2006	[***]

5. Minimum Liquidity. Pursuant to Section 6.14 of the Credit Agreement, as of the Reporting Date, Heska's Liquidity was, on a consolidated basis,

\$ _____, which o satisfies o does not satisfy the requirement that such amount be no less than \$1,500,000 on the Reporting Date.

6. Minimum Individual Book Net Worth. Pursuant to Section 6.15 of the Credit Agreement, as of the Reporting Date, Heska's Book Net Worth was \$ _____ and Diamond's Book Net Worth was \$ _____, which o satisfies o does not satisfy the requirement that such amounts be no less than zero on the Reporting Date.

7. Maximum Contributions. Pursuant to Section 7.4(a)(v) of the Credit Agreement, as of the Reporting Date, Heska's fiscal year-to-date aggregate contributions to non-Borrower Subsidiaries was \$ _____, which o satisfies o does not satisfy the requirement that such amounts be no more than \$700,000 during any fiscal year.

8. Capital Expenditures. Pursuant to Section 7.10 of the Credit Agreement, for the fiscal year-to-date period ending on the Reporting Date, Heska's Capital Expenditures were, in the aggregate and on a consolidated basis, \$ _____ which o satisfies o does not satisfy the requirement that such amount be not more than \$ _____ during the period ending on the Reporting Date, as set forth in the table below:

<u>Date</u>	<u>Maximum Capital Expenditures</u>
November 30, 2005	***
December 31, 2005	***
January 1, 2006	***
February 28, 2006	***
March 31, 2006	***
April 30, 2006	***
May 31, 2006	***
June 30, 2006	***
July 31, 2006	***
August 31, 2006	***
September 30, 2006	***
October 31, 2006	***
November 30, 2006	***
December 31, 2006	***

Attached hereto are all relevant facts in reasonable detail to evidence, and the computations of the financial covenants referred to above. These computations were made in accordance with GAAP.

HESKA CORPORATION

By _____
Its _____

Exhibit C to Third Amended and Restated
Credit and Security Agreement

Consolidating Balance Sheets

Schedule 5.1 to Third Amended and
Restated Credit and Security Agreement

Trade Names, Chief Executive Office, Principal Place of Business,
and Locations of Collateral

Trade Names

Diamond Animal Health, Inc.
Diamond
Diamond Animal Health
Diamond Scientific, Inc.
Heska
Heska Corp.
Heska Des Moines

Chief Executive Office/Principal Place of Business

Heska Corporation
3760 Rocky Mountain Avenue
Loveland, Colorado 80538

Diamond Animal Health, Inc.
2538 43rd Street SE
Des Moines, Iowa 50317

Other Inventory and Equipment Locations

440 170th Avenue
Carlisle, Iowa

Subsidiaries

Heska Corporation Subsidiaries:

Diamond Animal Health, Inc. (Iowa)
Heska Holding AG (Switzerland)
Sensor Devices, Inc. (Wisconsin—inactive)

Diamond Animal Health, Inc. Subsidiaries:

None

Heska Holding AG Subsidiaries:

Heska AG (Switzerland)

Litigation Matters

On September 9, 2005, United Vaccines, Inc. (“United”), a customer of Diamond, filed a lawsuit in Wisconsin against Diamond and Heska alleging various claims, including breach of contract and breach of warranty, and demanding compensatory and punitive damages. On October 20, 2005, Diamond and Heska filed a motion to dismiss certain claims against Diamond and all claims against Heska, as well as an answer to United’s claims, affirmative defenses and counterclaims on behalf of Diamond. While Diamond and Heska intend to pursue the matter vigorously and believe they are entitled to damages from United and that United is not entitled to damages from Heska or Diamond, there can be no assurance the ultimate resolution of this case will reflect Heska’s and Diamond’s current beliefs.

Plans

Borrower now maintains or has maintained the following employee pension benefit plans as defined in ERISA, . 3(2), 29 U.S.C. 1002(2):

1. The Diamond Animal Health, Inc. Pension Plan for Collective Bargaining Unit Employees.

This Defined Benefit Pension Plan is currently frozen. No new participants may enter the plan nor are any contribution liabilities accruing. The plan has a funding liability of \$235,974 for *Termination* purposes, calculated as of May 1, 1998; this liability is a result of the difference between the GATT rates used to calculate contributions and the PBGC rates required to be used by a terminating plan. Upon termination, participants must receive the larger of the accrued benefit calculated using GATT rates and using PBGC rates. Since the PBGC rates have been consistently lower than the GATT rates, the Pension Plan has a funding liability on termination. The Plan can remain frozen until such time as the PBGC rates match the GATT rates or Diamond chooses to contribute funds to make up the termination funding liability. The termination funding liability varies from year to year based upon fluctuations in interest and mortality rates.

The Plan does not have a funding liability under the provisions of Internal Revenue Code . 412, and there are no reportable events.

2. The Diamond Animal Health, Inc. Saving Plan (the “Savings Plan”).

The Savings Plan is a profit sharing/401(k) plan. It was merged into the Heska Corporation 401(k) Plan (the “Heska Plan”) effective January 1, 1998. Diamond Animal Health, Inc. is the wholly owned subsidiary of its parent, Heska Corporation. Diamond Animal Health, Inc. was acquired by Heska Corporation in April, 1996. At the time of the acquisition, both Heska and Diamond sponsored 401(k) plans. In accordance with the provisions of Treas. Reg. . 1.401(k)-1(d)(3), Heska Corporation determined that it would be in the best interests of both Heska and Diamond to merge the Savings Plan into the Heska Plan. Both plans have been submitted to the Internal Revenue Service for a Determination that:

- (1) the Savings Plan was a tax-qualified plan as of the effective date of the merger; and
- (2) the Heska Plan remains a tax-qualified plan on and after the merger date.

3. The Heska Corporation 401(k) Plan (the “Heska Plan”).

The Heska Plan is a defined contribution plan that was established under the provisions of Section 401(a) of the Internal Revenue Code (“IRC”), which includes a qualified deferred arrangement as defined in Section 401(k) of the IRC, for the benefit of eligible employees of

Heska Corporation. The Heska Plan is subject to the provisions of ERISA. Benefits under the plan are not guaranteed by the Pension Benefit Guaranty Corporation. On July 1, 2003, the Heska Plan changed custodians and record keepers from Principal Life Insurance Company to Putnam Fiduciary Trust Company.

Schedule 5.12 to Third Amended and Restated Credit and Security Agreement

Environmental Matters

Settlement Agreement between Williams Pipe Line Company and Bayer Corporation

Schedule 7.1 to Third Amended and Restated Credit and Security Agreement

Permitted Liens

<u>Creditor</u>	<u>Collateral</u>	<u>Jurisdiction</u>	<u>Filing Date</u>	<u>Filing No.</u>
None				

[***] – Certain information in this exhibit have been omitted and filed separately with the Securities and Exchange Commission. Confidential treatment has been requested with respect to the omitted portions.

Schedule 7.2 to Third Amended and Restated Credit and Security Agreement

Permitted Indebtedness and Guaranties

Indebtedness

Diamond Animal Health, Inc.

<u>Lender</u>	<u>Final Pmt Due</u>	<u>Type</u>	<u>Amt Due</u>	<u>Assets Secured</u>
Bankers Leasing	11/2008	Cap Lease	\$ 9,615	Copier
Bankers Leasing	4/2009	Cap Lease	\$ 17,914	Copier
City of Des Moines	6/2006	LTD	\$ 40,310	Subordinated
[***]	5/2006	LTD	\$ 500,000	Subordinated

Guaranties

<u>Primary Obligor</u>	<u>Amount and Description of Obligation Guaranteed</u>	<u>Beneficiary of Guaranty</u>
NONE.		

[***] – Certain information in this exhibit have been omitted and filed separately with the Securities and Exchange Commission. Confidential treatment has been requested with respect to the omitted portions.

Schedule 7.4 to Third Amended and Restated Credit and Security Agreement

Investments

Diamond Animal Health, Inc.

Stancorp Financial Group Inc. (shares received in demutualization)(SFG) 1,008 shares

Investments in Subsidiaries

As of November 30, 2005 Heska Corporation had the following investments in subsidiaries:

Diamond Animal Health, Inc.	\$	297,350
European Subsidiaries	\$	6,805,913

Summary Sheet for Executive Cash Compensation

Base Salaries

The following table sets forth the base salaries for 2006 provided to our chief executive officer and four most highly compensated executive officers, which salaries were determined by the Compensation Committee in December 2005 and remained unchanged from 2005 at the request of management:

<u>Name</u>	<u>2006 Base Salary</u>
Robert B. Grieve	\$ 341,000
Jason A. Napolitano	\$ 221,500
Carol T. Verser	\$ 198,000
Joseph H. Ritter	\$ 190,000
Michael A. Bent	\$ 157,000

Heska Corporation

Management Incentive Plan Master Document

December 15, 2005

This Management Incentive Plan Master Document (“MIP”) is intended to provide incentives to the senior management of Heska Corporation (“Heska” or the “Company”) for the achievement of goals and objectives that are essential to the growth and continued success of the Company. This MIP is to act as a master document for future plans and replaces in its entirety any and all previous Management Incentive Plans. At the sole and absolute discretion of the Compensation Committee of the Board of Directors (the “Compensation Committee”), Heska may adopt an annual plan for a given year (a “Plan Year”) by agreeing upon Category Percentages, a Plan Allocation, Key Parameters and a Payout Structure, as defined and discussed below. For example, a plan effective January 1, 20xx and ending December 31, 20xx with given characteristics could be adopted by the Compensation Committee and would be referred to as the “20xx MIP”. As described below, any and all payments made under the MIP (each an “MIP Payout”) must be funded by an Incentive Pool (defined below).

The MIP will include an “Incentive Target” (as defined below) for each eligible participant to be based on a percentage of the participant’s base salary earned during the year. This calculation excludes commissions, bonuses, relocation payments or other forms of compensation not considered part of the participant’s base pay. The percent of base salary used for determining the Incentive Target will be determined by the category of position held by the participant (the “Category Percentages”). The Compensation Committee shall agree upon the Category Percentages for each Plan Year.

Each participant’s Category Percentage will be multiplied by the individual’s actual earnings for each Plan Year while a participant of the plan. This will result in an Incentive Target for each participant. The Compensation Committee shall agree on a “Plan Allocation”, which may include parameters such as company, department or individual performance, for each Plan Year. The Plan Allocation is to be used as a guideline in determining any MIP Payout to each participant in a given Plan Year, although the Chief Executive Officer (the “CEO”) or the Compensation Committee, as outlined below, shall maintain sole and absolute discretion in determining the appropriate MIP Payout for any participant.

For individuals becoming eligible for participation in the MIP after the beginning of a Plan Year, all MIP calculations shall be based on the amount of base pay earned while a plan participant. Earnings prior to becoming a plan participant shall be excluded.

The MIP is built on the following components:

- “Key Parameters” to be determined by the Compensation Committee for each Plan Year which may consist of one or more items such as earnings per share, net income or revenue growth
- Self funding status

For each plan year, the Compensation Committee shall agree upon a “Payout Structure” based on the Key Parameters. The Payout Structure shall fund an “Incentive Pool” based on performance in excess of agreed upon targets for the Key Parameters. The Compensation Committee, in its sole and absolute discretion, may include or exclude items it considers to be extraordinary, unusual, or unanticipated in setting the targets for the Key Parameters for purposes of calculating the Incentive Pool. A “Fully Funded Pool” shall be defined as an Incentive Pool equal to the sum of the Incentive Targets of all MIP participants.

While self funding status is an important and underlying principle of the MIP, executive management and the Compensation Committee recognize that the MIP may not actually be cash self funding under certain circumstances and it may not be wise to fully or partially fund the plan in cash under these or other circumstances. Therefore, while the intent of the MIP is that the Incentive Pool will consist solely of cash, alternative forms of compensation may be used for part or all of the Incentive Pool at the sole and absolute discretion of the Compensation Committee. For example, if the Compensation Committee determines it is not wise to fund the Incentive Pool in cash, it may fund the Incentive Pool in stock valued at the closing market value on a date determined by the Compensation Committee.

The Compensation Committee will determine any MIP Payout to the CEO. Any individual MIP Payouts to other executive officers will generally be recommended to the Compensation Committee by the CEO, although the Compensation Committee will make the final determination of any individual MIP Payouts to executive officers other than the CEO. Any individual MIP Payouts to other plan participants will be determined by the CEO.

All MIP Payouts earned shall be paid only after the Compensation Committee has reviewed management’s calculations of such MIP Payouts and ensured the Incentive Pool is large enough to cover all such MIP Payouts. MIP Payouts shall be made as soon as reasonably possible following the first Form 10-K filing with the Securities and Exchange Commission by Heska after the end of a given Plan Year.

MIP participants are determined by the CEO and must remain active employees of Heska Corporation or one of its affiliates in a position which qualifies for MIP participation through the end of a given Plan Year in order to be eligible to earn any MIP Payouts.

In the case of a Change of Control. If the Company experiences a Change in Control (as defined in Heska’s 1997 Stock Incentive Plan) during any Plan Year, the Plan Year Incentive Pool will be a Fully Funded Pool and any MIP Payouts will be prorated from the beginning of the Plan Year until the date of the Change of Control. Payouts will occur at a time as close to the Change of Control as practical.

In the case of disability. Time spent on Short Term Disability will count as active time in the plan. Long Term Disability time will not count as active time. Personal leave time will be considered by the Compensation Committee or its designee on a case by case basis.

In the case of death. A prorated payment of any MIP Payout will be made to the employee's designated beneficiary. The payment will be paid at the normal payment time of the MIP Payouts.

The Compensation Committee must approve partial payments or exceptions to any major provision of this plan.

Nothing in this document is to be construed as a contract of employment of a defined period of time or otherwise altering the status of employee as an at-will employee of the company. Either party may elect to terminate the employment relationship at any time, without cause or advance notice.

Heska Corporation 2006 Management Incentive Plan

The following is intended to implement the Heska Corporation Management Incentive Plan Master Document for the year beginning on January 1, 2006 and ending on December 31, 2006 (the "2006 MIP"). The Compensation Committee has agreed on the following for the 2006 MIP.

1) The Category Percentages for the 2006 MIP are as follows:

Chief Executive Officer	50.0% of base pay
Chief Financial Officer	35.0% of base pay
Vice Presidents	35.0% of base pay
Directors	25.0% of base pay

2) The Plan Allocation for the 2006 MIP is as follows:

75% on overall achievement of the company-wide financial objective and 25% on individual performance

3) The Key Parameters for the 2006 MIP is as follows:

Pre-MIP Net Income

4) The Payout Structure for the 2006 MIP is as follows:

The Payout Structure is designed so that after specific Pre-MIP Net Income target is achieved a Share Percentage is applied to the amount of Pre-MIP Net Income over a specific target. There are pre-set Share Percentages associated with Pre-MIP Net Income targets. The result of this relationship creates a cumulative amount of funding.

The plan is designed to begin funding the Incentive Pool once \$1.00 of Pre-MIP Net Income is achieved.

2006 MIP Table

Pre-MIP Net Income	MIP Funding by increment	Share Percentage	MIP Cumulative Funding	Post-MIP Net Income by increment	Post-MIP Cumulative Net Income
>\$ 3,000,001	—	0%	\$ 1,500,000	Pre-MIP Net Income	>\$ 1,500,001
\$ 2,500,001 to \$3,000,000	\$ 250,000	50%	\$ 1,500,000	250,000	\$ 1,500,000
\$ 2,000,001 to \$2,500,000	\$ 250,000	50%	\$ 1,250,000	250,000	\$ 1,250,000
\$ 1,500,001 to \$2,000,000	\$ 250,000	50%	\$ 1,000,000	250,000	\$ 1,000,000
\$ 1,000,001 to \$1,500,000	\$ 250,000	50%	\$ 750,000	250,000	\$ 750,000
\$ 1 to \$1,000,000	\$ 500,000	50%	\$ 500,000	500,000	\$ 500,000

Any MIP payment based on Pre-MIP Net Income over \$3,000,000 will be at the sole and absolute discretion of the Compensation Committee.

SUBSIDIARIES OF COMPANY

Diamond Animal Health, Inc., an Iowa corporation

Heska Holding AG, a corporation incorporated under the laws of Switzerland

Consent of Independent Registered Public Accounting Firm

The Board of Directors
Heska Corporation:

We consent to the incorporation by reference in the Registration Statements File Nos. 333-102871, 333-89738, 333-82096, 333-55112, 333-39448, 333-38138, 333-72155, 333-47129, 333-34111, 333-30951, 333-106679, 333-115995, 333-112701, and 333-123196 (Form S-8) of Heska Corporation and subsidiaries of our report dated March 29, 2006, with respect to the consolidated balance sheets of Heska Corporation and subsidiaries as of December 31, 2004 and 2005, and the related consolidated statements of operations and comprehensive income (loss), stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2005 and related financial statement schedule, which report appears in the December 31, 2005 annual report on Form 10-K of Heska Corporation and subsidiaries.

/s/ **KPMG LLP**

Denver, Colorado
March 29, 2006

CERTIFICATION

I, Robert B. Grieve, certify that:

1. I have reviewed this annual report on Form 10-K of Heska Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 29, 2006

/s/ Robert B. Grieve

ROBERT B. GRIEVE

Chairman of the Board and Chief Executive Officer
(Principal Executive Officer)

CERTIFICATION

I, Jason A. Napolitano, certify that:

1. I have reviewed this annual report on Form 10-K of Heska Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 29, 2006

/s/ Jason A. Napolitano

JASON A. NAPOLITANO

Executive Vice President and Chief Financial Officer

(Principal Financial Officer)

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Robert B. Grieve, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Annual Report of Heska Corporation on Form 10-K for the year ended December 31, 2005 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Form 10-K fairly presents in all material respects the financial condition and results of operations of Heska Corporation.

By: /s/ Robert B. Grieve
Name: ROBERT B. GRIEVE
Title: Chairman of the Board and Chief
Executive Officer

I, Jason A. Napolitano, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Annual Report of Heska Corporation on Form 10-K for the year ended December 31, 2005 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Form 10-K fairly presents in all material respects the financial condition and results of operations of Heska Corporation.

By: /s/ Jason A. Napolitano
Name: JASON A. NAPOLITANO
Title: Executive Vice President and
Chief Financial Officer

A signed original of this written statement required by Section 906 has been provided to Heska Corporation and will be retained by Heska Corporation and furnished to the Securities and Exchange Commission or its staff upon request.
