BLOCKBUSTER INC
Form PRE 14A
March 22, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a)

of the Securities Exchange Act of 1934

(Amendment No.)

Filed by the Registrant x

Filed by a Party other than the Registrant ¨

Check the appropriate box:

x Preliminary Proxy Statement
¨ Definitive Proxy Statement
¨ Definitive Additional Materials
¨ Soliciting Material Pursuant to §240.14a-12

¨ **Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**

Blockbuster Inc.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

x No fee required.

¨ Fee computed on table below per Exchange Act Rules 14a-6(i)(4) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

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(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

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(4) Proposed maximum aggregate value of transaction:

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(5) Total fee paid:

¨ Fee paid previously with preliminary materials.

¨ Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

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(2) Form, Schedule or Registration Statement No.:

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(3) Filing Party:

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(4) Date Filed:

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, 2007

Dear Blockbuster Stockholder:

You are cordially invited to attend the 2007 annual meeting of stockholders of Blockbuster Inc. on **, , 2007, at 10:00 a.m., Eastern Daylight Time**. The meeting will be held at .

The enclosed notice of annual meeting and proxy statement describe the formal business to be transacted at the meeting, which includes (1) the election of three Class II directors, (2) a proposal to amend our Second Amended and Restated Certificate of Incorporation to eliminate the classification of the Board of Directors, (3) the ratification of the appointment of PricewaterhouseCoopers LLP as our independent registered public accounting firm for fiscal 2007, and (4) if presented at the meeting, two stockholder proposals described in the proxy statement. Directors and officers of Blockbuster will be present to help host the meeting.

Please note that we are requiring a form of personal identification and, for beneficial owners, appropriate proof of ownership of our common stock to attend the annual meeting. For more information, please refer to the enclosed proxy statement.

Most stockholders have a choice of submitting a proxy (1) on the Internet, (2) by telephone or (3) by mail using a traditional proxy card. Please refer to the proxy card or other voting instructions included with these proxy materials for information on the voting methods available to you.

Your vote is important. We urge you to review the accompanying material carefully and to submit your proxy as soon as possible so that your shares will be represented at the meeting.

Thank you for your continued interest and support. I look forward to seeing you at the meeting.

Sincerely,

John F. Antioco
Chairman of the Board and
Chief Executive Officer

Blockbuster Inc. Renaissance Tower 1201 Elm Street Dallas, TX 75270-2102 Phone: (214) 854-3000

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BLOCKBUSTER INC.

1201 Elm Street

Dallas, Texas 75270

NOTICE OF 2007 ANNUAL MEETING OF STOCKHOLDERS

TO BE HELD , 2007

NOTICE IS HEREBY GIVEN that the 2007 annual meeting of stockholders of Blockbuster Inc., a Delaware corporation, will be held at , on , , 2007, at 10:00 a.m., Eastern Daylight Time, for the following purposes:

(1) To elect three Class II directors;

(2) To consider and vote upon a proposal to amend Blockbuster s Second Amended and Restated Certificate of Incorporation to eliminate the classification of the Board of Directors;

(3) To ratify the appointment of PricewaterhouseCoopers LLP as Blockbuster s independent registered public accounting firm for fiscal 2007;

(4) If presented at the meeting, to consider and vote upon two stockholder proposals described in the accompanying proxy statement; and

(5) To transact such other business as may properly come before the meeting or any adjournment or postponement thereof.

The close of business on , 2007 has been fixed as the record date for determining stockholders entitled to notice of and to vote at the meeting or any adjournment or postponement thereof.

Your vote is important. We urge you to review the accompanying material carefully and to submit your proxy as soon as possible so that your shares will be represented at the meeting.

By Order of the Board of Directors,

Andi Yorio
Assistant Secretary

Dallas, Texas

, 2007

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BLOCKBUSTER INC.

1201 Elm Street

Dallas, Texas 75270

PROXY STATEMENT

FOR

ANNUAL MEETING OF STOCKHOLDERS

To Be Held , 2007

GENERAL INFORMATION

This proxy statement is being furnished to you in connection with the solicitation of proxies by the Board of Directors of Blockbuster (the Board) for use at our 2007 annual meeting. In this proxy statement, references to Blockbuster, the Company, we, us, our and similar expr refer to Blockbuster Inc., unless the context of a particular reference provides otherwise.

2007 Annual Meeting Date and Location

Blockbuster s 2007 annual meeting of stockholders will be held at , on , , 2007, at 10:00 a.m., Eastern Daylight Time, or at such other time and place to which the meeting may be adjourned. References in this proxy statement to the annual meeting also refer to any adjournments or changes in location of the meeting, to the extent applicable.

Delivery of Proxy Materials

Mailing Date

The approximate date on which this proxy statement and accompanying proxy are first being sent or given to stockholders is , 2007.

Stockholders Sharing an Address

Registered Stockholders: Each registered stockholder (you own shares in your own name on the books of our transfer agent) will receive one copy of each of our proxy statement and annual report on Form 10-K per account even if at the same address.

Street-name Stockholders: Most banks and brokers are delivering only one copy of each of our proxy statement and annual report on Form 10-K to consenting street-name stockholders (you own shares beneficially in the name of a bank, broker or other holder of record on the books of our transfer agent) who share the same address. This procedure reduces our printing and distribution costs. Those who wish to receive separate copies may do so by contacting their bank, broker or other nominee, or, in most cases, by checking the appropriate box on the voting instruction card sent to them. Similarly, most street-name stockholders who are receiving multiple copies of our proxy statement and annual report on Form 10-K at a single address may request that only a single set of materials be sent to them in the future by checking the appropriate box on the voting instruction card sent to them or by contacting their bank, broker or other nominee. In the alternative, most street-name stockholders may give instructions to receive separate copies or discontinue multiple mailings of materials by contacting the third party that mails annual meeting materials for most banks and brokers by writing to Householding Department, ADP, 51 Mercedes Way, Edgewood, NY 11717, or telephoning (800) 542-1061. Your instructions must include the name of your bank or broker and your account number.

Electronic Delivery Option

Instead of receiving future copies of these materials by mail, street-name stockholders may have the opportunity to receive copies of the proxy materials electronically. Opting to receive your proxy materials online

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will save us the cost of producing and mailing documents to your home or business. Please check the information provided in the proxy materials mailed to you by your bank or broker or contact your bank or broker regarding the availability of this service. In addition, the notice of annual meeting, proxy statement and other proxy materials are available on our website at www.blockbuster.com. Neither the Blockbuster website nor any other website included in this proxy statement is intended to function as a hyperlink, and the information contained on such websites is not a part of this proxy statement.

Voting by Class A Common Stockholders and Class B Common Stockholders

Stockholders Entitled to Vote

We have two classes of common stock outstanding: (1) Class A common stock, which is entitled to one vote per share; and (2) Class B common stock, which is entitled to two votes per share.

The holders of Class A common stock and Class B common stock will vote together as a single class on the matters to be considered at the annual meeting, and their votes will be counted and totaled together. The record date for determining the Class A common stockholders and Class B common stockholders entitled to notice of and to vote at the meeting and any adjournment thereof was the close of business on , 2007, at which time we had issued and outstanding shares of Class A common stock and 72,000,000 shares of Class B common stock. Please refer to Security Ownership of Certain Beneficial Owners and Management for information about Class A common stock and Class B common stock beneficially owned by our directors and executive officers as of the date indicated in such section. For a period of at least ten days prior to the meeting, a complete list of stockholders entitled to vote at the meeting will be open to the examination of any Class A common stockholder or Class B common stockholder, for any purpose germane to the meeting, during ordinary business hours at Blockbuster s corporate headquarters located at 1201 Elm Street, Dallas, Texas 75270.

Voting of Proxies By Management Proxy Holders

The Board has appointed Mr. John F. Antioco, Chairman and Chief Executive Officer, Mr. Larry J. Zine, Executive Vice President, Chief Financial Officer and Chief Administrative Officer, and Ms. Andi Yorio, Senior Corporate Counsel and Assistant Secretary, as the management proxy holders for the annual meeting. Your shares will be voted in accordance with the instructions on the proxy card you submit by mail, or the instructions provided for any proxy submitted by telephone or Internet, as applicable. For stockholders who have their shares voted by duly submitting a proxy by mail, telephone or Internet, the management proxy holders will vote all shares represented by such valid proxies as follows, unless a stockholder appropriately specifies otherwise:

Proposal I (Election of Directors) **FOR** the election of each of the three persons named under Proposal I Election of Directors as nominees for election as Class II directors;

Proposal II (Amendment to Second Amended and Restated Certificate of Incorporation to Eliminate the Classification of the Board of Directors) **FOR** the proposal to amend Blockbuster s Second Amended and Restated Certificate of Incorporation (the Certificate of Incorporation) to eliminate the classification of the Board of Directors;

Proposal III (Ratification of the Appointment of Independent Auditors) **FOR** the proposal to ratify the appointment of PricewaterhouseCoopers LLP as our independent registered public accounting firm (independent auditors) for fiscal 2007; and

Proposals IV and V (Stockholder Proposals) **AGAINST** each proposal.

As of the date of printing this proxy statement, the Board is not aware of any other business or nominee to be presented or voted upon at the annual meeting. If any other business or nominee is properly presented, the proxies solicited by the Board will provide the management proxy holders with the authority to vote on those matters and nominees in accordance with such persons discretion. Where a stockholder has appropriately specified how a proxy is to be voted, it will be voted by the management proxy holders in accordance with the specification.

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Quorum; Required Votes

The presence at the meeting, in person or by proxy, of the stockholders entitled to cast at least a majority of the votes that all Class A common stockholders and Class B common stockholders are entitled to cast is necessary to constitute a quorum. Each vote represented at the meeting in person or by proxy will be counted toward a quorum. If a quorum is not present, the meeting may be adjourned from time to time until a quorum is obtained.

Under the rules of the New York Stock Exchange (NYSE), brokers holding shares of record for a customer have the discretionary authority to vote on some matters if the brokers do not receive timely instructions from the customer regarding how the customer wants the shares voted. There are also non-discretionary matters for which brokers do not have discretionary authority to vote even if they do not receive timely instructions from the customer. When a broker does not have discretion to vote on a particular matter and the customer has not given timely instructions on how the broker should vote, a broker non-vote results. Although any broker non-vote would be counted as present at the meeting for purposes of determining a quorum, it would be treated as not entitled to vote with respect to non-discretionary matters. For proposals I, II and III to be voted on at our annual meeting, brokers will have discretionary authority in the absence of timely instructions from their customers. Under NYSE rules, however, a broker may not vote a client s shares on proposals IV and V (the stockholder proposals) absent instructions from the client. Without these voting instructions, a broker non-vote will occur.

Proposal I (Election of Directors) To be elected, each nominee for election as a Class II director must receive the affirmative vote of a plurality of the votes of the shares of Class A common stock and Class B common stock, voting as a single class, present in person or represented by proxy at the meeting and entitled to vote on such proposal. This means that director nominees with the most votes are elected. Votes may be cast in favor of or withheld from the election of each nominee. Votes that are withheld from a director s election will be counted toward a quorum, but will not affect the outcome of the vote on the election of such director.

Proposal II (Amendment to Certificate of Incorporation to Eliminate the Classification of the Board of Directors) The Certificate of Incorporation provides that the affirmative vote of the holders of not less than 75% in voting power of the outstanding shares of Class A common stock and Class B common stock, voting as a single class, is required to amend the Certificate of Incorporation to eliminate the classification of the Board of Directors. In determining whether this proposal has received the requisite number of affirmative votes, abstentions will have the same effect as a vote against this proposal. Although brokers have discretionary authority to vote on this proposal, if a broker submits a non-vote, it will have the same effect as a vote against this proposal.

Proposal III (Ratification of the Appointment of Independent Auditors) Ratification of the appointment of PricewaterhouseCoopers LLP as our independent auditors for fiscal 2007 requires the affirmative vote of the holders of a majority of the votes of the Class A common stock and Class B common stock, voting as a single class, present in person or represented by proxy at the meeting and entitled to vote on such proposal. Abstentions may be specified on this proposal and will have the same effect as a vote against this proposal. Although brokers have discretionary authority to vote on this proposal, if a broker submits a non-vote, it will have the same effect as a vote against this proposal.

Proposals IV and V (Stockholder Proposals) The affirmative vote of the holders of a majority of the votes of the Class A common stock and Class B common stock, voting as a single class, present in person or represented by proxy at the meeting and entitled to vote on these proposals is required for approval. Abstentions may be specified on these proposals and will have the same effect as a vote against these proposals. Because brokers do not have authority to vote on these proposals, broker non-votes will not have an effect on the outcome of the vote on these proposals. The approval of one or both of the stockholder proposals does not mean that their requested actions automatically will go into effect. The Board will take stockholder support for the stockholder proposals into account in making a final decision on whether to adopt or take the actions requested by the stockholder proposals.

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Voting Procedures

Registered Stockholders: Registered stockholders may vote their shares or submit a proxy to have their shares voted by one of the following methods:

- By Mail. You may submit a proxy by signing, dating and returning your proxy card in the enclosed pre-addressed envelope.

- By Telephone. You may submit a proxy by telephone (from U.S. and Canada only) using the toll-free number listed on the proxy card. Please have your proxy card in hand when you call. Telephone voting facilities will be available 24 hours a day and will close at 2:00 a.m., Eastern Daylight Time, on , 2007.

- By Internet. You may submit a proxy electronically on the Internet, using the web site listed on the proxy card. Please have your proxy card in hand when you log onto the web site. Internet voting facilities will be available 24 hours a day and will close at 2:00 a.m., Eastern Daylight Time, on , 2007.

- In Person. You may vote in person at the annual meeting by completing a ballot; however, attending the meeting without completing a ballot will not count as a vote.

Street-name Stockholders: Street-name stockholders may generally vote their shares or submit a proxy to have their shares voted by one of the following methods:

- By Mail. You may submit a proxy by signing, dating and returning your proxy card in the enclosed pre-addressed envelope.

- By Methods Listed on Proxy Card. Please refer to your proxy card or other information forwarded by your bank, broker or other holder of record to determine whether you may submit a proxy by telephone or electronically on the Internet, following the instructions on the proxy card or other information provided by the record holder.

- In Person with a Proxy from the Record Holder. A street-name stockholder who wishes to vote in person at the meeting will need to obtain a legal proxy from their bank, broker or other nominee. Please consult the voting form or other information sent to you by your bank, broker or other nominee to determine how to obtain a legal proxy in order to vote in person at the annual meeting.

Revoking Your Proxy

If you are a registered stockholder, you may revoke your proxy at any time before the shares are voted at the meeting by:

- timely delivery of a valid, later-dated executed proxy card;

- timely submitting a proxy with new voting instructions using the telephone or Internet voting system;

- voting in person at the meeting by completing a ballot; however, attending the meeting without completing a ballot will not revoke any previously submitted proxy; or

filing an instrument of revocation received by the Secretary of Blockbuster Inc. at 1201 Elm Street, Dallas, Texas 75270, by 6:00 p.m., Eastern Daylight Time, on , , 2007.

If you are a street-name stockholder and you vote by proxy, you may change your vote by submitting new voting instructions to your bank, broker or nominee in accordance with that entity s procedures.

Annual Meeting Admission

If you wish to attend the annual meeting in person, you must present a form of personal identification. If you are a beneficial owner of Blockbuster Class A common stock or Class B common stock that is held of record

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by a bank, broker or other nominee, you will also need proof of ownership to be admitted to the meeting. A recent brokerage statement or a letter from your bank or broker are examples of proof of ownership. **No cameras, recording equipment, electronic devices, large bags, briefcases or packages will be permitted in the meeting.**

Solicitation Expenses

We will bear all costs incurred in the solicitation of proxies by our Board. In addition to solicitation by mail, our directors, officers and employees may solicit proxies personally or by telephone, e-mail, facsimile or other means, without additional compensation. We also have retained Morrow & Co., Inc. (Morrow) to solicit proxies from stockholders in connection with our annual meeting. Under the agreement, Morrow will provide consultation and preparation services in connection with the solicitation, deliver proxy materials to banks, brokers and intermediaries, as well as perform the actual solicitation of proxies from brokers, banks and nominees for a fee of $12,000. In addition, we will reimburse Morrow for any mailing expenses and other disbursements made on our behalf in connection with the solicitation. We may also make arrangements with brokerage houses and other custodians, nominees and fiduciaries for the forwarding of solicitation materials to the beneficial owners of shares of Class A common stock and Class B common stock held by such persons, and we may reimburse these brokerage houses and other custodians, nominees and fiduciaries for reasonable expenses incurred in connection therewith.

Copies of the Annual Report

A copy of our annual report on Form 10-K for the year ended December 31, 2006, including the financial statements and the financial statement schedules, if any, but not including exhibits, will be furnished at no charge to each person to whom a proxy statement is delivered upon the written request of such person addressed to Blockbuster Inc., Attn: Investor Relations, 1201 Elm Street, Dallas, Texas 75270.

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CORPORATE GOVERNANCE

Governance Overview

Our Board has adopted corporate governance guidelines as part of its continuing effort to enhance corporate governance at Blockbuster and to communicate Blockbuster s governance policies to stockholders and other interested parties. The guidelines address a variety of governance topics, including:

- director independence and qualification standards,
- responsibilities of directors,
- Board meetings,
- executive sessions of non-management directors,
- Board committees,
- Board access to management and outside advisors,
- director orientation and continuing education,
- non-employee director compensation,
- evaluation and succession planning for our Chief Executive Officer,
- periodic self-evaluations of Board and committee effectiveness and functioning, and
- service by directors on other boards.

Our Corporate Governance Guidelines, along with our Business Conduct Statement, Supplemental Code of Ethics for Blockbuster s Senior Financial Officers, charters of our standing Board committees and our second amended and restated certificate of incorporation and amended and restated bylaws, provide the basic framework for the governance of Blockbuster. Our certificate of incorporation and bylaws are filed as exhibits to our public filings with the SEC. These filings can be accessed free of charge from our website at www.blockbuster.com under the link for Investor Relations. The remaining documents referenced above are also available free of charge on our website under the link for Investor Relations. Copies of these documents will be provided to stockholders, without charge, upon written request to Blockbuster Inc., Attn: Investor Relations, 1201 Elm Street, Dallas, Texas 75270.

From time to time, these governance documents may be revised in response to changing regulatory requirements, evolving best practices and the concerns of our stockholders and other interested parties. We encourage you to check our website periodically for the most recent versions.

Board of Directors and Board Committees

Our business is managed under the direction of our Board. The Board meets on a regularly scheduled basis to review significant developments affecting our Company, to act on matters requiring approval by the Board and to otherwise fulfill its responsibilities. It also holds special meetings when an important matter requires action or review by the Board between regularly scheduled meetings. The Board met 8 times and acted by unanimous written consent 7 times during the 2006 fiscal year. During the 2006 fiscal year, each incumbent director participated in at least 75% of the aggregate number of meetings of the Board and applicable committee meetings held during the period for which he or she was a director.

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The Board has separately designated standing audit, nominating/corporate governance and compensation committees. The following table provides Board and committee membership and meeting information for each of the Board s standing committees:

Director	Independent (1)	Audit Committee	Nominating / Corporate Governance Committee	Compensation Committee
John F. Antioco	No			
Edward Bleier	Yes		Member	
Robert A. Bowman	Yes	Chair (2)		
James W. Crystal	Yes			Member
Jackie M. Clegg	Yes	Member (2)	Chair	
Gary J. Fernandes	Yes		Member	Chair
Jules Haimovitz	Yes			Member
Carl C. Icahn	Yes			Member
Strauss Zelnick	Yes	Member		
Number of Meetings in 2006		14	8	4
Number of Written Consents in 2006			1	

(1) The Board has determined that the director is independent as described below under Director Independence.

(2) The Board has determined that the director is an audit committee financial expert as described below under Audit Committee Financial Experts and Financial Literacy.

A brief description of the principal functions of each of the Board s three standing committees follows. Notwithstanding the following, the Board retains the right to exercise the powers of any committee and may do so from time to time. For additional information, please refer to the committee charters that are available on our website.

Audit Committee The primary function of the Audit Committee is to assist the Board in fulfilling its oversight responsibilities relating to (1) the quality and integrity of our financial reports and other financial information provided by us to our stockholders, the public and others; (2) our compliance with legal and regulatory requirements; (3) our independent auditors qualifications, independence and performance; and (4) the performance of our internal audit function, including our systems of internal controls.

Compensation Committee The primary functions of the Compensation Committee are to (1) assist management and the Board in defining and overseeing our general compensation practices; (2) review and approve, or make recommendations to the Board or the other independent directors with respect to, as the case may be, the compensation, including equity grants, of our Chief Executive Officer, other executive officers and any other employees or categories of employees as directed by the Board; (3) review and discuss the Company s Compensation Discussion and Analysis with management; and (4) produce the Compensation Committee s report required by the SEC for inclusion in our proxy statement.

Nominating/Corporate Governance Committee The primary functions of the Nominating/Corporate Governance Committee are to (1) assist the Board in identifying individuals qualified to become members of the Board; (2) recommend to the Board the director nominees for election at the next annual meeting of stockholders or for appointment to fill any vacancy on the Board; (3) monitor significant developments in the law and practice of corporate governance and of the duties and responsibilities of directors of public companies; (4) review the criteria to be used in connection with

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the self-evaluations of the Board and each of its committees and oversee the evaluation of the Board and management; and (5) develop and recommend to the Board and administer our Corporate Governance Guidelines.

Director Nomination Process

The Nominating/Corporate Governance Committee is responsible for managing the process for nomination of new directors. The Nominating/Corporate Governance Committee may identify potential candidates for first-time nomination as a director using a variety of sources recommendations from our management, current Board members, stockholders or contacts in communities served by Blockbuster, or by conducting a formal search using an outside search firm selected and engaged by the Nominating/Corporate Governance Committee. During 2006, the Nominating/Corporate Governance Committee retained Spencer Stuart to assist it in identifying and evaluating potential director nominees. Following the identification of a potential director nominee, the Nominating/Corporate Governance Committee commences an inquiry to obtain sufficient information on the background of a potential new director nominee. Included in this inquiry is an initial review of the candidate with respect to the following factors: (1) whether the individual meets the Board s minimum qualifications for first-time director nominees; (2) whether the individual would be considered independent under NYSE and SEC rules; and (3) whether the individual would meet any additional requirements imposed by law or regulation on the members of the Audit and/or Compensation Committees of the Board.

The Nominating/Corporate Governance Committee evaluates candidates for director nominees in the context of the current composition of the Board, taking into account all factors it considers appropriate, including but not limited to the characteristics of independence, diversity, age, skills, experience, availability of service to Blockbuster, tenure of incumbent directors on the Board and the Board s anticipated needs. The Nominating/Corporate Governance Committee believes that, at a minimum, all directors, as well as any nominee recommended by the Nominating/Corporate Governance Committee, should have (1) high personal and professional integrity, (2) the ability to read and understand basic financial statements, (3) the ability to exercise sound business judgment, (4) an understanding of Blockbuster s business and the industry in which we operate, (5) a commitment to enhancing stockholder value and (6) the willingness and sufficient time to carry out their responsibilities as a member of the Board. In addition, at least one member of the Board should have accounting or related financial management expertise, as determined in the Board s business judgment. The Nominating/Corporate Governance Committee will consider potential nominees recommended by our stockholders for the Nominating/Corporate Governance Committee s consideration taking into account the same considerations as are taken into account for other potential nominees. Stockholders may recommend candidates by writing to the Nominating/Corporate Governance Committee in care of Blockbuster s Secretary at Blockbuster Inc., 1201 Elm Street, Dallas, Texas 75270. Our bylaws provide additional procedures and requirements for stockholders wishing to nominate a director for election as part of the official business to be conducted at an annual stockholders meeting, as described further under Submission of Stockholder Proposals for 2008 Annual Meeting.

Assuming a satisfactory conclusion to the Nominating/Corporate Governance Committee s review and evaluation process, the Nominating/Corporate Governance Committee presents the candidate s name to the Board for nomination for election as a director and/or inclusion in our proxy statement.

Director Independence

Annual written questionnaires are used to gather input to assist the Nominating/Corporate Governance Committee and the Board in their determinations of the independence of the non-employee directors. In addition, our Corporate Governance Guidelines require directors to notify the Chair of the Nominating/Corporate Governance Committee (or, in the case of the Chair of the Nominating/Corporate Governance Committee, another member of such Committee), as soon as reasonably practicable, in the event that such director s personal circumstances change or are anticipated to change in a manner that may affect the Board s evaluation of such director s independence.

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Based on the foregoing and on such other due consideration and diligence as it deemed appropriate, the Nominating/Corporate Governance Committee presented its findings to the Board on the independence of (1) Edward Bleier, (2) Robert A. Bowman, (3) Jackie M. Clegg, (4) Gary J. Fernandes, (5) Jules Haimovitz, (6) Carl C. Icahn and (7) Strauss Zelnick. With respect to these directors and with respect to James W. Crystal, whose independence was assessed in the first instance by the Board, the Board determined that, other than in their capacity as directors, none of these non-employee directors had a material relationship with Blockbuster, either directly or as a partner, shareholder or officer of an organization that has a relationship with Blockbuster. The Board further determined that (1) all such non-employee directors are independent under applicable NYSE listing standards and (2) all such non-employee directors also satisfy the additional audit committee independence standards of Rule 10A-3 of the SEC other than Mr. Icahn because of his reported beneficial ownership in Blockbuster s equity securities in excess of 10%.

In making its most recent independence determinations, the Board considered certain relationships that it deemed not to be material. Mr. Fernandes holds a general partner interest and a limited partner interest in two real estate limited partnerships that each lease one retail building to Blockbuster. The Board determined that Mr. Fernandes relationship was not material, as it did during 2005 and 2006 when considering this same relationship, because the transactions between Blockbuster and the limited partnerships were at arms length, Mr. Fernandes had no direct involvement with any such transactions, and the transactions in question involved only two of Blockbuster s thousands of domestic leases. The Board also considered Mr. Icahn s sizable beneficial ownership of Blockbuster s common stock and preferred stock and determined that his significant equity beneficial ownership did not constitute a material relationship that impaired his independence from management. In addition, the Board considered that Mr. Bleier, previously an executive with Warner Bros. Entertainment Inc. in New York, is provided with access to certain office space and related services, but not any compensation, by his former employer. Warner Bros. is one of our many suppliers of movie inventory. In light of the limited nature of these office services provided to Mr. Bleier, the Board determined that these services did not constitute a material relationship that would impair Mr. Bleier s independence from management.

In addition to considering potential relationships for purposes of the Board s director independence determinations, our Board has also adopted certain policies and procedures relating to its review, approval or ratification of any transaction in which Blockbuster is a participant and that is required to be reported by the SEC s rules and regulations regarding transactions with related persons (a related party transaction). These policies and procedures supplement our annual written questionnaires which are discussed above and are set forth in our Corporate Governance Guidelines. Specifically, each of our directors is expected to notify the Chair of the Nominating/Corporate Governance Committee (or, in the case of the Chair of the Nominating/Corporate Governance Committee, another member of such Committee), as soon as reasonably practicable, of any direct or indirect (including through an affiliated entity or an immediate family member) material interest in any transaction, proposed transaction or series of similar transactions in which Blockbuster is, or is to be, a participant and that is required to be reported by the SEC s rules and regulations regarding transactions with related persons. Any such related party transactions require approval or ratification by the disinterested members of the Board or a committee thereof designated by such disinterested directors, taking into account whether the transaction is on terms comparable to those that could be obtained in arm s length dealings with an unrelated third party, the value and materiality of such transaction, Blockbuster s Business Conduct Statement (including its conflict of interest provisions), any affiliate transaction approval requirements in our debt agreements, any impact on the Board s evaluation of such director s independence or on such director s eligibility to serve on one of the Board s committees, any required public disclosures by Blockbuster, and such other factors as may be deemed appropriate by the disinterested members of the Board or any committee thereof. These policies and procedures also provide that the Board will follow similar procedures and take into account similar factors, to the extent applicable, in connection with its review, approval or ratification of any related party transactions in which any of our executive officers or significant security holders has a material direct or indirect interest and that is required to be reported by the SEC s rules and regulations regarding transactions with related persons. Each of our directors is also expected to notify the Chair of the Nominating/Corporate Governance Committee (or, in the case of the Chair of the Nominating/Corporate Governance Committee, another member of such Committee), as

soon as reasonably practicable, of any transaction, proposed transaction or series of similar transactions in which such director has a direct or indirect (including through an affiliated entity or an immediate family member) material interest and in which another director on our Board also has a direct or indirect (including through an affiliated entity or an immediate family member) material interest.

Executive Sessions and the Presiding Director

Our Corporate Governance Guidelines provide for regular executive sessions of the non-management directors without management participation. Our Corporate Governance Guidelines designate the Chair of the Audit Committee as the presiding director at such meetings. Mr. Bowman currently serves as the Chair of the Audit Committee.

Communications with Non-Management Directors and Other Board Communications

The Board provides a process to enhance the ability of stockholders and other interested parties to communicate directly with the non-management directors as a group, the entire Board or individual directors, including the Chairman and chair of any Board committee. The chairs of Blockbuster s standing Board committees are all independent directors as determined by the Board and described above under Director Independence.

Stockholders and other interested parties may communicate directly with the Audit Committee and the non-management directors of the Board by calling our hotline, which is administered by a third party, at 1-888-441-WORD. The Chair of the Audit Committee, who is also the presiding director for meetings of non-management directors, has been designated to receive such communications. In addition, stockholders may send communications to the Board or individual directors by mail, by writing to the Board or such individual directors, c/o Blockbuster Inc., 1201 Elm Street, Dallas, Texas 75270, Attn: Secretary. The Secretary s office receives all such mailed communications initially and forwards all such communications to the applicable director or directors.

The Board has requested that items unrelated to the duties and responsibilities of the Board, such as junk mail and mass mailings, business solicitations, advertisements and other commercial communications, surveys and questionnaires, and resumes or other job inquiries, not be forwarded.

Audit Committee Financial Experts and Financial Literacy

The Board has determined that Messrs. Bowman and Zelnick and Ms. Clegg, the current members of the Audit Committee, are each financially literate as interpreted by the Board in its business judgment and that Mr. Bowman and Ms. Clegg each further qualifies as an audit committee financial expert, as such term is defined in the applicable rules of the SEC.

Policies on Business Conduct and Ethics

Blockbuster has established a corporate compliance program as part of its commitment to responsible business practices in all of the communities in which it operates. The Board has adopted a Business Conduct Statement that applies to all of our employees and directors and a Supplemental Code of Ethics that applies specifically to our Chief Executive Officer, Chief Financial Officer and Controller. The Business Conduct Statement and Supplemental Code of Ethics form the foundation of a compliance program that includes policies and procedures covering a variety of specific areas of professional conduct, including compliance with laws, conflicts of interest, confidentiality, public corporate disclosures, insider trading, trade practices, protection and proper use of Company assets, intellectual property, financial accounting, employment practices, health, safety and environment, political contributions and payments and matters relating to international business activities.

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Both the Business Conduct Statement and Supplemental Code of Ethics are published on our website. Please refer to Governance Overview above for the location of these documents.

In accordance with NYSE and SEC rules, we currently intend to disclose any future amendments to our Supplemental Code of Ethics, or waivers from our Supplemental Code of Ethics for our Chief Executive Officer, Chief Financial Officer and Controller, by posting such information on our website (www.blockbuster.com) within the time period required by applicable SEC and NYSE rules.

Director Attendance at Annual Meetings

Our Corporate Governance Guidelines provide that directors are expected to attend our annual stockholders meetings. At our 2006 annual meeting, each of the incumbent directors was in attendance except for Mr. Icahn.

Processes and Procedures for Determining Executive and Director Compensation

The following discussion is intended to illustrate our typical processes and procedures for the consideration and determination of executive officer and director compensation, rather than to provide a detailed discussion of specific executive and director compensation matters. From time to time, our Board, Compensation Committee or Nominating/Corporate Governance Committee may deem additional or different processes and procedures to be appropriate for a particular matter.

Executive Compensation

As detailed in its charter, one of the primary functions of our Compensation Committee is to review and approve, or make recommendations to the Board or to the other independent directors on the Board with respect to, the compensation of our executives and such other employees or categories of employees as directed by the Board. In general, executive compensation matters can be presented to the Compensation Committee or raised with the Committee in one of the following ways: (1) at the request of the Committee chair or another Committee member or Board member, (2) in accordance with the Committee s annual agenda, which is reviewed by the Committee members and other directors on an annual basis, (3) by our Chief Executive Officer, Chief Financial Officer/Chief Administrative Officer or Senior Vice President of Human Resources or (4) by the Committee s outside compensation consultant.

Pursuant to its charter, the Compensation Committee has the sole authority to retain and terminate any compensation consultant to be used to assist in the evaluation of the compensation of our executives and our directors, and also has the sole authority to approve any such firm s fees and other retention terms. During 2006, the Compensation Committee engaged Lyons, Benenson & Company Inc. to assist it in evaluating executive compensation matters. The terms of Lyons, Benenson s engagement are set forth in an engagement agreement which provides, among other things, that Lyons, Benenson will perform the advisory services requested by the Compensation Committee or by Blockbuster. Pursuant to its charter, the Compensation Committee also has the authority to engage, and determine the fees of, independent counsel and other advisors as it deems necessary to carry out its duties, and has the authority to request that any of our officers or employees or our outside legal counsel attend Compensation Committee meetings or meet with any members of, or consultants to, the Committee.

Together with management, the Compensation Committee s compensation consultant and any counsel or other advisors deemed appropriate by the Compensation Committee, the Compensation Committee typically reviews and discusses the particular executive compensation matter presented and formulates a recommendation. The Compensation Committee s chair then generally reports the Compensation Committee s recommendation for approval by the full Board or, in certain cases, by the independent directors. For example, performance-based compensation matters that require approval by outside directors under Section 162(m) of the Internal Revenue Code would not generally be voted on by the Chairman of our Board, who also serves as our Chief Executive Officer, nor would our Chairman and Chief Executive Officer typically vote on matters regarding his individual compensation.

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To the extent permitted by applicable law, the Compensation Committee may delegate its authority to any subcommittee or individual members of the Compensation Committee as it deems appropriate.

Director Compensation

Pursuant to its charter and our Corporate Governance Guidelines, the Nominating/Corporate Governance Committee is responsible for annually reviewing the form and amount of director compensation, taking into account any evaluation prepared by any compensation consultant retained by the Compensation Committee. If appropriate, the Nominating/Corporate Governance Committee recommends changes in director compensation to the Board, based on the following principles:

- directors should be fairly compensated for the services they provide to Blockbuster (taking into account, among other things, the size and complexity of our business, and compensation and benefits paid to directors of comparable companies);
- directors interests should be aligned with the interests of our stockholders; and
- directors compensation should be easy for our stockholders to understand.

Our Corporate Governance Guidelines also provide that the Nominating/Corporate Governance Committee and the Board shall consider that the independence of a director may be jeopardized if compensation and perquisites exceed customary levels, if we make substantial charitable contributions to organizations with which the director is affiliated, or if we enter into consulting contracts with (or provide other indirect forms of compensation to) a director or an organization with which a director is affiliated.

During 2006, the Nominating/Corporate Governance Committee utilized the services of Lyons, Benenson & Company Inc., the consultant engaged by the Compensation Committee, to assist it in reviewing and evaluating our current non-employee directors compensation program.

As with the Compensation Committee, the Nominating/Corporate Governance Committee may, to the extent permitted by applicable law, delegate its authority to any subcommittee or individual members of the Nominating/Corporate Governance Committee as it deems appropriate.

Management Certifications

In accordance with the Sarbanes-Oxley Act of 2002 and SEC rules thereunder, our Chief Executive Officer and Chief Financial Officer have signed certifications under Sarbanes-Oxley Section 302, which have been filed as exhibits to our annual report on Form 10-K for the year ended December 31, 2006. In addition, our Chief Executive Officer submitted his most recent annual certification to the NYSE under Section 303A.12(a) of the NYSE listing standards on June 1, 2006.

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SECURITY OWNERSHIP OF CERTAIN

BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth information with respect to the number of shares of Blockbuster Class A common stock and Class B common stock beneficially owned by (1) the named executive officers, which, for purposes of this proxy statement, include our Chief Executive Officer, our Chief Financial Officer, each of our three other most highly compensated executive officers who were serving as such on December 31, 2006, and Edward B. Stead, our former Executive Vice President, General Counsel and Executive Vice President Business Development, who would have been among our three other most highly compensated executive officers had he been serving as an executive officer on December 31, 2006; (2) each current Blockbuster director and each nominee for director; and (3) all current Blockbuster directors and executive officers as a group. The following table also sets forth information with respect to the number of shares of Blockbuster Class A common stock and Class B common stock beneficially owned by each person known by Blockbuster to beneficially own more than 5% of the outstanding shares of Blockbuster Class A common stock or Class B common stock. Except as otherwise noted, (1) the persons named in the table have sole voting and investment power with respect to all shares beneficially owned by them and (2) ownership is as of March 1, 2007.

As of March 1, 2007, there were 120,143,244 shares of Blockbuster Class A common stock outstanding and 72,000,000 shares of Blockbuster Class B common stock outstanding.

		Beneficial Ownership of Equity Securities		
Name	**Title of Equity Securities**	**Number of Outstanding Shares(1)**	**Number of Shares Underlying Options or Conversion Rights(2)**	**Percent of Class(3)**
John F. Antioco	Blockbuster Class A Common	999,116(4)	3,333,336	3.6%
	Blockbuster Class B Common	27(4)		*
Edward Bleier	Blockbuster Class A Common	19,670		*
	Blockbuster Class B Common			
Robert A. Bowman	Blockbuster Class A Common	20,493		*
	Blockbuster Class B Common			
Jackie M. Clegg	Blockbuster Class A Common	22,652		*
	Blockbuster Class B Common			
James W. Crystal	Blockbuster Class A Common	2,847		*
	Blockbuster Class B Common			
Gary J. Fernandes	Blockbuster Class A Common	20,493		*
	Blockbuster Class B Common			
Jules Haimovitz	Blockbuster Class A Common	10,592		*
	Blockbuster Class B Common			
Carl C. Icahn (5)	Blockbuster Class A Common	11,503,770(6)	7,378,641(6)	15.7%
	Blockbuster Class B Common	5,566,131(6)		7.7%
High River Limited Partnership (5)				
Icahn & Co., Inc. (5)				
Hopper Investments LLC (5)				
Barberry Corp. (5)				
Icahn Partners Master Fund L.P. (5)				

Icahn Offshore L.P. (5)

CCI Offshore Corp. (5)

Icahn Partners L.P. (5)

Icahn Onshore L.P. (5)

CCI Onshore Corp. (5)

Strauss Zelnick	Blockbuster Class A Common Blockbuster Class B Common	19,670	*
Frank G. Paci	Blockbuster Class A Common Blockbuster Class B Common	120,140(4)	*
Nicholas P. Shepherd	Blockbuster Class A Common Blockbuster Class B Common	238,067	*
Edward B. Stead	Blockbuster Class A Common Blockbuster Class B Common		
Chris Wyatt	Blockbuster Class A Common Blockbuster Class B Common	133,238	*
Larry J. Zine	Blockbuster Class A Common Blockbuster Class B Common	433,675(4)	*

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Name	Title of Equity Securities	Beneficial Ownership of Equity Securities Number of Outstanding Shares(1)	Number of Shares Underlying Options or Conversion Rights(2)	Percent of Class(3)
Barclays Global Investors, NA (7) Barclays Global Fund Advisors (7)	Blockbuster Class A Common	6,864,211(8)		5.7%
Deutsche Bank AG (9) Deutsche Bank Securities Inc. (9) Deutsche Bank AG, London Branch (9)	Blockbuster Class A Common	11,468,099(10)		9.6%
Dimensional Fund Advisors LP (11)	Blockbuster Class A Common	8,179,976(12)		6.8%
Elm Ridge Capital Management, LLC (13) Ronald Gutfleish (13)	Blockbuster Class A Common	5,951,058(14)		5.0%
HBK Investments L.P. (15) HBK Services LLC (15) HBK Partners II L.P. (15) HBK Management LLC (15) HBK Master Fund L.P. (15)	Blockbuster Class B Common	4,967,215(16)		6.9%
JPMorgan Chase & Co. (17)	Blockbuster Class B Common	4,605,470(18)		6.4%
M.A.M. Investments Ltd. (19) Marathon Asset Management (Services) Ltd (19) Marathon Asset Management LLP (19) William James Arah (19) Jeremy John Hosking (19) Neil Mark Ostrer (19)	Blockbuster Class B Common	8,117,883(20)		11.3%
Morgan Stanley (21) Morgan Stanley Capital Services Inc. (21)	Blockbuster Class A Common	8,693,519(22)		7.2%
Prentice Capital Management, LP (23) Michael Zimmerman (23)	Blockbuster Class A Common Blockbuster Class B Common	11,398,757(24) 4,077,410(24)		9.5% 5.7%
President and Fellows of Harvard College (25)	Blockbuster Class B Common	5,773,889(26)		8.0%
The TCW Group, Inc., on behalf of the TCW Business Unit (27)	Blockbuster Class A Common	6,083,251(28)		5.1%
UBS AG (29)	Blockbuster Class B Common	6,828,243(30)		9.5%
Current directors and current executive officers as a group (12 persons)	Blockbuster Class A Common	13,411,185(4)	10,711,977	20.1% 7.7%

Blockbuster Class B Common	5,566,158(4)

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* Represents less than 1% of the outstanding common stock of the class.

(1) The shares reported in this column include any restricted shares, whether vested or unvested, held by the named executive officers on March 1, 2007.

(2) Amounts indicated reflect shares subject to stock options or conversion rights that, on March 1, 2007, were unexercised or unconverted but were exercisable or convertible for shares of Blockbuster Class A common stock within a period of 60 days from that date. These shares are excluded from the column headed Number of Outstanding Shares.

(3) Percentages are calculated based on the outstanding shares of Blockbuster Class A common stock or Class B common stock, as appropriate, as of March 1, 2007.

(4) This includes shares held through Blockbuster s 401(k) plan as of December 31, 2006.

(5) The address for Carl C. Icahn; Icahn & Co., Inc.; Icahn Offshore L.P.; CCI Offshore Corp.; Icahn Partners L.P.; Icahn Onshore L.P.; and CCI Onshore Corp. is c/o Icahn Associates Corp., 767 Fifth Avenue, 47th Floor, New York, New York 10153. The address for High River Limited Partnership; Hopper Investments LLC; and Barberry Corp. is 100 South Bedford Road, Mount Kisco, New York 10549. The address for Icahn Partners Master Fund L.P. is c/o Walkers SPV Limited, P.O. Box 908GT, 87 Mary Street, George Town, Grand Cayman, Cayman Islands.

(6) This is based on a Schedule 13D filed with the SEC on December 14, 2004, an amendment to Schedule 13D filed with the SEC on November 16, 2005, and a Form 4 filed with the SEC on January 4, 2007. The Schedules 13D and 13D/A were jointly filed by Carl C. Icahn; Icahn & Co., Inc.; Icahn Offshore L.P.; CCI Offshore Corp.; Icahn Partners L.P.; Icahn Onshore L.P.; CCI Onshore Corp.; High River Limited Partnership; Hopper Investments LLC; Barberry Corp.; and Icahn Partners Master Fund L.P. The Form 4 was filed by Carl C. Icahn. According to the Schedules 13D and 13D/A, (1) High River Limited Partnership has sole voting power and sole dispositive power with regard to 2,874,548 shares of Class A common stock and 772,320 shares of Class B common stock, and each of Barberry Corp., Hopper Investments LLC, and Carl C. Icahn has shared voting power and shared dispositive power with regard to such shares, but disclaim beneficial ownership of such shares for all other purposes; (2) Icahn & Co., Inc. has sole voting power and sole dispositive power with regard to 898,000 shares of Class A common stock and 340,906 shares of Class B common stock, and each of Barberry Corp. and Carl C. Icahn has shared voting power and shared dispositive power with regard to such shares, but disclaim beneficial ownership of such shares for all other purposes; (3) Icahn Partners Master Fund L.P. has sole voting power and sole dispositive power with regard to 7,381,540 shares of Class A common stock and 1,932,985 shares of Class B common stock, and each of Icahn Offshore L.P., CCI Offshore Corp., and Carl C. Icahn has shared voting power and shared dispositive power with regard to such shares, but disclaim beneficial ownership of such shares for all other purposes; and (4) Icahn Partners L.P. has sole voting power and sole dispositive power with regard to 7,708,653 shares of Class A common stock and 2,519,920 shares of Class B common stock, and each of Icahn Onshore L.P., CCI Onshore Corp., and Carl C. Icahn has shared voting power and shared dispositive power with regard to such shares, but disclaim beneficial ownership of such shares for all other purposes. According to the Schedule 13D/A and the Form 4, Carl C. Icahn has sole voting power and sole dispositive power with regard to 19,670 shares of Class A common stock, and each of High River Limited Partnership, Icahn & Co., Inc., Hopper Investments LLC, Barberry Corp., Icahn Partners Master Fund L.P., Icahn Offshore L.P., CCI Offshore Corp., Icahn Partners L.P., Icahn Onshore L.P., and CCI Onshore Corp. disclaim beneficial ownership of such shares for all purposes. All of the shares of Class A common stock and Class B common stock owned by High River Limited Partnership are held in a margin account and are subject to a lien in favor of the applicable brokerage house. All other shares of Class A common stock and Class B common stock owned by Carl C. Icahn and his affiliated entities are held in prime brokerage accounts, in which case the applicable investment banks have a lien on the shares for present and future obligations of the holders to the prime brokers.

(7) The address for Barclays Global Investors, NA and Barclays Global Fund Advisors is 45 Fremont St., San Francisco, California 94105.

(8) This is based on a Schedule 13G filed with the SEC on January 23, 2007, by Barclays Global Investors, NA; Barclays Global Fund Advisors; Barclays Global Investors, Ltd.; Barclays Global Investors Japan Trust and Banking Company Limited; and Barclays Global Investors Japan Limited. According to the Schedule 13G, (1) Barclays Global Investors, NA, has sole voting power with regard to 3,118,814 shares of Class A common stock, sole dispositive power with regard to 3,778,873 shares of Class A common stock, and is deemed to beneficially own 3,778,873 shares of Class A common stock; and (2) Barclays Global Fund Advisors has sole voting power and sole dispositive power with regard to 3,085,338 shares of Class A common stock and is deemed to beneficially own 3,085,338 shares of Class A common stock.

(9) The address for Deutsche Bank AG; Deutsche Bank Securities Inc.; and Deutsche Bank AG, London Branch is Taunusanlage 12, D-60325 Frankfurt am Main, Federal Republic of Germany.

(10) This is based on an amendment to Schedule 13G filed with the SEC on January 30, 2007, by Deutsche Bank AG; Deutsche Bank Securities Inc.; and Deutsche Bank AG, London Branch. According to the Schedule 13G/A, (1) Deutsche Bank AG has sole voting power and sole dispositive power with regard to 11,468,099 shares of Class A common stock; (2) Deutsche Bank Securities Inc. has sole voting power and sole dispositive power with regard to 2,793,700 shares of Class A common stock; and (3) Deutsche Bank AG, London Branch, has sole voting power and sole dispositive power with regard to 8,674,399 shares of Class A common stock. According to the Schedule 13G/A, the filing reflects securities beneficially owned

by the Corporate and Investment Banking business group and the Corporate Investments business group (collectively, CIB) of Deutsche Bank AG and its subsidiaries and affiliates; and, furthermore, CIB disclaims beneficial ownership of the securities beneficially owned by (1) any client accounts with respect to which CIB or its employees have voting or investment discretion, or both, and (2) certain investment entities, of which CIB is the general partner, managing general partner, or other manager, to the extent interests in such entities are held by persons other than CIB.

(11) The address for Dimensional Fund Advisors LP is 1299 Ocean Avenue, Santa Monica, California 90401.

(12) This is based on an amendment to Schedule 13G filed with the SEC on February 9, 2007, by Dimensional Fund Advisors LP. According to the Schedule 13G/A, Dimensional Fund Advisors LP has sole voting power and sole dispositive power with regard to 8,179,976 shares of Class A common stock. Also according to the Schedule 13G/A, Dimensional Fund Advisors LP (formerly, Dimensional Fund Advisors Inc.) (Dimensional), an investment advisor registered under Section 203 of the Investment Advisors Act of 1940, furnishes investment advice to four investment companies registered under the Investment Company Act of 1940, and serves as investment manager to certain other commingled group trusts and separate accounts. These investment companies, trusts and accounts are the Funds. In its role as investment advisor or manager, Dimensional possesses investment and/or voting power over the securities that are owned by the Funds, and may be deemed to be the beneficial owner of the shares held by the Funds. However, all securities reported in the Schedule 13G/A are owned by the Funds. Dimensional disclaims beneficial ownership of such securities. In addition, the filing of the Schedule 13G shall not be construed as an admission that the reporting person or any of its affiliates is the beneficial owner of any securities covered by the Schedule 13G for any other purposes than Section 13(d) of the Securities Exchange Act of 1934.

(13) The address for Elm Ridge Capital Management, LLC and Ronald Gutfleish is 3 West Main Street, 3rd Floor, Irvington, New York 10533.

(14) This is based on an amendment to Schedule 13G filed with the SEC on February 13, 2007, by Ronald Gutfleish, c/o Elm Ridge Capital Management, LLC. According to the Schedule 13G/A, Ronald Gutfleish and Elm Ridge Capital Management, LLC have shared voting power and shared dispositive power with regard to 5,951,058 shares of Class A common stock. Also according to the Schedule 13G/A, Ronald Gutfleish is the managing member of two limited liability companies, which each manage one or more private investment funds that hold the shares, and Ronald Gutfleish disclaims beneficial ownership in the Class A common stock, except to the extent of his pecuniary interest therein.

(15) The address for HBK Investments L.P.; HBK Services LLC; HBK Partners II L.P.; HBK Management LLC; and HBK Master Fund L.P. is 300 Crescent Court, Suite 700, Dallas, Texas 75201.

(16) This is based on an amendment to Schedule 13G filed with the SEC on February 9, 2007, by HBK Investments L.P.; HBK Services LLC; HBK Partners II L.P.; HBK Management LLC; and HBK Master Fund L.P. According to the Schedule 13G/A, HBK Investments L.P.; HBK Services LLC; HBK Partners II L.P.; HBK Management LLC; and HBK Master Fund L.P. have shared voting power and shared dispositive power with regard to 4,967,215 shares of Class B common stock, and are deemed to beneficially own 4,967,215 shares of Class B common stock. Also according to the Schedule 13G/A, HBK Investments L.P. has delegated discretion to vote and dispose of the securities to HBK Services LLC (Services). Services may, from time to time, delegate discretion to vote and dispose of certain of the securities to HBK New York LLC, a Delaware limited liability company, HBK Virginia LLC, a Delaware limited liability company, HBK Europe Management LLP, a limited liability partnership organized under the laws of the United Kingdom, and/or HBK Hong Kong Ltd., a corporation organized under the laws of Hong Kong (collectively, the Subadvisors). Each of Services and the Subadvisors is under common control with HBK Investments L.P. The Subadvisors expressly declare that the filing of the statement on Schedule 13G shall not be construed as an admission that they are, for the purpose of Section 13(d) or 13(g) of the Securities Exchange Act of 1934, beneficial owners of the Securities. Also according to the Schedule 13G/A, Jamiel A. Akhtar, Richard L. Booth, David C. Haley, Lawrence H. Lebowitz and William E. Rose are each managing members (collectively, the Members) of HBK Management LLC. The Members expressly

declare that the filing of the Schedule 13G shall not be construed as an admission that they are, for the purpose of Section 13(d) or 13(g) of the Securities Exchange Act of 1934, beneficial owners of the securities.

(17) The address for JPMorgan Chase & Co. is 270 Park Avenue, New York, New York 10017.

(18) This is based on a Schedule 13G filed with the SEC on February 12, 2007, by JPMorgan Chase & Co. According to the Schedule 13G, JPMorgan Chase & Co. has sole voting power and sole dispositive power with regard to 4,605,470 shares of Class B common stock. According to the Schedule 13G, it was filed on behalf of JPMorgan Chase & Co. and its wholly owned subsidiary, J.P. Morgan Ventures Corporation.

(19) The address for M.A.M. Investments Ltd.; Marathon Asset Management (Services) Ltd; Marathon Asset Management LLP; William James Arah; Jeremy John Hosking; and Neil Mark Ostrer is Orion House, 5 Upper St. Martin s Lane, London, WC2H 9EA, United Kingdom.

(20) This is based on a Schedule 13G filed with the SEC on January 16, 2007, by M.A.M. Investments Ltd.; Marathon Asset Management (Services) Ltd; Marathon Asset Management LLP; William James Arah; Jeremy John Hosking; and Neil Mark Ostrer (the Reporting Persons). According to the Schedule 13G, Marathon Asset Management LLP; Marathon Asset Management (Services) Ltd; M.A.M. Investments Ltd.; William James Arah; Neil Mark Ostrer; and Jeremy John Hosking have shared voting power with regard to 6,064,383 shares of Class B common stock and shared dispositive power with regard to 8,117,883 shares of Class B common stock. Each of the Reporting Persons are deemed to beneficially own 8,117,883 shares of Class B common stock and each of the Reporting Persons, except for Marathon Asset Management LLP, disclaim any direct ownership of the shares reported in the Schedule 13G. Marathon Asset Management (Services) Limited, an owner of Marathon Asset Management LLP, is a wholly owned subsidiary of M.A.M. Investments Ltd., and as such, shares with M.A.M. Investments Ltd. the voting and dispositive power as to all of the shares beneficially owned by Marathon Asset Management (Services) Limited. Messrs Arah, Hosking and Ostrer are directors and indirect owners of Marathon Asset Management (Services) Limited and owners and Executive Committee members of Marathon Asset Management LLP.

(21) The address for Morgan Stanley and Morgan Stanley Capital Services Inc. is 1585 Broadway, New York, New York 10036.

(22) This is based on an amendment to Schedule 13G filed with the SEC on February 15, 2007, by Morgan Stanley and Morgan Stanley Capital Services Inc. According to the Schedule 13G/A, (1) Morgan Stanley beneficially owns and has sole voting power and sole dispositive power with regard to 8,693,519 shares of Class A common stock; and (2) Morgan Stanley Capital Services Inc. beneficially owns and has sole voting power and sole dispositive power with regard to 8,544,990 shares of Class A common stock.

(23) The address for Prentice Capital Management, LP and Michael Zimmerman is 623 Fifth Avenue, 32nd Floor, New York, New York 10022.

(24) This is based on amendments to Schedules 13G filed with the SEC on February 14, 2006 and February 14, 2007, by Prentice Capital Management, LP and Michael Zimmerman. According to the Schedules 13G/A, Prentice Capital Management, LP and Michael Zimmerman both have shared voting power and shared dispositive power with regard to 11,398,757 shares of Class A common stock and 4,077,410 shares of Class B common stock. The shares of Class A common stock and Class B common stock are beneficially owned by Prentice Capital Management, LP as investment manager for investment funds in which such shares are held. Michael Zimmerman is the managing member of (1) Prentice Management GP, LLC, the general partner of Prentice Capital Management, LP, (2) Prentice Capital GP, LLC, the general partner of certain investment funds, and (3) Prentice Capital GP II, LLC, the managing member of Prentice Capital GP II, LP, which is the general partner of certain investment funds. Each of Michael Zimmerman and Prentice Capital Management, LP disclaims any beneficial ownership of such shares.

(25) The address for President and Fellows of Harvard College is c/o Harvard Management Company, Inc., 600 Atlantic Avenue, Boston, Massachusetts 02210.

(26) This is based on an amendment to Schedule 13G filed with the SEC on February 8, 2007, by President and Fellows of Harvard College. According to the Schedule 13G/A, President and Fellows of Harvard College has sole voting power, sole dispositive power and beneficial ownership with regard to 5,773,889 shares of Class B common stock.

(27) The address for The TCW Group, Inc., on behalf of the TCW Business Unit, is 865 South Figueroa Street, Los Angeles, California 90017.

(28) This is based on a Schedule 13G filed with the SEC on February 12, 2007, by The TCW Group, Inc., on behalf of the TCW Business Unit. According to the Schedule 13G, The TCW Group, Inc. has shared voting power with regard to 3,686,251 shares of Class A common stock, shared dispositive power with regard to 6,083,251 shares of Class A common stock, and is deemed to beneficially own 6,083,251 shares of Class A common stock. According to the Schedule 13G, it was filed by The TCW Group, Inc., on behalf of itself and its direct and indirect subsidiaries: Trust Company of the West, TCW Asset Management Company and TCW Investment Management Company (collectively, the TCW Business Unit). Also according to the Schedule 13G, the TCW Business Unit is primarily engaged in the provision of investment management services.

(29) The address for UBS AG is Bahnhofstrasse 45, PO Box CH-8021, Zurich, Switzerland.

(30) This is based on an amendment to Schedule 13G filed with the SEC on February 14, 2007, by UBS AG. According to the Schedule 13G/A, the shares of Class B common stock were acquired directly by UBS AG and certain of its subsidiaries.

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SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934 and related rules of the SEC require our directors and officers, and persons who own more than 10% of a registered class of our equity securities, to file initial reports of ownership and reports of changes in ownership with the SEC. These persons are required by SEC regulations to furnish us with copies of all Section 16(a) reports that they file. As with many public companies, we provide assistance to our directors (other than Mr. Icahn, one of our non-employee directors, who obtains such assistance from his own advisors) and executive officers in making their Section 16(a) filings pursuant to powers of attorney granted by our insiders. To our knowledge, based solely on our review of the copies of Section 16(a) reports received by us with respect to fiscal 2006, including those reports that we have filed on behalf of our directors and executive officers pursuant to powers of attorney, or written representations from certain reporting persons, we believe that all filing requirements applicable to our directors, officers and persons who own more than 10% of a registered class of our equity securities have been satisfied.

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EXECUTIVE OFFICER AND DIRECTOR COMPENSATION

Compensation Discussion & Analysis

Executive Summary

As discussed in more detail below, the following actions concerning the compensation of Blockbuster s named executive officers were taken for fiscal 2006:

- Nicholas P. Shepherd, Blockbuster s Executive Vice President and President, Worldwide Stores, received a salary increase for fiscal 2006.

- Larry J. Zine, Blockbuster s Executive Vice President, Chief Financial Officer and Chief Administrative Officer; Frank G. Paci, Blockbuster s Executive Vice President, Strategic Planning and Business Development; Mr. Shepherd; and Chris Wyatt, Blockbuster s former Executive Vice President and President, International received bonuses pursuant to Blockbuster s Senior Executive Annual Performance Bonus Plan (the Senior Bonus Plan).

- John F. Antioco, Blockbuster s Chairman and Chief Executive Officer, received a bonus of $3.0525 million for 2006. As previously disclosed, Blockbuster and Mr. Antioco were in discussions in an attempt to resolve a disagreement concerning the Board s 2006 bonus award to Mr. Antioco. The $3.0525 million bonus amount reflects a compromise between the 2006 bonus amount of $2.28 million previously conditionally offered by the Board but not paid and $7.65 million, which is the amount to which Mr. Antioco was entitled pursuant to his previous employment agreement and Blockbuster s 2006 Senior Bonus Plan, if negative discretion was not invoked.

- Messrs. Paci and Shepherd received performance-based restricted stock awards during fiscal 2006.

- Edward B. Stead, Blockbuster s former Executive Vice President, General Counsel and Executive Vice President Business Development was terminated without cause upon mutual agreement and, in connection therewith, Blockbuster entered into an amendment to its employment agreement with Mr. Stead to provide him with a reduced lump sum severance payment in lieu of the severance payments to which he was formerly entitled under his employment agreement.

- Mr. Wyatt was awarded a contingent bonus payable only in the event of any sale or other disposition of Blockbuster s international operations or a requisite portion thereof. To date, this bonus has not been earned.

- Mr. Zine s employment agreement was amended to provide him with the right to resign from Blockbuster after December 31, 2006 and, in that event or in the event of any termination without cause, to receive a reduced lump sum severance payment in lieu of the severance payments to which he was formerly entitled under his employment agreement.

Compensation Objectives and Philosophy

Blockbuster s primary objectives when determining compensation for its named executive officers are to:

- set levels of annual salary, bonus and equity compensation that are competitive and that will attract and retain superior executives, taking into account the difficult industry conditions and competitive environment that Blockbuster currently faces,

- incorporate a performance-based component to executive compensation by linking both bonus and equity compensation to Blockbuster s financial and operational performance, and

- provide long-term equity-based compensation, thereby further aligning the interests of Blockbuster s executives with those of its other stockholders.

These objectives are designed to reward each executive s (1) past individual performance and contribution to Blockbuster s corporate performance, (2) level and scope of responsibility and experience, and (3) ability to influence Blockbuster s future growth and profitability.

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Internal Revenue Code Section 162(m)

Section 162(m) of the Internal Revenue Code (Section 162(m)) generally limits to $1,000,000 the federal tax deductibility of compensation paid to Blockbuster s Chief Executive Officer and its four other highest paid officers, but provides an exception to this limitation for certain performance-based compensation. Except where deemed not to be in Blockbuster s best interests, Blockbuster s objective is for executive compensation in excess of $1,000,000 to qualify for the performance-based compensation exception. Nevertheless, from time to time the Board authorizes compensation that does not meet the exception in order to maintain flexibility with respect to compensating executives in a manner designed to promote varying corporate goals. Of the components of compensation for Blockbuster s named executive officers, bonus and performance-based equity compensation are each typically designed to be deductible under Section 162(m), while salary and perquisites are not. As such, performance targets for bonus and performance-based equity compensation are generally set during the first quarter of Blockbuster s fiscal year in order to ensure that these awards are eligible for deductibility under Section 162(m). With respect to the fiscal 2006 compensation of the named executive officers, only the portion of each such executive s bonus attributable to Blockbuster s adjusted operating income performance and the performance-based restricted stock awards made to Messrs. Paci and Shepherd qualify for deductibility pursuant to Section 162(m).

Compensation Process

The Compensation Committee of Blockbuster s Board is responsible for assisting management and the Board in defining and overseeing Blockbuster s general compensation practices. During fiscal 2006, the Compensation Committee engaged Lyons, Benenson & Company Inc. to assist it in evaluating executive compensation matters. For a more complete description of Blockbuster s processes and procedures for determining executive compensation, please see the section of this proxy statement entitled Corporate Governance Processes and Procedures for Determining Executive and Director Compensation Executive Compensation.

Compensation of the Chief Executive Officer

Employment Agreement Analysis and Compensation Elements

Mr. Antioco s 2006 compensation was principally established by the terms of his employment agreement that was in effect during 2006, which was approved by the former Senior Executive Compensation Committee of the Board (comprised of current director Jackie M. Clegg and former directors Linda Griego and John L. Muething) in June 2004 in connection with Blockbuster s divestiture from Viacom, and, with respect to his 2006 bonus, by his amended and restated employment agreement dated March 19, 2007, which was approved by the Board on March 19, 2007. During its review and analysis of Mr. Antioco s employment agreement in 2004, the Senior Executive Compensation Committee hired an outside compensation consultant, Pearl Meyer & Partners, that was considered to be a leading authority on executive compensation. As part of its deliberations regarding Mr. Antioco s employment agreement, the Senior Executive Compensation Committee considered (1) Mr. Antioco s accomplishments since joining Blockbuster in 1997, (2) indications received from investors that the retention of Mr. Antioco would be a key consideration from their standpoint, and (3) the necessity of a successful split-off from Viacom. In addition, the Senior Executive Compensation Committee reviewed the total compensation (including salary, bonus, deferred compensation, equity compensation, and potential severance and change-in-control payments) of the CEOs of (1) direct competitors of Blockbuster (such as Hollywood Entertainment, Movie Gallery and Netflix), (2) indirect retail competitors of Blockbuster (such as Borders, Barnes & Noble, Albertsons, Saks and Dollar General), (3) certain of Viacom s competitors (such as Clear Channel Communications and Gannett Co.), and (4) Viacom s COO and CFO. Further, the Senior Executive Compensation Committee compared Mr. Antioco s then-current compensation (including salary, bonus and equity compensation) with that of these comparable groups, as well as with that of thirty CEOs in a broad industry survey group and with the compensation of the CEOs of a peer retail survey group (including 7-Eleven, Corporate Express, Dollar General, Gap, Foot Locker, Liz Claiborne, Office Depot, Polo Ralph Lauren and

Starbucks). Based on the advice of Pearl Meyer & Partners, its outside consultant, and this review of benchmark compensation for comparable CEOs, the Senior Executive Compensation Committee determined that a multiple-component agreement would be advisable and consistent with Blockbuster s compensation philosophy.

Therefore, the Senior Executive Compensation Committee reviewed the key proposed components of Mr. Antioco s compensation, including salary, bonus, deferred compensation, equity compensation, accumulated realized and unrealized stock option grants, perquisites and other personal benefits, and the potential effect on and cost to Blockbuster of severance and change-in-control scenarios. Based on this review, the Senior Executive Compensation Committee established the various components of compensation in Mr. Antioco s employment agreement, including salary (to address market data and related retention considerations), bonus (to address a pay-for-performance component), deferred compensation (to address Section 162(m)), stock options (to address alignment with stockholder interests), and restricted share units to be settled in cash only upon termination of executive status (to address alignment of stockholder interests and Section 162(m)). In determining the long-term incentive component of Mr. Antioco s compensation, the Senior Executive Compensation Committee also considered the appropriate appreciation factor to incorporate for a five-year employment agreement. In determining the grant dates for the equity components of Mr. Antioco s compensation, the Senior Executive Compensation Committee decided to spread out the grants in order to avoid a base value that would potentially be unfair to Mr. Antioco or to stockholders, given the potential for stock price volatility after the split-off. Upon conclusion of its negotiations in June 2004, the Senior Executive Compensation Committee approved Mr. Antioco s employment agreement, which was dated June 18, 2004, but by its terms would become effective only if and when Viacom ceased to own more than 50% of the voting power of Blockbuster. The employment agreement became effective on October 14, 2004, when Blockbuster successfully split-off from Viacom.

Mr. Antioco s employment agreement with Blockbuster dated June 18, 2004 provided that he would be employed as Chairman and Chief Executive Officer through October 14, 2009, at an annual salary of $1,250,000. Mr. Antioco s agreement provided for automatic one-year renewals beginning on October 14, 2008, unless terminated by either party in accordance with the notice provisions in such agreement. Mr. Antioco s agreement also provided for deferred compensation of $1,300,000 for 2006, and for increases to Mr. Antioco s deferred compensation of $150,000 annually on each January 1. In addition, Mr. Antioco s agreement provided for his annual eligibility to receive a bonus pursuant to the Senior Bonus Plan, formerly known as the Company s Senior Executive Short-Term Incentive Plan, at a target of 150% of his base salary and deferred compensation. Any bonus would be subject to satisfaction of performance objectives, as determined each year in accordance with the Senior Bonus Plan.

On March 19, 2007, Blockbuster and Mr. Antioco entered into a settlement agreement and an amended and restated employment agreement that collectively resolved a disagreement between Blockbuster and Mr. Antioco concerning the Board s 2006 bonus award to Mr. Antioco and set forth the terms of Mr. Antioco s continued employment with Blockbuster. The terms of the amended and restated employment agreement are discussed in more detail below under the heading Employment Contracts and Potential Payments Upon Termination or Change-in-Control Employment Agreement with Chairman and CEO.

Fiscal 2006 Compensation

Pursuant to his employment agreement that was in effect during 2006, for fiscal 2006, Mr. Antioco received (1) a base salary of $1,250,000, (2) additional, deferred compensation of $1,300,000, and (3) a car allowance of $1,100 per month. He was also entitled to continued use of Blockbuster s aircraft and subsequent to the November 29, 2006 addendum to his employment agreement entered into in connection with the sale of Blockbuster s aircraft, he was entitled to access to privately chartered aircraft on terms comparable to those in effect at the time Blockbuster owned and operated its own aircraft. The return on Mr. Antioco s deferred compensation is approximately equal to the rate of return on Mr. Antioco s investment portfolio under Blockbuster s Excess Investment Plan. The Excess Investment Plan permits eligible employees to defer a greater amount of salary and bonus compensation than would otherwise be allowed under Blockbuster s tax-qualified

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401(k) plan based on the Internal Revenue Code s qualified plan compensation limits. In addition, as was the case in 2005, because Mr. Antioco received equity compensation under his employment agreement during 2004, he was not awarded any additional equity compensation during 2006.

With respect to Mr. Antioco s fiscal 2006 bonus, his employment agreement that was in effect during 2006 confirmed his continued annual eligibility for a bonus under Blockbuster s Senior Bonus Plan at a target of 150% of the salary and deferred compensation to which he was entitled during the year. Mr. Antioco s fiscal 2006 bonus was based on Blockbuster s achievement of a pre-established adjusted operating income target of $285 million, which was consistent with Blockbuster s internal projections regarding adjusted operating income performance for 2006. For 2006 bonus purposes, Blockbuster calculated adjusted operating income by adding the following items: (1) Operating income, as disclosed in Blockbuster s Consolidated Statements of Operations, (2) Depreciation and intangible amortization, as disclosed in Blockbuster s Consolidated Statements of Operations, (3) Impairment of goodwill and other long-lived assets, as disclosed in Blockbuster s Consolidated Statements of Operations, (4) Non-cash share-based compensation expense, as disclosed in Blockbuster s Consolidated Statements of Cash Flows, and (5) costs incurred during 2006 due to Blockbuster s exit from the Spanish market, store closures and severance, as disclosed in footnotes 11, 1 and 1, respectively, to Blockbuster s Consolidated Financial Statements, which are included in Blockbuster s annual report on Form 10-K filed with the SEC on March 1, 2007.

In addition, once the minimum adjusted operating income target had been met, Mr. Antioco also became eligible to receive an additional bonus payment that was dependent on the satisfaction of a pre-established online subscriber growth performance goal of two million online subscribers, which was consistent with Blockbuster s internal projections regarding the number of online subscribers Blockbuster would have at year-end. The Compensation Committee s outside compensation consultant was consulted with respect to both the pre-established adjusted operating income target and supplemental online subscriber growth performance goal.

Under the terms of the Senior Bonus Plan, once the pre-established performance criteria have been met, bonuses are deemed to have been earned, except that the Outside Directors may, in their sole discretion, reduce the amount of any final bonus payout to reflect the Outside Directors assessment of the named executive officer s individual performance or for any other reason. In addition, the terms of Mr. Antioco s employment agreement that was in effect during 2006 provided that in exercising negative discretion, the Outside Directors must take into consideration the amount of Mr. Antioco s target bonus to the extent that such consideration is consistent with the terms of the Senior Bonus Plan and Section 162(m). As previously disclosed, Blockbuster and Mr. Antioco were in discussions in an attempt to resolve a disagreement concerning the Board s 2006 bonus award to Mr. Antioco. Blockbuster and Mr. Antioco entered into a settlement agreement and an amended and restated employment agreement, each dated March 19, 2007, that collectively resolved the disagreement and set forth the terms of Mr. Antioco s continued employment with Blockbuster. Pursuant to the amended and restated employment agreement, Mr. Antioco received a bonus of $3.0525 million for 2006. This bonus amount reflects a compromise between the 2006 bonus amount of $2.28 million previously conditionally offered by the Board but not paid and $7.65 million, which is the amount to which Mr. Antioco was entitled pursuant to his previous employment agreement and Blockbuster s 2006 Senior Bonus Plan, if negative discretion was not invoked.

Compensation of the Other Named Executive Officers

Blockbuster s other named executive officers include (1) Frank G. Paci, Executive Vice President, Strategic Planning and Business Development, (2) Nicholas P. Shepherd, Executive Vice President and President, Worldwide Stores, (3) Edward B. Stead, former Executive Vice President, General Counsel and Executive Vice President Business Development, (4) Chris Wyatt, former Executive Vice President and President, International, and (5) Larry J. Zine, Executive Vice President, Chief Financial Officer and Chief Administrative Officer. Except where it is appropriate to discuss an element of an individual named executive officer s compensation separately, the following is an aggregated discussion of the elements of compensation for these individuals.

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Salary

Blockbuster views cash compensation as a key element of overall executive compensation and generally targets salary levels to be at the seventy-fifth percentile for Blockbuster s retail peer group. This peer group is made up of twelve small box retailers that have median revenues that are comparable to Blockbuster s (7-Eleven, Barnes & Noble, Bed, Bath & Beyond, Borders, Dollar General, Foot Locker, Limited Brands, Office Depot, RadioShack, Starbucks, The TJX Companies, and YUM! Brands) and two peer competitors (Movie Gallery and Netflix) that Blockbuster has defined as being representative of the marketplace for the talent it seeks.

The salaries of the named executive officers are reviewed annually and may also be reviewed upon a promotion or other change in job responsibilities. During its 2006 salary review, the Compensation Committee s outside compensation consultant performed a review of the cash compensation, including salary and bonus, of executives in similar positions at the companies in the retail peer group. As a result of this review and of the other considerations discussed below, and based upon the Chief Executive Officer s recommendation and the recommendation of the Compensation Committee, the Board approved a salary increase for Mr. Shepherd only. The other named executive officers did not receive salary increases due to the fact that (1) Mr. Paci s job responsibilities had recently changed and his salary had previously been adjusted to bring it within the seventy-fifth percentile for the retail peer group, (2) Mr. Stead was no longer with Blockbuster, (3) Mr. Wyatt had recently been awarded a contingent retention bonus and his salary appeared to already be competitive, and (4) Mr. Zine had recently entered into an amendment to his agreement with Blockbuster providing him with the right to resign after December 31, 2006 and receive a lump sum severance payment in that event, and his salary appeared to already be competitive. With respect to Mr. Shepherd s salary increase, management and the Board considered (1) the anticipated additional responsibilities that Mr. Shepherd was expected to assume, (2) the data provided by the Compensation Committee s outside compensation consultant regarding the cash compensation of those executives in similar positions in the retail peer group, and (3) Mr. Shepherd s past performance at Blockbuster, and determined that such a salary increase was advisable. Actual 2006 salaries earned by each of the named executive officers are set forth below under Summary Compensation Table.

Bonus

Consistent with its view that cash compensation is a key element of overall compensation, bonuses for the other named executive officers are also considered annually. Blockbuster s bonus program is designed to emphasize pay-for-performance, and bonuses for the other named executive officers are determined based on Company achievement of pre-established performance criteria. Similar to the Chief Executive Officer s bonus, bonuses for the other named executive officers are awarded under the Senior Bonus Plan and were based on achievement of the same pre-established adjusted operating income target as was the Chief Executive Officer s bonus. In addition, also similar to the Chief Executive Officer s bonus, once this minimum adjusted operating income target had been met, the other named executive officers also became eligible to receive an additional bonus payment that was dependent on the satisfaction of the same pre-established online subscriber growth performance goal as was the Chief Executive Officer s potential additional bonus payment. The Compensation Committee s outside compensation consultant was consulted with respect to both the pre-established adjusted operating income target and supplemental online subscriber growth performance goal.

Under the terms of the Senior Bonus Plan, once the pre-established performance criteria have been met, bonuses are deemed to have been earned, except that the Outside Directors may, in their sole discretion, reduce the amount of any final bonus payout to reflect the Outside Directors assessment of the named executive officer s individual performance or for any other reason. With respect to fiscal 2006 bonuses for the named executive officers other than the Chief Executive Officer, the Outside Directors chose not to exercise negative discretion and approved the payout of full bonuses earned. Bonuses are discussed in more detail below under Fiscal 2006 Grants of Plan-Based Awards.

Long-Term Equity Compensation

Blockbuster believes that the use of restricted stock appropriately links executive interests to enhancing stockholder value and enhances the retentive value of Blockbuster s equity compensation awards. In addition,

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Blockbuster believes that the inclusion of a performance-based component to such awards further solidifies the concept of named executive officers as owners and further aligns their interests with those of Blockbuster s other stockholders.

In February 2006, subsequent to consulting with the Compensation Committee s outside compensation consultant and based upon the Chief Executive Officer s recommendation and the recommendation of the Compensation Committee, the Outside Directors approved awards of performance-based restricted shares of Blockbuster s Class A common stock for Messrs. Paci and Shepherd. The assumed dollar value of these awards was set at the same level as the dollar value of the performance-based restricted stock awards made during 2005, under which no shares were ever issued because a condition precedent to the awards was not met. The restricted shares issuable pursuant to the February 2006 performance-based awards will be granted to Messrs. Paci and Shepherd on May 5, 2007 because Blockbuster achieved the required pre-established level of adjusted operating income for the one-year period commencing on January 1, 2006 and ending on December 31, 2006. This adjusted operating income target was the same adjusted operating income target that was used with respect to the 2006 bonuses for the named executive officers. The restricted shares will vest in three equal installments on each of May 5, 2007, May 5, 2008 and May 5, 2009. The actual number of restricted shares granted could have been 0%, or ranged from 40% to 200%, of the target awards for each of Messrs. Paci and Shepherd.

Additionally, by accepting their awards and receiving a grant of restricted shares thereunder, Messrs. Paci and Shepherd each agreed to comply with the Company s stock ownership guidelines. These stock ownership guidelines, which become effective for Messrs. Paci and Shepherd on December 31, 2011, require that they own shares of the Company s common stock having a value equal to three times their base salary. Failure to meet the ownership guidelines may result in a reduction of future long-term incentive grants. The restricted share awards are discussed in more detail below under Fiscal 2006 Grants of Plan-Based Awards.

Lump Sum Severance Payment for Mr. Stead

On February 28, 2006, as part of Blockbuster s cost-cutting initiatives and based on mutual agreement, Blockbuster provided Mr. Stead with written notice of the termination without cause of Mr. Stead s employment, effective February 28, 2006. In connection therewith, and subsequent to consulting with the Compensation Committee s outside compensation consultant on the matter, Blockbuster entered into an amendment to its employment agreement with Mr. Stead to provide him with a reduced lump sum severance payment of $1,045,800 in lieu of the severance payments to which he was formerly entitled under his employment agreement.

Retention Bonus for Mr. Wyatt

As part of Blockbuster s efforts to address the challenging conditions facing the home video industry, Blockbuster has previously disclosed that it is reviewing its asset portfolio and would consider the divestiture or other strategic alternatives with regard to some or all of its international operations upon acceptable terms. In that regard, on February 16, 2006, subsequent to consulting with the Compensation Committee s outside compensation consultant on the matter, Mr. Wyatt was awarded a contingent bonus that would be payable only in the event of any sale or other disposition of Blockbuster s international operations or a requisite portion thereof. The amount of the bonus would be equal to one year s salary (approximately $618,360 based on exchange rates at the time the contingent bonus was awarded), and would be awarded regardless of whether Mr. Wyatt is offered employment with any purchaser. To date, this bonus has not been earned.

Amendment to Mr. Zine s Employment Agreement

Subsequent to consulting with the Compensation Committee s outside compensation consultant on the matter, on February 16, 2006, an amendment to Blockbuster s employment agreement with Mr. Zine was approved to provide Mr. Zine with the right to resign from Blockbuster after December 31, 2006 and, in that

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event or in the event of any termination without cause, to receive a reduced lump sum severance payment of $1,189,800 in lieu of the severance payments to which he was formerly entitled under his employment agreement.

Summary

The actions taken during 2006 with respect to the compensation of Blockbuster s named executive officers were consistent with Blockbuster s compensation objectives and philosophy. Blockbuster does not provide its named executive officers with defined benefit pension plan benefits. Blockbuster intends to continuously monitor and evaluate its compensation practices to ensure that they remain aligned with its focus on (1) setting competitive compensation levels that allow Blockbuster to attract and retain quality executives under challenging industry conditions, (2) emphasizing performance-based compensation, and (3) providing equity-based compensation that further aligns the interests of Blockbuster s named executive officers to those of its other stockholders.

Compensation Committee Report

The Compensation Committee has reviewed and discussed with management the Compensation Discussion and Analysis. Based on this review and discussion, the Compensation Committee recommended to the Board of Directors that the Compensation Discussion and Analysis be included in Blockbuster s proxy statement with respect to its 2007 annual meeting of stockholders.

Compensation Committee of the Board of Directors

James W. Crystal*

Gary J. Fernandes, Chair

Jules Haimovitz**

Carl C. Icahn

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* James W. Crystal was not appointed to the Compensation Committee until February 14, 2007 and, therefore, did not participate in compensation decisions during fiscal 2006.

** Jules Haimovitz was not appointed to the Compensation Committee until May 25, 2006, and, therefore, did not participate in compensation decisions prior to such date.

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Fiscal 2006 Summary Compensation Table

The following table provides information concerning the compensation of our named executive officers for fiscal 2006. Mr. Edward B. Stead, our former Executive Vice President, General Counsel and Executive Vice President Business Development, served in that capacity until February 28, 2006.

For a discussion of the material terms of each named executive officer s employment agreement, please refer to the section of this proxy statement entitled Employment Contracts and Potential Payments Upon Termination or Change-in-Control. Fiscal 2006 compensation for each of the named executive officers consisted of salary, non-equity incentive plan compensation and all other compensation, which includes the value of perquisites, gross ups, termination payments, employer contributions to Blockbuster s defined contribution plan and the dollar value of supplemental life insurance, as applicable. In addition, Messrs. Paci and Shepherd received performance-based restricted stock awards in February 2006, as discussed in more detail below under Fiscal 2006 Grants of Plan-Based Awards. Based on the information presented below, Salary accounted for approximately 19% of the total compensation of the named executive officers and Non-Equity Incentive Plan Compensation accounted for approximately 21% of the total compensation of the named executive officers for fiscal 2006.

Name and Principal Position	Year	Salary ($)	Stock Awards ($)(1)	Option Awards ($)(2)	Non-Equity Incentive Plan Compensation ($)(3)	All Other Compensation ($)	Total ($)
John F. Antioco Chairman of the Board and Chief Executive Officer	2006	$ 2,550,000(4)	$ 4,886,359	$ 5,815,822	$ 3,052,500	$ 23,983(5)	$ 16,328,664(6)
Larry J. Zine Executive Vice President, Chief Financial Officer and Chief Administrative Officer	2006	$ 640,000	$ 850,662		$ 768,000	$ 19,609(7)	$ 2,278,271(8)
Frank G. Paci Executive Vice President, Strategic Planning and Business Development	2006	$ 434,000	$ 794,685		$ 434,000	$ 4,856(9)	$ 1,667,541(10)
Nicholas P. Shepherd Executive Vice President and President, Worldwide Stores	2006	$ 599,615	$ 1,876,218		$ 750,000	$ 103,967(11)	$ 3,329,800(12)
Edward B. Stead Former Executive Vice President, General Counsel and Executive Vice President Business Development	2006	$ 131,385	$ (757,719)			$ 1,048,499(13)	$ 422,165(14)
Chris Wyatt Former Executive Vice President and President, International	2006	$ 636,913(15)	$ 465,535		$ 519,721(15)	$ 143,343(16)	$ 1,765,512(17)

(1) The amounts in this column reflect dollar amounts recognized for financial statement reporting purposes with respect to fiscal 2006 in accordance with FAS 123R. The amounts reflected for Messrs. Antioco, Zine, Stead and Wyatt correspond to equity awards made prior to fiscal 2006. The amounts reflected for Messrs. Paci and Shepherd correspond to equity awards made prior to fiscal 2006 and to performance-based restricted stock awards made during fiscal 2006. Any assumptions used in the calculation of these amounts are included in footnote 4 to the Company s audited financial statements for the fiscal year ended December 31, 2006, which are included in the Company s annual report on Form 10-K filed with the SEC on March 1, 2007. Other than forfeitures with respect to 264,688 restricted shares previously awarded to Mr. Stead, there were no forfeitures of stock awards during fiscal 2006.

(2) This reflects the dollar amount recognized for financial statement reporting purposes with respect to fiscal 2006 in accordance with FAS 123R. The amount reflected for Mr. Antioco corresponds to option awards

made prior to fiscal 2006. The assumptions used in the calculation of this amount are included in footnote 4 to the Company s audited financial statements for the fiscal year ended December 31, 2006, which are included in the Company s annual report on Form 10-K filed with the SEC on March 1, 2007. There were no forfeitures of options during fiscal 2006.

(3) The amounts shown for Messrs. Zine, Paci, Shepherd and Wyatt reflect cash amounts paid during 2007 based on the Company s fiscal 2006 performance pursuant to the Company s Senior Bonus Plan. The amount shown for Mr. Antioco reflects the cash amount paid during 2007 with respect to fiscal 2006 pursuant to his amended and restated employment agreement dated March 19, 2007.

(4) This includes $1,250,000 in base salary and $1,300,000 in deferred compensation.

(5) This includes (1) executive perquisites consisting of an auto allowance and insurance and personal use of the Company airplane, neither of which exceeds the greater of $25,000 or 10% of the total amount of perquisites for Mr. Antioco; (2) reimbursement for taxes not exceeding $10,000; and (3) employer matching contributions to the Company s 401(k) plan not exceeding $10,000.

(6) This amount includes $10,702,181 in compensation expense relating to equity awards made prior to 2006.

(7) This includes (1) executive perquisites consisting of an auto allowance and insurance and internet and email service provided by the Company at Mr. Zine s personal residence, neither of which exceeds the greater of $25,000 or 10% of the total amount of perquisites for Mr. Zine; (2) reimbursement for taxes not exceeding $10,000; and (3) employer matching contributions to the Company s 401(k) plan not exceeding $10,000.

(8) This amount includes $850,662 in compensation expense relating to equity awards made prior to 2006.

(9) This includes (1) employer matching contributions to the Company s 401(k) plan not exceeding $10,000 and (2) a payment pursuant to the BLOCKBUSTER Total Access Friends and Family incentive program not exceeding $10,000.

(10) This amount includes $383,984 in compensation expense relating to equity awards made prior to 2006.

(11) This includes (1) executive perquisites consisting of an auto allowance and insurance, personal tax advice provided for Mr. Shepherd at the Company s expense, storage for goods held by Mr. Shepherd internationally provided at the Company s expense and the costs of an incentive-based trip, none of which exceeds the greater of $25,000 or 10% of the total amount of perquisites for Mr. Shepherd; (2) reimbursement for taxes in the amount of $46,779; (3) $21,855 in employer contributions to the Company s U.K. defined contribution plan (converted from British pounds to U.S. dollars at an average annual conversion rate of 1.84079 for 2006); and (4) the costs of supplemental life insurance not exceeding $10,000.

(12) This amount includes $592,547 in compensation expense relating to equity awards made prior to 2006.

(13) This includes (1) reimbursement for taxes not exceeding $10,000; (2) employer contributions to the Company s 401(k) plan not exceeding $10,000; and (3) a lump sum severance payment in the amount of $1,045,800.

(14) This amount includes $(757,719) in compensation expense relating to equity awards made prior to 2006.

(15) Mr. Wyatt s salary and non-equity incentive plan compensation amounts are paid in British pounds. The salary and non-equity incentive plan compensation amounts disclosed reflect a conversion from British pounds to U.S. dollars at an average annual conversion rate of 1.84079 for 2006.

(16) This includes (1) $36,289 in costs incurred by the Company relating to Mr. Wyatt s auto perquisite; (2) other executive perquisites consisting of a physical exam, not exceeding the greater of $25,000 or 10% of the total amount of perquisites for Mr. Wyatt; and (3) $106,152 in employer contributions to the Company s U.K. defined contribution plan. Each of these amounts has been converted from British pounds to U.S. dollars at an average annual conversion rate of 1.84079 for 2006.

(17) This includes $465,535 in compensation expense relating to equity awards made prior to 2006.

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Fiscal 2006 Grants of Plan-Based Awards

The following table and accompanying narrative disclosure provide information related to grants of plan-based awards to our named executive officers during the 2006 fiscal year.

			Estimated Future Payouts Under Non-Equity Incentive Plan Awards			Estimated Future Payouts Under Equity Incentive Plan Awards			
Name	Award Approval Date	Grant Date	Threshold ($)	Target ($)	Maximum ($)	Threshold (#)	Target (#)	Maximum (#)	Grant Date Fair Value of Stock Awards
John F. Antioco			$ 1,912,500	$ 3,825,000	$ 9,180,000				
Larry J. Zine			$ 192,000	$ 384,000	$ 921,600				
Frank G. Paci			$ 108,500	$ 217,000	$ 520,800				
	02/16/2006	05/05/2007				36,000	90,000	180,000	$ 901,257(1)
Nicholas P. Shepherd			$ 187,500	$ 375,000	$ 900,000				
	02/16/2006	05/05/2007				112,520	281,300	562,600	$ 2,816,930(1)
Edward B. Stead									
Chris Wyatt			$ 191,074	$ 382,148	$ 917,155				

(1) As discussed below, 170,370 and 532,501 restricted shares will be granted to Messrs. Paci and Shepherd, respectively, on May 5, 2007 under performance-based awards approved in fiscal 2006. Because the restricted shares to be granted under these awards will not be granted until May 5, 2007, we have assumed for purposes of this calculation that the closing stock price on the grant date is $5.29, which was the closing price of a share of Blockbuster Class A common stock on December 29, 2006.

The amounts reported under Estimated Future Payouts Under Non-Equity Incentive Plan Awards reflect the threshold, target and maximum amounts that were payable to each of the named executive officers under the Senior Bonus Plan, a short-term incentive plan designed to meet the requirements of Section 162(m). Because Mr. Wyatt s bonus is paid in British pounds, the amounts disclosed for him reflect a conversion from British pounds to U.S. dollars at a conversion rate of 1.84079, which was the annual average conversion rate for 2006. Target awards were approved by the Outside Directors (as such term is defined in regulations pursuant to Section 162(m)) in February 2006, and were conditioned upon the Company s achievement of performance goals based on adjusted operating income for the one-year period commencing on January 1, 2006 and ending on December 31, 2006. The adjusted operating income target was $285 million, which was consistent with Blockbuster s internal projections regarding adjusted operating income performance for 2006. For 2006 bonus purposes, Blockbuster calculated adjusted operating income by adding the following items: (1) Operating income, as disclosed in Blockbuster s Consolidated Statements of Operations, (2) Depreciation and intangible amortization, as disclosed in Blockbuster s Consolidated Statements of Operations, (3) Impairment of goodwill and other long-lived assets, as disclosed in Blockbuster s Consolidated Statements of Operations, (4) Non-cash share-based compensation expense, as disclosed in Blockbuster s Consolidated Statements of Cash Flows, and (5) costs incurred during 2006 due to Blockbuster s exit from the Spanish market, store closures and severance, as disclosed in footnotes 11, 1 and 1, respectively, to Blockbuster s Consolidated Financial Statements, which are included in Blockbuster s annual report on Form 10-K filed with the SEC on March 1, 2007.

Because the minimum performance goals for adjusted operating income were met, each of the named executive officers also became eligible to receive an additional bonus payment, the size of which was dependent on the Company s satisfaction of a pre-approved online subscriber growth performance goal of two million online subscribers, which was consistent with Blockbuster s internal projections regarding the number of online subscribers Blockbuster would have at year-end. The maximum additional bonus payment that each named executive officer could have received is included in the totals under the Maximum sub-column.

In February 2007, the Company s achievement of the adjusted operating income goal was certified. As such, and because the Company similarly achieved its online subscriber growth goal, the Company paid bonuses for fiscal 2006 to the named executive officers other than the Chief Executive Officer as follows: Mr. Zine received $768,000, Mr. Paci received $434,000, Mr. Shepherd received $750,000 and Mr. Wyatt received $519,721 (converted from British pounds to U.S. dollars at a conversion rate of 1.84079, which was the annual average

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conversion rate for 2006). Mr. Antioco received a bonus of $3.0525 million for 2006. As previously disclosed, Blockbuster and Mr. Antioco were in discussions in an attempt to resolve a disagreement concerning the Board s 2006 bonus award to Mr. Antioco. The $3.0525 million bonus amount reflects a compromise between the 2006 bonus amount of $2.28 million previously conditionally offered by the Board but not paid and $7.65 million, which is the amount to which Mr. Antioco was entitled pursuant to his previous employment agreement and Blockbuster s 2006 Bonus Plan, if negative discretion was not invoked.

The amounts reported for Messrs. Paci and Shepherd under Estimated Future Payouts Under Equity Incentive Plan Awards reflect the threshold, target and maximum number of restricted shares that could have been granted under the Company s 1999 Amended and Restated Long-Term Management Incentive Plan. In February 2006, the Outside Directors approved awards of performance-based restricted shares of Blockbuster Class A common stock for Messrs. Paci and Shepherd and for certain other employees. The awards were conditioned upon the Company s achievement of the same adjusted operating income goals used for the 2006 bonuses for the named executive officers. In February 2007, the Company s achievement of the adjusted operating income goal was certified and, as such, 170,370 and 532,501 restricted shares will be granted to Messrs. Paci and Shepherd, respectively, on May 5, 2007, and will vest in three equal installments on each of May 5, 2007, May 5, 2008 and May 5, 2009. In addition, once the restricted shares have been granted, Messrs. Paci and Shepherd will have immediate dividend rights equal to those of our other Class A common stockholders with respect to their restricted shares unless and until such shares are forfeited.

Outstanding Equity Awards at 2006 Fiscal Year-End

The following table provides information related to the outstanding equity awards held by each of our named executive officers at December 31, 2006.

	Option Awards				Stock Awards	
Name	**Number of Securities Underlying Unexercised Options (#) Exercisable**	**Number of Securities Underlying Unexercised Options (#) Unexercisable**	**Option Exercise Price ($)**	**Option Expiration Date**	**Number of Shares or Units of Stock That Have Not Vested (#)**	**Market Value of Shares or Units of Stock That Have Not Vested ($)**
John F. Antioco	1,111,112(1)	555,554(1)	$ 7.1700	10/21/2014	864,486(2)	$ 4,404,556(3)
	1,111,112(1)	555,554(1)	$ 8.3900	11/15/2014		
	1,111,112(1)	555,556(1)	$ 8.8000	12/13/2014		
	239,687(4)		$ 24.0000	05/17/2008		
	764,062(4)		$ 32.9816	05/17/2008		
Larry J. Zine	50,937(4)		$ 33.5215	05/17/2008	83,333(5)	$ 440,832(6)
	31,835(4)		$ 43.3473	05/17/2008		
	31,835(4)		$ 31.0184	05/17/2008		
	31,835(4)		$ 30.8849	05/17/2008		
Frank G. Paci					41,666(5)	$ 220,413(6)
					170,370(7)	$ 901,257(6)
Nicholas P. Shepherd	5,093(4)		$ 24.0000	05/17/2008	66,666(5)	$ 352,663(6)
	25,468(4)		$ 30.8849	05/17/2008	532,501(7)	$ 2,816,930(6)
Edward B. Stead						
Chris Wyatt	25,468(4)		$ 31.0184	05/17/2008	50,000(5)	$ 264,500(6)
	25,468(4)		$ 30.8849	05/17/2008		

(1) Represents securities underlying options to purchase Blockbuster Class A common stock. All of the remaining unexercisable stock options vest on October 14, 2007.

(2)

Represents restricted share units settleable in cash based on the average of the closing market prices of Blockbuster Class A common stock and Class B common stock on the date of Mr. Antioco s termination of employment with the Company that vest on October 14, 2007.

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(3) Calculated by multiplying the average of the closing market prices of Blockbuster Class A common stock and Class B common stock on December 29, 2006 by the number of restricted share units listed in the foregoing column.

(4) Represents securities underlying options to purchase CBS Corporation Class B common stock.

(5) Represents restricted shares of Blockbuster Class A common stock that vest on December 20, 2007.

(6) Calculated by multiplying the closing market price of Blockbuster Class A common stock on December 29, 2006 by the number of restricted shares listed in the foregoing column.

(7) Represents restricted shares of Blockbuster Class A common stock that will be granted on May 5, 2007 and will vest in three equal installments on each of May 5, 2007, May 5, 2008 and May 5, 2009.

Fiscal 2006 Option Exercises and Stock Vested

The following table provides information related to options exercised by, and stock awards vested for, our named executive officers during fiscal 2006.

	Option Awards		**Stock Awards**	
Name	**Number of Shares Acquired on Exercise (#)**	**Value Realized on Exercise ($)(1)**	**Number of Shares Acquired on Vesting (#)**	**Value Realized on Vesting ($)(2)**
John F. Antioco			549,390(4)	$ 2,823,865
			864,486(5)	$ 3,293,692(5)
Larry J. Zine			268,969(4)	$ 1,382,501
Frank G. Paci			78,034(4)	$ 401,095
Nicholas P. Shepherd			124,693(4)	$ 640,922
Edward B. Stead				
Chris Wyatt	5,093(3)	$ 25,822	114,458(4)	$ 588,314

(1) Calculated by determining the difference between the market price of the underlying securities at exercise and the exercise price of the options.

(2) Calculated by multiplying the number of restricted shares or restricted share units by the market value of the underlying shares on the vesting date.

(3) Represents shares of CBS Corporation Class B common stock acquired on exercise.

(4) Represents shares of Blockbuster Class A common stock acquired on vesting.

(5) Pursuant to his previous employment agreement, on October 21, 2004, Mr. Antioco received 1,728,972 restricted share units that vest in two equal installments on October 14, 2006 and October 14, 2007, and that are payable in cash immediately after Mr. Antioco s termination of employment with the Company. Each restricted share unit will be valued based on the average of the closing prices of a share of

Blockbuster Class A common stock and a share of Blockbuster Class B common stock on the date of termination of employment. For purposes of determining the value realized on vesting, the average of the closing prices of a share of Blockbuster Class A common stock and a share of Blockbuster Class B common stock on October 13, 2006 was used.

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Defined Benefit Pension Plans

Through December 31, 1999, we participated in a non-contributory qualified defined benefit pension plan and, for some of our highly compensated employees, a non-qualified excess defined benefit pension plan. Both plans were sponsored by the company formerly known as Viacom Inc. (Viacom). Our employees became eligible to participate in these plans effective January 1, 1996, with credit for past service on and after September 29, 1994, for eligibility and vesting purposes. Benefits under both Viacom plans were determined by a formula that uses final average compensation (salary and bonus) and years of benefit service. The benefits under Viacom s excess defined benefit pension plan are not subject to the provisions of the Internal Revenue Code that limit the compensation used to determine benefits and the amount of annual benefits payable under Viacom s qualified defined benefit pension plan.

Our employees ceased to participate in Viacom s defined benefit pension plans on December 31, 1999. All of our employees who were actively employed by us and participating in Viacom s qualified defined benefit pension plan or Viacom s excess defined benefit pension plan on December 31, 1999, were fully vested in their accrued benefits in Viacom s plans on that date. The aggregate accrued annual retirement benefit payable under the Viacom qualified defined benefit pension plan and the Viacom excess defined benefit pension plan, assuming payment as a single life annuity at age 65 and not subject to deduction or offset, is approximately $19,200 for Mr. Antioco and approximately $12,200 for Mr. Stead. Messrs. Paci, Shepherd, Wyatt and Zine were not participants in the Viacom qualified defined benefit pension plan or the Viacom excess defined benefit pension plan.

In connection with our divestiture from Viacom in October 2004, Viacom agreed to retain the accrued liability for benefits for our current and former employees under the Viacom qualified defined benefit pension plan. We agreed to indemnify Viacom for taking certain actions that increase Viacom s liability under the Viacom qualified defined benefit pension plan. The amount of the indemnity will be determined by the amount of the actuarial loss experienced by Viacom as a result of such action by us. After the first $1 million of such actuarial losses, we will indemnify Viacom for the next $4 million of such losses. We also agreed to assume liabilities attributable to our current and former employees in Viacom s excess defined benefit pension plan, with the amount of such assumed liability capped at $800,000.

On January 1, 2006, Viacom announced that it had completed a transaction (the Viacom Split) to separate itself into two publicly traded entities: CBS Corporation and New Viacom Inc. (New Viacom). As a result of the Viacom Split, the assets and liabilities of our employees under Viacom s qualified defined benefit pension plan were transferred to a New Viacom qualified defined benefit pension plan that is sponsored by New Viacom. In addition, the liabilities of our employees under Viacom s excess defined benefit pension plan were transferred to New Viacom s excess defined benefit pension plan that is sponsored by New Viacom. New Viacom s defined benefit pension plans have essentially the same terms and provisions as Viacom s defined benefit pension plans and will be administered by New Viacom. Blockbuster participants will be eligible to receive accrued benefits under the New Viacom defined benefit pension plans in accordance with their terms upon their separation from service with us.

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Fiscal 2006 Nonqualified Deferred Compensation

The following table provides information related to the nonqualified deferred compensation of our named executive officers for fiscal 2006.

Name	Executive Contributions in Last FY ($)(1)	Registrant Contributions in Last FY ($)	Aggregate Earnings in Last FY ($)(2)	Aggregate Withdrawals/ Distributions ($)	Aggregate Balance at Last FYE ($)
John F. Antioco, Deferred Compensation Arrangement	$ 1,300,000		$ 303,438		$ 6,054,904(3)
John F. Antioco, Restricted Share Units Settleable in Cash on Termination of Employment			$ 1,110,864(4)		$ 4,404,556(5)
John F. Antioco, Excess Investment Plan			$ 136,465		$ 2,281,007(6)
Larry J. Zine, Excess Investment Plan			$ 66,761		$ 461,589(7)
Frank G. Paci					
Nicholas P. Shepherd					
Edward B. Stead, Excess Investment Plan			$ 26,969		$ 261,801(8)
Chris Wyatt					

(1) The amount reflected in this column is also reflected in its entirety in the Salary column of the Fiscal 2006 Summary Compensation Table on page 27 of this proxy statement.

(2) Because the amounts in this column do not reflect above-market or preferential earnings, they are not reported in the Fiscal 2006 Summary Compensation Table on page 27 of this proxy statement.

(3) Of this amount, $4,843,337 has previously been reported in the Salary column of the Summary Compensation Table for Mr. Antioco during prior years and $1,211,566 constitutes earnings on such contributions, which have not previously been reported.

(4) As previously disclosed in more detail above under Fiscal 2006 Option Exercises and Stock Vested, 864,486 of Mr. Antioco s restricted share units that are payable in cash immediately after his termination of employment with the Company vested on October 14, 2006. Aggregate earnings in the last fiscal year were calculated by subtracting the value of these vested restricted share units on December 29, 2006 from the value of the restricted share units on October 14, 2006.

(5) The grant date value of these restricted share units was previously reported in the Long-Term Compensation Restricted Stock Awards column of the Summary Compensation Table for Mr. Antioco during 2004.

(6) Of this amount, $1,864,702 has previously been reported in either the Salary or Bonus columns of the Summary Compensation Table for Mr. Antioco during prior years, $65,817 has previously been reported in the All Other Compensation column of the Summary Compensation Table for Mr. Antioco during prior years, and $350,538 constitutes earnings on such contributions (minus $50 in administrative fees) under the Company s Excess Investment Plan, which have not previously been reported.

(7) Of this amount, $299,044 has previously been reported in either the Salary or Bonus columns of the Summary Compensation Table for Mr. Zine during prior years, $79,167 has previously been reported in the All Other Compensation column of the Summary Compensation Table for Mr. Zine during prior years, and $83,427 constitutes earnings on such contributions (minus $50 in

administrative fees) under the Company s Excess Investment Plan, which have not previously been reported.

(8) Of this amount, $179,270 has previously been reported in either the Salary or Bonus columns of the Summary Compensation Table for Mr. Stead during prior years, $61,493 has previously been reported in the

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All Other Compensation column of the Summary Compensation Table for Mr. Stead during prior years, and $21,088 constitutes earnings on such contributions (minus $50 in administrative fees) under the Company s Excess Investment Plan, which have not previously been reported.

Mr. Antioco s Deferred Compensation Arrangement

Pursuant to the terms of his previous and current employment agreements, Mr. Antioco is entitled to deferred compensation the payment of which shall be deferred until January of the first calendar year in which he ceases to be an executive officer of the Company at which time it will be paid in a single lump sum cash payment. During 2006, Mr. Antioco earned $1,300,000 in deferred compensation. Mr. Antioco s previous and current employment agreements each also provide that the Company shall maintain a bookkeeping account with respect to Mr. Antioco s deferred compensation, the balance of which shall be periodically credited or debited with the deemed positive or negative return calculated in the same manner and at the same times as the deemed return on his account is determined under the Company s Excess Investment Plan. The Company s obligation to pay Mr. Antioco s deferred compensation, including any return thereon, is an unfunded obligation to be satisfied from the general funds of the Company.

Blockbuster s Excess Investment Plan

The Company s Excess Investment Plan permits eligible employees to defer salary and bonus compensation in addition to amounts that would otherwise be allowed under the Company s tax-qualified 401(k) plan based on the Internal Revenue Code s qualified plan compensation limits. The plan is a nonqualified deferred compensation plan and is intended to comply with the requirements of Internal Revenue Code Section 409A.

An eligible employee is any employee of the Company, its affiliates and subsidiaries who receives annual salary and bonus compensation in an amount equal to or greater than the annual compensation limit under Section 401(a)(17) of the Internal Revenue Code (which was $220,000 for 2006 and is $225,000 for 2007) and who is designated by the Retirement/Investments Committee that administers the plan as an employee who is eligible to participate in the plan. Eligible employees may contribute up to 15% of each of their salary and bonus to the plan, which contributions are matched by the Company at a rate of 50% up to 5% of the participant s compensation, which is capped at $750,000 under the plan. All contributions are fully vested at all times. Each participant s account in the plan is periodically adjusted to reflect the investment performance of the investment funds selected by such participant for amounts contributed to the Company s 401(k) plan. Plan obligations are a general unsecured liability of the Company, and the Company has not established a trust to hold any assets to meet its future obligations under the plan. The table below shows the funds that were available under the Company s 401(k) plan during the 2006 plan year and their annual rate of return for the calendar year ended December 31, 2006, as reported by the administrator of the plan.

Name of Fund	Rate of Return
Vanguard Lifestrategy Moderate	13.31%
Blockbuster Class A Stock Fund	41.07%
Blockbuster Class B Stock Fund	47.15%
Putnam Voyager Fund Y	5.52%
Vanguard Morgan Growth Fund	11.15%
CBS Corp. Class A Stock Fund	25.65%
CBS Corp. Class B Stock Fund	33.16%
New Viacom Class A Stock Fund	2.52%
New Viacom Class B Stock Fund	-0.29%
EuroPacific Growth Fund	21.87%
Dimensional Small Cap Port	16.61%
Putnam Investors Fund Y	14.20%

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Name of Fund	Rate of Return
Vanguard Total Stock Market	15.51%
Vanguard Growth and Income	14.01%
George Putnam Fund of Boston Y	12.51%
Putnam Equity Income Fund Y	19.56%
Vanguard Windsor II	18.25%
PIMCO Total Return Fund	3.74%
Putnam Income Fund Y	4.37%

For amounts deferred prior to January 1, 2005 and earnings on those amounts, the balance of each participant s account in the plan is distributed in cash after termination of employment in accordance with such participant s payment election. Participants may elect to have these amounts paid in a single lump sum in January of the first, second, third, fourth or fifth year following termination of employment, or in up to five annual installments in amounts designated by the participant beginning in January following the year of termination of employment. Payment elections may be changed up to three times during employment, and participants may change an existing payment election only one time in any calendar year.

For amounts deferred on and after January 1, 2005, and earnings on those amounts, the balance of each participant s account in the plan is distributed in cash after separation of service in accordance with such participant s payment election. Participants may elect to have these amounts paid in single lump sum in January of the first, second, third, fourth or fifth year following separation from service, or in up to five annual installments in amounts designated by the participant beginning in January following the year of separation from service. If the participant is a specified employee, any payment that is due to be made to such participant before the date that is six months after the date of the participant s separation from service will be delayed and paid on or about the day that is six months after the date of separation from service, or if earlier, as soon as administratively practicable following the date of such participant s death. A specified employee is an employee that is an officer of the Company with annual compensation greater than $140,000 for 2006, or $145,000 for 2007, a 5% owner of the Company or a 1% owner of the Company with annual compensation of more than $150,000. Payment elections may be changed up to three times during employment, and participants may change an existing payment election only one time in any calendar year. Any change to a participant s existing payment election may not take effect until at least 12 months after the date on which the change is made and, if the election relates to a payment due to separation from service, the payment must be deferred for at least five years from the date the payment would otherwise have been paid.

Participants may also petition the Retirement/Investments Committee for withdrawals in the event of an unanticipated and severe financial hardship or an unforeseeable emergency. Participants are not permitted to borrow from their plan accounts.

Employment Contracts and Potential Payments Upon Termination or Change-in-Control

We have entered into employment agreements with our named executive officers. The following discussion provides an overview of these agreements; it is not a complete description of all terms of the agreements. Mr. Antioco s amended and restated employment agreement was filed as an exhibit to our Current Report on Form 8-K filed with the SEC on March 20, 2007. For the location of the other agreements discussed below in our public SEC filings, please refer to the exhibit index in our annual report on Form 10-K for the year ended December 31, 2006, filed with the SEC on March 1, 2007 and available on our public website.

Amended and Restated Employment Agreement with Chairman and CEO

As previously disclosed, Blockbuster and John F. Antioco, Blockbuster s Chairman and Chief Executive Officer, were in discussions in an attempt to resolve a disagreement concerning the Board s 2006 bonus award to Mr. Antioco. On March 19, 2007, Blockbuster and Mr. Antioco entered into a settlement agreement and an amended and restated employment agreement that collectively resolved the disagreement and set forth the terms of Mr. Antioco s continued employment with Blockbuster.

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The term of Mr. Antioco s employment pursuant to the amended and restated agreement will expire on December 31, 2007, unless concluded prior to such date (a) due to Mr. Antioco s death or disability or (b) because Blockbuster, in its sole discretion, gives Mr. Antioco 30 days written notice of his required resignation, which notice may not be given prior to June 1, 2007 nor later than December 1, 2007. The amended and restated agreement provides that Mr. Antioco will receive a bonus of $3,052,500 for 2006. For 2007, Mr. Antioco will receive (i) a salary of $1,250,00, (ii) a bonus of $2,025,000, and (iii) deferred compensation of $1,450,000. Other than the amounts listed above, Mr. Antioco will not receive any new equity-based compensation, deferred compensation, or other incentive awards during the remainder of his employment. While he remains employed, Mr. Antioco will be able to participate in the medical, dental, and other insurance plans offered by Blockbuster; however, other than as required by law, Mr. Antioco will not continue participation in these arrangements following the conclusion of his employment. In addition, Mr. Antioco is entitled to a car allowance of $1,100 per month, access to privately chartered aircraft on terms comparable to those in effect at the time Blockbuster owned and operated its own aircraft, and reimbursement of reasonable travel and other expenses incurred in the performance of his duties.

The amended and restated agreement also provides that Mr. Antioco will be subject to non-compete provisions in favor of Blockbuster until December 31, 2008, and Mr. Antioco may not at any time following the conclusion of his employment with Blockbuster use for his own purposes, or disclose to or for the benefit of any third party, any trade secret or other confidential information of Blockbuster or any of its affiliates and he must comply with any confidentiality obligations of Blockbuster to a third party. He also may not, directly or indirectly, during the non-compete period (i) employ or solicit the employment of any person who is then or has been within six months prior thereto, an employee of Blockbuster or any of its affiliates or (ii) knowingly interfere with, disturb or interrupt the relationships of Blockbuster or any of its affiliates with any customer, supplier or consultant. Further, during the non-compete period he may not make any public statement that is intended to or could reasonably be expected to disparage Blockbuster.

All good reason, cause, and change in control provisions from Mr. Antioco s prior employment agreement have been removed and are no longer applicable under the amended and restated agreement. In the event Mr. Antioco voluntarily terminates his employment with Blockbuster prior to December 31, 2007, he will not be entitled to receive any payments, benefits or awards under the amended and restated agreement that as of the date of his termination of his employment are unpaid, unvested or unaccrued.

In the event Mr. Antioco s employment concludes automatically on December 31, 2007 or as a result of receiving 30 days written notice from Blockbuster of his required resignation, Mr. Antioco will be entitled to receive the severance payments and benefits set forth in the chart and paragraphs below:

	Automatic Conclusion of Employment on December 31, 2007	**Required Resignation following Notice from Blockbuster**
2007 Salary	$1,250,000 (to the extent unpaid on the date of conclusion of employment)	Through the date that is the midpoint between the date of the conclusion of his employment and December 31, 2007.
2007 Bonus	$2,025,000	$2,025,000 multiplied by the number of days from January 1, 2007 until the date that is the midpoint between the date of the conclusion of his employment and December 31, 2007, and divided by 365.
2007 Deferred Compensation	$1,450,000 (to the extent unpaid on the date of conclusion of employment), together with return thereon	$1,450,000 multiplied by the number of days from January 1, 2007 until the date that is the midpoint between the date of the conclusion of his employment and December 31, 2007, and divided by 365, together with return thereon.

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In addition, if Mr. Antioco s employment concludes for either of these reasons, he will receive:

The deferred compensation credited for prior years (which does not include deferred compensation for the period from May 1, 2005 until December 31, 2005, which was previously waived by Mr. Antioco), together with return thereon.

A payment equal to $4,987,500.

Accelerated vesting of any unvested stock options and continued exercisability of all vested stock options for a period of up to 30 months following the date of the conclusion of his employment. As of December 29, 2006, the exercise prices of all of Mr. Antioco s options exceeded the closing market price of our Class A common stock.

Accelerated vesting of any unvested restricted share units and immediate settlement of all vested restricted share units. Mr. Antioco currently has 864,486 unvested restricted share units that would otherwise vest on October 14, 2007. The other 864,486 of Mr. Antioco s restricted share units previously vested on October 14, 2006. Based on the closing market price per share on December 29, 2006 of our Class A common stock ($5.29) and our Class B common stock ($4.90), the value attributable to the acceleration of the restricted share units is $4,404,556.

Any other amounts, payments, entitlements or benefits earned, accrued, or owing but not yet paid, including incentive payments.

The above amounts will be paid to Mr. Antioco immediately as of the date that his employment concludes, unless delaying such payment would enable Blockbuster to retain its deduction of such amounts in accordance with Section 162(m) and/or would allow Mr. Antioco to avoid excise taxes under section 409A of Internal Revenue Code and provided such delay is no longer than necessary to accomplish these goals.

In the event Mr. Antioco s employment concludes prior to December 31, 2007 due to his disability or death, he will generally receive the same payments and benefits as described above, except that (a) the $4,987,500 payment will not be made, and (b) with respect to the 2007 salary, bonus, and deferred compensation amounts, such amounts will generally be prorated through the date long term disability benefits commence or the date of his death, respectively. These amounts will be paid to Mr. Antioco or his designated beneficiary as soon as administratively feasible following Mr. Antioco s disability or death, as applicable, subject to delay in order to comply with section 162(m) and/or section 409A of the Internal Revenue Code, as described above.

Employment Agreements with Other Named Executive Officers

Mr. Paci. The Company s employment agreement with Mr. Paci provides for automatic renewal on March 1 of each year for a term of three years unless terminated by the Company for any reason. Mr. Paci s agreement provides that he will be employed at a monthly salary of $32,500, subject to increase pursuant to the authority of the Compensation Committee to make individual compensation recommendations. Actual annual salary earned by Mr. Paci for fiscal 2006 is set forth above under Summary Compensation Table. In addition, Mr. Paci s agreement provides that he will be eligible to receive an annual bonus pursuant to Blockbuster s short-term incentive plan or Senior Bonus Plan at a target amount of 50% of his salary (as defined in the Senior Bonus Plan, if applicable). Mr. Paci s bonuses are payable upon satisfaction of performance objectives determined each year in accordance with the applicable plan. In addition, Mr. Paci s agreement provides that he is entitled to a car allowance and car insurance in accordance with the Company s policies, as they may be amended from time to time. In the event of the termination of Mr. Paci s employment without cause (as defined in the agreement) during the employment term, he will be entitled to receive his salary for 24 months after the date of termination, subject to mitigation after the first twelve months and conditioned on his execution of a General Release and Waiver of Claims against the Company. In addition, he will be entitled to receive bonus compensation and certain benefits for the balance of the employment term, subject to mitigation after the first twelve months. Mr. Paci s agreement also provides that certain payments will be made in the event of his death or disability, including a pro-rated bonus payment. Additionally, Mr. Paci will be subject to non-competition

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provisions for the length of time he receives severance payments pursuant to a termination of his employment without cause, ongoing confidentiality and non-disparagement obligations, and non-solicitation provisions for one year following the termination of his employment with the Company. Further, Mr. Paci is also entitled to the acceleration of his currently outstanding restricted shares upon a change of control of the Company pursuant to the terms of the restricted share award agreement under which they were granted.

The following table quantifies the payments to which Mr. Paci is entitled upon termination, change-in-control, death and disability. In determining the estimated amount of these payments, the following assumptions were used: (1) the triggering event took place on December 31, 2006, and (2) the price per share of our Class A common stock was $5.29, which was the closing market price on December 29, 2006.

Estimated Payments	Voluntary Termination	Termination for Cause	Termination without Cause	Change in Control Resulting in Termination	Change in Control Not Resulting in Termination	Death	Disability
Severance Salary			$ 868,000	$ 868,000			
Severance Bonus			$ 469,077	$ 469,077			
Acceleration of Restricted Shares				$ 220,413	$ 220,413		
Benefits/Perquisites			$ 36,777(1)	$ 36,777(1)			
TOTAL			$ 1,373,854	$ 1,594,267	$ 220,413		

(1) This consists of (i) $27,202 in estimated COBRA expenses for medical and dental insurance coverage, (ii) an auto allowance and (iii) life insurance coverage, each through the balance of the employment term.

Mr. Shepherd. The Company s employment agreement with Mr. Shepherd provides for automatic renewal on March 1 of each year for a term of two years unless terminated by the Company for any reason. Mr. Shepherd s agreement provides that he will be employed at a monthly salary of $33,500, subject to increase pursuant to the authority of the Compensation Committee to make individual compensation recommendations. Actual annual salary earned by Mr. Shepherd for fiscal 2006 is set forth above under Summary Compensation Table. In addition, Mr. Shepherd s agreement provides that he will be eligible to receive an annual bonus pursuant to Blockbuster s short-term incentive plan or Senior Bonus Plan at a target amount of 50% of his salary (as defined in the Senior Bonus Plan, if applicable). Beginning with the 2004 calendar year, the former Senior Executive Compensation Committee increased the target bonus for Mr. Shepherd to 60% of his salary. Mr. Shepherd s bonuses are payable upon satisfaction of performance objectives determined each year in accordance with the applicable plan. In addition, Mr. Shepherd s agreement provides that he is entitled to a car allowance and car insurance in accordance with the Company s policies, as they may be amended from time to time. Mr. Shepherd receives additional perquisites relating to his international assignment pursuant to an addendum to his employment agreement, including various pension, life insurance, home country housing, vacation, home leave, dependent schooling, tax services and relocation benefits. In the event of the termination of Mr. Shepherd s employment without cause (as defined in the agreement) during the employment term, he will be entitled to receive his salary for 24 months after the date of termination, subject to mitigation after the first twelve months and conditioned on his execution of a General Release and Waiver of Claims against the Company. In addition, he will be entitled to receive bonus compensation and certain benefits for the balance of the employment term, subject to mitigation after the first twelve months. Mr. Shepherd s agreement also provides that certain payments will be made in the event of his death or disability, including a pro-rated bonus payment. Additionally, Mr. Shepherd will be subject to non-competition provisions for the length of time he receives severance payments pursuant to a termination of his employment without cause, ongoing confidentiality and non-disparagement obligations, and non-solicitation provisions for one year following the termination of his employment with the Company. Further, Mr. Shepherd is also entitled to the acceleration of his currently outstanding restricted shares upon a change of control of the Company pursuant to the terms of the restricted share award agreement under which they were granted.

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The following table quantifies the payments to which Mr. Shepherd is entitled upon termination, change-in-control, death and disability. In determining the estimated amount of these payments, the following assumptions were used: (1) the triggering event took place on December 31, 2006, and (2) the price per share of our Class A common stock was $5.29, which was the closing market price on December 29, 2006.

Estimated Payments	Voluntary Termination	Termination for Cause	Termination without Cause	Change in Control Resulting in Termination	Change in Control Not Resulting in Termination	Death	Disability
Severance Salary			$ 1,250,000	$ 1,250,000			
Severance Bonus			$ 435,616	$ 435,616			
Acceleration of Restricted Shares				$ 352,663	$ 352,663		
Benefits/Perquisites	$ 143,073(1)	$ 143,073(1)	$ 166,054(2)	$ 166,054(2)		$ 143,073(1)	$ 143,073(1)
TOTAL	$ 143,073	$ 143,073	$ 1,851,671	$ 2,204,334	$ 352,663	$ 143,073	$ 143,073

(1) This is the amount of estimated relocation expenses associated with Mr. Shepherd s return to the United Kingdom. Relocation expenses consist of (i) return travel for Mr. Shepherd and his family to the United Kingdom, (ii) $31,000 in estimated expenses associated with the movement of Mr. Shepherd s household goods to the United Kingdom, (iii) temporary living expenses for Mr. Shepherd upon his return to the United Kingdom, (iv) temporary auto rental expenses for Mr. Shepherd upon his return to the United Kingdom, (v) temporary storage expenses for Mr. Shepherd s household goods in the United States, (vi) a $50,000 resettlement allowance and (vii) closing costs associated with the sale of Mr. Shepherd s home in the United States.

(2) This consists of (i) medical and dental insurance coverage, (ii) an auto allowance and (iii) life insurance coverage, each through the balance of the employment term, as well as $143,073 in estimated relocation expenses associated with Mr. Shepherd s return to the United Kingdom as discussed further in footnote 1 above.

Mr. Wyatt. Mr. Wyatt s employment agreement is with Blockbuster Entertainment Limited, a subsidiary of the Company, and allows for continued effectiveness until terminated by Blockbuster Entertainment Limited for any reason upon six months prior notice or by Mr. Wyatt upon three months prior notice. Mr. Wyatt s agreement provides that he will be employed at an annual salary of £346,000 ($636,913 based on an annual average conversion rate of 1.84079 for 2006), subject to increase pursuant to the authority of the Company s Compensation Committee to make individual compensation recommendations. Actual annual salary earned by Mr. Wyatt for fiscal 2006 is set forth above under Summary Compensation Table. In addition, Mr. Wyatt s agreement provides that he will be eligible to receive an annual bonus pursuant to the Company s short-term incentive plan or Senior Bonus Plan at a target amount of 60% of his salary (as defined in the Senior Bonus Plan, if applicable). Mr. Wyatt s bonuses are payable upon satisfaction of performance objectives determined each year in accordance with the applicable plan. In addition, Mr. Wyatt s agreement provides that he is entitled, for his sole business use, to a motorcar of a make, model and specification that, in the reasonable opinion of Blockbuster Entertainment Limited, is commensurate with his status, together with appropriate insurance and a fuel card, in accordance with Blockbuster Entertainment Limited s policies, as they may be amended from time to time.

As part of its ongoing efforts to streamline its organization, the Company announced that on July 19, 2006, based on mutual agreement, it notified Mr. Wyatt of its intention to terminate Mr. Wyatt s employment agreement in accordance with the terms of that agreement. Mr. Wyatt continued his services and assisted with the transition of his responsibilities through the end of 2006, and his employment agreement will be terminated effective June 30, 2007. Mr. Wyatt s employment agreement provides that in the event of the termination of Mr. Wyatt s employment by Blockbuster Entertainment Limited for any reason other than for breach (as defined in the agreement) and conditioned on Mr. Wyatt entering into a valid waiver of claims (a Compromise Agreement) against Blockbuster Entertainment Limited and its affiliated companies in a form satisfactory to

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Blockbuster Entertainment Limited, he will be entitled to receive his salary and bonus compensation for 18 months after the date of termination, subject to mitigation after the first six months. In the event Mr. Wyatt s employment had been terminated by Mr. Wyatt for any reason and conditioned on Mr. Wyatt entering into a Compromise Agreement, he would have been entitled to receive his salary for six months after the date of termination, subject to mitigation. Mr. Wyatt s agreement also provides that certain payments will be made in the event of his death, including a pro-rated bonus payment. Additionally, Mr. Wyatt will be subject to non-competition and non-solicitation provisions for six months following the date of termination of his employment and to ongoing confidentiality and non-disparagement obligations. Further, Mr. Wyatt is also entitled to the acceleration of his currently outstanding restricted shares upon a change of control of the Company pursuant to the terms of the restricted share award agreement under which they were granted.

On February 23, 2006, the Company announced that Mr. Wyatt was awarded a contingent bonus that would be payable by Blockbuster only in the event of any sale or other disposition of Blockbuster s international operations or a requisite portion thereof. The amount of the bonus would be equal to one year s salary (approximately $618,360 based on exchange rates at the time the contingent bonus was awarded), and would be awarded regardless of whether Mr. Wyatt is offered employment with any purchaser. To date, this bonus has not been earned.

The following table quantifies the payments to which Mr. Wyatt is entitled upon termination, change-in-control, death and disability. In determining the estimated amount of these payments, the following assumptions were used: (1) the triggering event took place on December 31, 2006, and (2) the price per share of our Class A common stock was $5.29, which was the closing market price on December 29, 2006. Additionally, the amounts presented below were converted from British pounds to U.S. dollars at a conversion rate of 1.95910, which was the daily average conversion rate on December 31, 2006.

Estimated Payments	Voluntary Termination	Termination for Breach	Termination other than for Breach	Change in Control Resulting in Termination	Change in Control Not Resulting in Termination	Death	Incapacity
Salary for Notice Period	$ 169,462		$ 338,924	$ 338,924			$ 92,856(1)
Bonus for Notice Period	$ 101,677		$ 203,354	$ 203,354			
Severance Salary			$ 1,016,773	$ 1,016,773			
Severance Bonus			$ 610,064	$ 610,064			
Acceleration of Restricted Shares				$ 264,500	$ 264,500		
Benefits/Perquisites	$ 26,083(2)		$ 52,166(3)	$ 52,166(3)			
TOTAL	$ 297,222		$ 2,221,281	$ 2,485,781	$ 264,500		$ 92,856

(1) Pursuant to Mr. Wyatt s agreement, in the event he is prevented by illness or accident from working, he must provide a statement of his disability signed by a medical practitioner covering his absence after the seventh day. In that event, the Company is required to pay his salary in full for five days per year and additionally at the discretion of the Board. This figure assumes that Mr. Wyatt is disabled for ten years.

(2) This consists of (i) medical insurance coverage, (ii) life insurance coverage, (iii) income protection, (iv) employer contributions to the Company s U.K. defined contribution plan at a rate of 15% of Mr. Wyatt s salary and (v) costs relating to Mr. Wyatt s auto perquisite, each through the three month notice period.

(3) This consists of (i) medical insurance coverage, (ii) life insurance coverage, (iii) income protection, (iv) $40,122 in employer contributions to the Company s U.K. defined contribution plan at a rate of 15% of Mr. Wyatt s salary and (v) costs relating to Mr. Wyatt s auto perquisite, each through the six month notice period.

Mr. Zine. The Company s employment agreement with Mr. Zine provides for automatic renewal on March 1 of each year for a term of three years unless terminated by the Company for any reason. Mr. Zine s agreement provides that he will be employed at a monthly salary of $37,500, subject to increase pursuant to the

authority of the Compensation Committee to make individual compensation recommendations. Actual annual salary earned by Mr. Zine for fiscal 2006 is set forth above under Summary Compensation Table. Additionally, Mr. Zine s agreement provides that he will be eligible to receive an annual bonus pursuant to Blockbuster s short-term incentive plan or Senior Bonus Plan at a target amount of 50% of his salary (as defined in the Senior Bonus Plan, if applicable). Beginning with the 2002 calendar year, the former Senior Executive Compensation Committee increased the target bonus for Mr. Zine to 60% of his salary. Mr. Zine s bonuses are payable upon satisfaction of performance objectives determined each year in accordance with the applicable plan. In addition, Mr. Zine s agreement provides that he is entitled to a car lease in accordance with the Company s policies, as they may be amended from time to time. On February 21, 2006, the Company and Mr. Zine entered into an amendment to Mr. Zine s employment agreement that provides Mr. Zine with the right to resign from the Company after December 31, 2006. In such event or in the event of any termination of Mr. Zine s employment without cause (as defined in the agreement), Mr. Zine will be entitled to receive a lump sum severance payment of $1,189,800, payable six months after the date of Mr. Zine s termination, such payment conditioned on his execution of a General Release and Waiver of Claims against the Company. Prior to such amendment, in the event of the termination of Mr. Zine s employment without cause during the employment term, he would have been entitled to receive his salary for 36 months after the date of termination, subject to mitigation after the first twelve months. In addition, he would have been entitled to receive bonus compensation and certain benefits for the balance of the employment term, subject to mitigation after the first twelve months. Prior to such amendment, however, in the event of Mr. Zine s resignation, he would not have been entitled to receive severance benefits. Mr. Zine s agreement also provides that certain payments will be made in the event of his death or disability, including a pro-rated bonus payment. Additionally, Mr. Zine will be subject to non-competition provisions for the length of time he receives severance payments pursuant to a termination of his employment without cause, ongoing confidentiality and non-disparagement obligations, and non-solicitation provisions for one year following the termination of his employment with the Company. Further, Mr. Zine is also entitled to the acceleration of his currently outstanding restricted shares upon a change of control of the Company pursuant to the terms of the restricted share award agreement under which they were granted.

The following table quantifies the payments to which Mr. Zine is entitled upon termination, change-in-control, death and disability. In determining the estimated amount of these payments, the following assumptions were used: (1) the triggering event took place on December 31, 2006, and (2) the price per share of our Class A common stock was $5.29, which was the closing market price on December 29, 2006.

Estimated Payments	Voluntary Termination	Termination for Cause	Termination without Cause	Change in Control Resulting in Termination	Change in Control Not Resulting in Termination	Death	Disability
Lump Sum Severance Payment			$ 1,189,800	$ 1,189,800			
Acceleration of Restricted Shares				$ 440,832	$ 440,832		
TOTAL			$ 1,189,800	$ 1,630,632	$ 440,832		

Mr. Stead. Mr. Stead s employment with the Company was terminated without cause, effective February 28, 2006. The Company s employment agreement with Mr. Stead provided for automatic renewal on March 1 of each year for a term of three years unless terminated by the Company for any reason. Mr. Stead s agreement provided that he was to be employed at a monthly salary of $31,250, subject to increase pursuant to the authority of the Compensation Committee to make individual compensation recommendations. Actual annual salary earned by Mr. Stead for fiscal 2006 is set forth above under Summary Compensation Table. Additionally, Mr. Stead s agreement provided that he was eligible to receive an annual bonus pursuant to Blockbuster s short-term incentive plan or Senior Bonus Plan at a target amount of 50% of his salary (as defined in the Senior Bonus Plan, if applicable). Beginning with the 2002 calendar year, the former Senior Executive Compensation Committee increased the target bonus for Mr. Stead to 60% of his salary. Bonuses were payable upon satisfaction of performance objectives determined each year in accordance with the applicable plan. In

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addition, Mr. Stead s agreement provided that he was entitled to a car allowance and car insurance in accordance with the Company s policies, as amended from time to time. On February 28, 2006, the Company and Mr. Stead entered into an amendment to Mr. Stead s employment agreement that provided Mr. Stead with a lump sum severance payment of $1,045,800, payable on a date selected by Mr. Stead, but in no event later than September 1, 2006, such payment conditioned on his execution of a General Release and Waiver of Claims against the Company. This lump sum severance payment is in lieu of the severance payments Mr. Stead was previously entitled to receive under his employment agreement. Pursuant to this amendment, the Company paid Mr. Stead $1,045,800 on September 1, 2006. Mr. Stead was subject to non-competition provisions for the length of time he received severance pursuant to the termination of his employment without cause, non-solicitation provisions for the one year period following his termination, and remains subject to ongoing confidentiality and non-disparagement obligations.

Fiscal 2006 Director Compensation

The following table provides information related to the compensation of our non-employee directors during fiscal 2006.

Name	Fees Earned or Paid in Cash ($)(1)	Stock Awards ($)(2)	Total ($)
Edward Bleier	$ 51,808	$ 49,995	$ 101,803
Robert A. Bowman	$ 67,809	$ 49,995	$ 117,804
Jackie M. Clegg	$ 72,309	$ 49,995	$ 122,304
James W. Crystal(3)			
Gary J. Fernandes	$ 63,309	$ 49,995	$ 113,304
Jules Haimovitz	$ 17,082	$ 30,064	$ 47,146
Carl C. Icahn	$ 47,808	$ 49,995	$ 97,803
Strauss Zelnick	$ 52,808	$ 49,995	$ 102,803

(1) Represents fees earned or paid in cash for services as a director during fiscal 2006, including the cash portion of the annual retainer fee, committee chairmanship fees and meeting fees incurred in connection with service on the Board or any committee of the Board.

(2) Represents both the dollar amount recognized for financial statement reporting purposes with respect to fiscal 2006 in accordance with FAS 123R and the grant date fair value of each equity award computed in accordance with FAS 123R. Any assumptions used in the calculation of these amounts are included in footnote 4 to the Company s audited financial statements for the fiscal year ended December 31, 2006, which are included in the Company s annual report on Form 10-K filed with the SEC on March 1, 2007.

The aggregate number of stock awards outstanding for each of our non-employee directors at December 31, 2006 was as follows: Mr. Bleier held 15,238 shares of Blockbuster Class A common stock; Mr. Bowman held 16,061 shares of Blockbuster Class A common stock; Ms. Clegg held 18,220 shares of Blockbuster Class A common stock; Mr. Crystal did not hold any shares of Blockbuster Class A common stock; Mr. Fernandes held 16,061 shares of Blockbuster Class A common stock; Mr. Haimovitz held 6,160 shares of Blockbuster Class A common stock; Mr. Icahn held 15,238 shares of Blockbuster Class A common stock; and Mr. Zelnick held 15,238 shares of Blockbuster Class A common stock. These shares of Blockbuster Class A common stock are non-transferable for one year after issuance.

(3) Mr. Crystal was not appointed to the Board until February 14, 2007.

Standard Compensation Arrangements for Non-Employee Directors

The Nominating/Corporate Governance Committee has the responsibility for recommending to the Board the form and amount of compensation for non-employee directors. Directors compensation includes cash and

stock-based incentives. Blockbuster does not have a retirement plan for non-employee directors. Employee directors are not paid additional compensation for their services as directors. As of the date of printing this proxy statement, non-employee directors receive the following compensation for their services on the Board. Directors compensation is subject to change from time to time.

Annual Retainer Fee The annual retainer fee is $100,000. Of the $100,000, $50,000 is to be paid in shares of our Class A common stock that is non-transferable for one year after it is paid. The other $50,000 is to be paid in cash. The stock portion of the retainer fee is paid semi-annually as soon as practicable on or after January 1 and July 1 based on the closing price of a share of Blockbuster Class A common stock on the date of issuance. The cash portion of the retainer fee is paid semi-annually on approximately June 30 and December 31. Retainer fees are subject to pro-ration with respect to any director who did not serve in such capacity for a complete semi-annual period.

On May 1, 2006, the Board changed the cash portion of the Board s annual retainer from $50,000 per year to $15,000 per year for the one-year period from May 25, 2006 to May 24, 2007. On May 25, 2007, the amount of the cash portion of the Board s annual retainer will revert back to $50,000.

Retainer Fee for Committee Chairs The annual cash retainer fee for (1) the Chair of the Audit Committee is $10,000, (2) the Chair of the Compensation Committee is $7,500, and (3) the Chair of the Nominating/Corporate Governance Committee is $7,500. Retainer fees for committee chairs are paid semi-annually on approximately June 30 and December 31 and are subject to pro-ration with respect to any director who did not serve in such capacity for a complete semi-annual period.

Meeting Fees Directors are paid $2,000 in cash for each meeting of the Board in which they participate (whether in person or by telephone) and $1,000 in cash for each committee meeting attended if such meeting is held on a different day from the day of a meeting of the Board.

Reimbursement Directors are also reimbursed for their expenses incurred in connection with their service on the Board or any committee of the Board.

Non-employee directors may also receive additional fees from time to time for site visits, for attending business meetings to which a director is invited as a representative of Blockbuster or for serving on any special Board committees. To the extent applicable, any such additional fees will be determined on a case-by-case basis.

Currently, the equity portion of the Board s annual retainer is issued pursuant to the Blockbuster Inc. Compensation Plan for Non-Employee Directors, which was approved by our stockholders on July 20, 2004. This plan provides that the total number of shares of stock that may be distributed under the plan is 200,000. It is currently anticipated that this authorized share limit will be exhausted in connection with the next semi-annual grant to directors in July 2007. As a result, the Board approved certain amendments to the director compensation program, including (1) upon exhaustion of the authorized share limit as discussed above, the equity portion of the Board s annual retainer will consist solely of restricted share units, settleable on a one-for-one basis in shares of Blockbuster Class A common stock, which restricted share units will be issued pursuant to the Blockbuster Inc. Amended and Restated 1999 Long-Term Management Incentive Plan (the 1999 Plan) and/or the Blockbuster Inc. Amended and Restated 2004 Long-Term Management Incentive Plan (together with the 1999 Plan, the Compensation Plans), which plans were approved by our stockholders on July 20, 2004, and (2) also upon exhaustion of the authorized share limit as discussed above, directors will be allowed to make annual elections to defer some or all of each following year s cash compensation (or in the case of new directors, current year cash compensation) into additional restricted share units.

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EQUITY COMPENSATION PLAN INFORMATION

The following table sets forth certain information, as of December 31, 2006, concerning shares of Blockbuster Class A common stock and Blockbuster Class B common stock authorized for issuance under all of our equity compensation plans.

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by stockholders	9,641,378(1)	$ 8.80(2)	24,802,968(3)
Equity compensation plans not approved by stockholders		N/A	
Total	9,641,378	$ 8.80	24,802,968

(1) Includes 6,729,820 shares of Blockbuster Class A common stock issuable upon exercise of outstanding options, 577,300 restricted share units settleable in shares of Blockbuster Class A common stock and 2,334,258 restricted shares of, and restricted share units settleable in shares of, Blockbuster Class A common stock that will be issued on May 5, 2007 as a result of performance-based awards made during 2006. The options and the restricted share units were issued under the Compensation Plans and the restricted shares and restricted share units to be issued on May 5, 2007 will also be issued under the Compensation Plans.

(2) The weighted-average exercise price does not take into account the restricted shares or restricted share units discussed in footnote (1) above because the restricted shares and restricted share units do not have an exercise price upon vesting.

(3) Includes an aggregate of 24,720,831 shares reserved at year-end 2006 for future issuance under the Compensation Plans; 64,637 shares reserved at year-end 2006 for future issuance under the Amended and Restated Compensation Plan for Non-Employee Directors; and 17,500 shares reserved at year-end 2006 for future issuance under the Amended and Restated Chairman s Award Plan. These shares are in addition to shares reserved for future issuance upon the exercise of options and vesting of restricted shares and restricted share units included in column (a) in the table.

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AUDIT COMMITTEE AND INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Audit Committee Report

A primary purpose of the Audit Committee is to assist the Board in fulfilling its oversight responsibilities relating to the quality and integrity of Blockbuster s financial reports and other financial information provided by Blockbuster to its stockholders, the public and others. In addition, the Audit Committee is directly responsible for the appointment and oversight of the work of Blockbuster s independent auditors. The Committee operates under a written charter adopted by the Board, a copy of which can be found on the investor relations section of our public website. Management has the responsibility for the financial statements and the reporting process, including establishing and maintaining adequate internal control over financial reporting. Blockbuster s independent auditors, PricewaterhouseCoopers LLP, are responsible for expressing an opinion on (1) the conformity of Blockbuster s audited financial statements to accounting principles generally accepted in the United States of America; (2) the effectiveness of Blockbuster s internal control over financial reporting; and (3) management s assessment of the effectiveness of Blockbuster s internal control over financial reporting in accordance with the standards adopted by the Public Company Accounting Oversight Board.

In this context, the Audit Committee reviewed and discussed with management and the Company s independent auditors the audited consolidated financial statements to be included in Blockbuster s annual report on Form 10-K for the year ended December 31, 2006. In addition, the Audit Committee has discussed with PricewaterhouseCoopers LLP the matters required to be discussed by Statement on Auditing Standards No. 61 (Communication with Audit Committees), as modified by Statement on Auditing Standards No. 90 (Audit Committee Communications). The Audit Committee has also received the written disclosures and the letter from PricewaterhouseCoopers LLP required by Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees) and has discussed with PricewaterhouseCoopers LLP that firm s independence from Blockbuster and its management.

In reliance on the Audit Committee s review and discussions referred to above, the Audit Committee recommended to the Board of Directors that the audited financial statements be included in Blockbuster s annual report on Form 10-K for the year ended December 31, 2006 for filing with the SEC.

Audit Committee of the Board of Directors

Robert A. Bowman, Chair

Jackie M. Clegg

Strauss Zelnick

Audit and Non-Audit Fees

The table below sets forth the approximate aggregate fees billed by PricewaterhouseCoopers LLP for audit, audit-related, tax and other professional services provided to Blockbuster in each of the last two fiscal years:

	152,355	$ 10.446			
$17.18 - $28.39	152,558	5.79	$18.465	91,647	$18.475
$28.40 - $39.76	161,255	9.43	$37.543	55,654	$34.361
$ 4.40 - $39.76	888,995	6.40	$14.893	633,469	$11.489

As of June 30, 2016, there was approximately $2.0 million in total unrecognized compensation cost related to outstanding stock options. That cost is expected to be recognized over a weighted average period of 1.60 years, with approximately $485 thousand to be recognized in the six months ending December 31, 2016 and all cost to be recognized as of March 2020, assuming all options vest according to the vesting schedules in place at June 30, 2016. As of June 30, 2016, the aggregate intrinsic value of outstanding options was approximately $20.1 million and the aggregate intrinsic value of exercisable options was approximately $16.3 million.

Employee Stock Purchase Plan (the "ESPP")

For the six months ended June 30, 2015 and 2016, we issued 6,043 and 4,497 shares under the ESPP, respectively. For the three and six months ended June 30, 2015 and 2016, we estimated the fair values of stock purchase rights granted under the ESPP using the Black-Scholes pricing model. The weighted average assumptions used for the periods presented were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Risk-free interest rate	0.24%	0.55%	0.24%	0.53%
Expected lives	1.2 years	1.2 years	1.2 years	1.2 years
Expected volatility	36%	43%	35%	42%
Expected dividend yield	0%	0%	0%	0%

For the six months ended June 30, 2015 and 2016, the weighted-average fair value of the purchase rights granted was $5.67 and $6.87 per share, respectively. For the three months ended June 30, 2015 and 2016, the weighted-average fair value of the purchase rights granted was $5.75 and $7.64 per share, respectively.

Restricted Stock Issuance

On March 17, 2015, the Company issued unvested shares to certain Executive Officers related to performance-based restricted stock grants (the "Performance Grants") and performance-based restricted stock grants related to the Company's 2015 Management Incentive Plan (the "2015 MIP Grants"). The Company issued 52,956 shares under the Performance Grants and 24,649 shares under 2015 MIP Grants. The Performance Grants have met the underlying performance condition based on the Company's 2015 financial

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

performance and are to cliff vest on March 17, 2018, subject to other vesting provisions in the underlying restricted stock grant agreement. The 2015 MIP Grants were subject to the Company’s achievement of certain financial goals and other vesting provisions in the underlying restricted stock grant agreement. On March 2, 2016, the Company vested 14,364 shares related to the 2015 MIP Grant based on the respective performance criteria, including 4,788 shares withheld for tax, and canceled the remaining 10,285 shares.
On March 2, 2016, the Company issued 15,000 unvested shares to certain Executive Officers related to performance-based restricted stock grants as part of the Company’s 2016 Management Incentive Plan (the "2016 MIP Grants"). The 2016 MIP Grants are to vest on the date MIP Payouts are to be made under the 2016 Management Incentive Plan and are subject to the Company’s achievement of certain financial goals and other vesting provisions in the underlying restricted stock grant agreement.
On March 26, 2016, 27,500 shares originally issued to Mr. Wilson on March 26, 2014 pursuant to an employment agreement between Mr. Wilson and the Company effective as of March 26, 2014 (the "Wilson Employment Agreement") vested pursuant to the Wilson Employment Agreement.
Restrictions on the transfer of Company stock
The Company's Restated Certificate of Incorporation, as amended (the "Certificate of Incorporation"), places restrictions (the "Transfer Restrictions") on the transfer of the Company's stock that could adversely affect the Company's ability to utilize its domestic Federal Net Operating Loss Position. In particular, the Transfer Restrictions prevent the transfer of shares without the approval of the Company's Board of Directors if, as a consequence of such transfer, an individual, entity or groups of individuals or entities would become a 5-percent holder under Section 382 of the Internal Revenue Code of 1986, as amended, and the related Treasury regulations, and also prevents any existing 5-percent holder from increasing his or her ownership position in the Company without the approval of the Company's Board of Directors. Any transfer of shares in violation of the Transfer Restrictions (a "Transfer Violation") shall be void ab initio under the Certificate of Incorporation, and the Company's Board of Directors has procedures under the Certificate of Incorporation to remedy a Transfer Violation including requiring the shares causing such Transfer Violation to be sold and any profit resulting from such sale to be transferred to a charitable entity chosen by the Company's Board of Directors in specified circumstances.
10. ACCUMULATED OTHER COMPREHENSIVE INCOME
Accumulated other comprehensive income consisted of the following (in thousands):

	Minimum pension liability	Foreign currency translation	Sale of Equity Investment	Total accumulated other comprehensive income
Balances at December 31, 2015	$ (576)	$ 673	$ 90	$ 187
Current period other comprehensive income (loss)	—	42	(90)	(48)
Balances at June 30, 2016	$ (576)	$ 715	$ —	$ 139

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

11. COMMITMENTS AND CONTINGENCIES

The Company holds certain rights to market and manufacture all products developed or created under certain research, development and licensing agreements with various entities. In connection with such agreements, the Company has agreed to pay the entities royalties on net product sales. In each of the three months ended June 30, 2015 and 2016, royalties of $0.1 million became payable under these agreements. In each of the six months ended June 30, 2015 and 2016, royalties of $0.2 million became payable under these agreements.

The Company has contracts with suppliers for unconditional annual minimum inventory purchases and milestone obligations to third parties the Company believes are likely to be triggered currently totaling approximately $0.2 million for each of the fiscal years 2016 and 2017.

From time to time, the Company may be involved in litigation relating to claims arising out of its operations. On March 12, 2015, a complaint was filed against us by Shaun Fauley in the United States District Court Northern District of Illinois alleging our transmittal of unauthorized faxes in violation of the federal Telephone Consumer Protection Act of 1991, as amended by the Junk Fax Prevention Act of 2005, as a class action seeking stated damages of the greater of actual monetary loss or five hundred dollars per violation. We intend to defend ourselves vigorously in this matter. As of June 30, 2016, the Company was not a party to any other legal proceedings that were expected, individually or in the aggregate, to have a material adverse effect on our business, financial condition or operating results.

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

12. INTEREST AND OTHER EXPENSE (INCOME)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Interest income	$(41)	$(30)	$(99)	$(63)
Interest expense	50	38	103	76
Other, net	28	26	170	(112)
Total	$37	$34	$174	$(99)

Cash paid for interest for the three months ended June 30, 2015 and 2016 was $21 thousand and $19 thousand, respectively. Cash paid for interest for the six months ended June 30, 2015 and 2016 was $40 thousand and $37 thousand, respectively.

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

13. CREDIT FACILITY

At June 30, 2016, we had a $15.0 million asset-based revolving line of credit with Wells Fargo which has a maturity date of December 31, 2017 as part of our credit and security agreement with Wells Fargo. At June 30, 2016, we had no borrowings outstanding on this line of credit. Our ability to borrow under this line of credit varies based upon available cash, eligible accounts receivable and eligible inventory. Any interest on borrowings due is to be charged at a stated rate of three month LIBOR plus 2.25% and payable monthly. There is an annual minimum interest charge of $75 thousand under the agreement. We are required to comply with various financial and non-financial covenants, and we have made various representations and warranties under our agreement with Wells Fargo. A key financial covenant is based on a fixed charge coverage ratio, as defined in our agreement with Wells Fargo. We were in compliance with all financial covenants as of June 30, 2016 and our available borrowing capacity based upon eligible accounts receivable and eligible inventory under our revolving line of credit was approximately $12.0 million.

14. SEGMENT REPORTING

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

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

Three Months Ended June 30, 2015	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 20,757	$ 3,153	$23,910
Operating Income	1,536	293	1,829
Income before income taxes	1,511	281	1,792
Capital expenditures	142	189	331
Depreciation and amortization	894	174	1,068

Three Months Ended June 30, 2016	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 24,464	$ 5,501	$29,965
Operating Income	2,746	810	3,556
Income before income taxes	2,724	798	3,522
Capital expenditures	82	381	463
Depreciation and amortization	915	200	1,115

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

Six Months Ended June 30, 2015	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 40,329	$ 6,475	$46,804
Operating Income	2,071	779	2,850
Income before income taxes	1,921	755	2,676
Capital expenditures	449	487	936
Depreciation and amortization	1,724	350	2,074

Six Months Ended June 30, 2016	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total revenue	$ 47,898	$ 9,213	$57,111
Operating Income	4,504	1,022	5,526
Income before income taxes	4,532	1,093	5,625
Capital expenditures	479	889	1,368
Depreciation and amortization	1,812	399	2,211

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
United States	$22,926	$28,908	$44,339	$54,729
Europe	515	567	1,046	1,120
Other International	469	490	1,419	1,262
Total	$23,910	$29,965	$46,804	$57,111

Asset information by reportable segment as of December 31, 2015 is as follows (in thousands):

	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total assets	$ 92,567	$ 17,152	$109,719
Net assets	48,175	15,353	63,528

Asset information by reportable segment as of June 30, 2016 is as follows (in thousands):

	Core Companion Animal Health	Other Vaccines, Pharmaceuticals and Products	Total
Total assets	$ 95,829	$ 23,796	$119,625
Net assets	59,303	16,355	75,658

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

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

	December 31, 2015	June 30, 2016
United States	$ 106,780	$ 116,552
Europe	2,939	3,073
Total	$ 109,719	$ 119,625

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

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

This discussion contains forward-looking statements that involve risks and uncertainties. Such statements, which include statements concerning future revenue sources and concentration, gross profit margins, selling and marketing expenses, research and development expenses, general and administrative expenses, capital resources, additional financings or borrowings and additional losses, are subject to risks and uncertainties, including, but not limited to, those discussed below and elsewhere in this Form 10-Q, particularly in Part II, Item 1A "Risk Factors," that could cause actual results to differ materially from those projected. The forward-looking statements set forth in this Form 10-Q are as of the close of business on August 5, 2016 and we undertake no duty and do not intend to update this information, except as required by applicable laws.

Overview

We sell advanced veterinary diagnostic and specialty products. Heska's state-of-the-art offerings include blood testing instruments and supplies, digital imaging products, software and services, and single use products and data services, allergy testing and immunotherapy, and single-use offerings such as in-clinic diagnostic tests and heartworm preventive products. The Company's core focus is on the canine and feline markets.

Our business consists of two reportable segments, Core Companion Animal Health ("CCA"), which represented 80% of our revenue for the twelve months ended June 30, 2016 (which we define as "LTM") and Other Vaccines, Pharmaceuticals and Products ("OVP"), which represented 20% of LTM revenue.

The CCA segment includes, primarily for canine and feline use, blood testing instruments and supplies, digital imaging products, software and services, and single use products and services such as heartworm diagnostic tests, heartworm preventive products, allergy immunotherapy products and allergy testing.

Blood testing and other non-imaging instruments and supplies represented approximately 37% of our LTM revenue. Many products in this area involve placing an instrument in the field and generating future revenue from consumables, including items such as supplies and service, as that instrument is used. Approximately 29% of our LTM revenue resulted from the sale of such consumables to an installed base of instruments and approximately 8% of our LTM revenue was from hardware revenue. A loss of, or disruption in, the supply of consumables we are selling to an installed base of instruments could substantially harm our business. All of our blood testing and other non-imaging instruments and supplies are supplied by third parties, who typically own the product rights and supply the product to us under marketing and/or distribution agreements. In many cases, we have collaborated with a third party to adapt a human instrument for

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veterinary use. Major products in this area include our chemistry instruments, our hematology instruments, our blood gas instruments, our immunodiagnostic instruments and their affiliated operating consumables. Revenue from products in these three areas, including revenues from consumables, represented approximately 33% of our LTM revenue.

Imaging hardware, software and services represented approximately 19% of LTM revenue. Digital radiography is the largest product offering in this area, which also includes ultrasound instruments. Digital radiography solutions typically consist of a combination of hardware and software placed with a customer, often combined with an ongoing service and support contract. With our acquisition of Cuattro Veterinary, LLC, subsequently renamed Heska Imaging International, LLC, we now sell our imaging solutions both in the United States and internationally. Our experience has been that most of the revenue is generated at the time of sale in this area, in contrast to the blood testing category discussed above where ongoing consumable revenue is often a larger component of economic value as a given blood testing instrument is used.

Other CCA revenue, including single use diagnostic and other tests, pharmaceuticals and biologicals as well as research and development, licensing and royalty revenue, represented approximately 24% of our LTM revenue. Since items in this area are often single use by their nature, our typical aim is to build customer satisfaction and loyalty for each product, generate repeat annual sales from existing customers and expand our customer base in the future. Products in this area are both supplied by third parties and provided by us. Major products and services in this area include our heartworm diagnostic tests, our heartworm preventives, our allergy test kits, our allergy immunotherapy and our allergy testing. Combined revenue from heartworm-related products and allergy-related products represented 23% of our LTM revenue.

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

All of our CCA products are ultimately sold primarily to or through veterinarians. In many cases, veterinarians will mark up their costs to their customer. The acceptance of our products by veterinarians is critical to our success. CCA products are sold directly to end users by us as well as through distribution relationships, such as our corporate agreement with Merck Animal Health, the sale of kits to conduct blood testing to third-party veterinary diagnostic laboratories and independent third-party distributors. Revenue from direct sales and distribution relationships represented approximately 63% and 37%, respectively, of CCA LTM revenue.

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

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

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

Results of Operations

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Revenue	$23,910	$29,965	$46,804	$57,111
Gross Profit	10,297	12,682	20,381	24,124
Operating expenses	8,468	9,126	17,531	18,598
Operating income	1,829	3,556	2,850	5,526
Interest and other expense (income), net	37	34	174	(99)
Income before income taxes	1,792	3,522	2,676	5,625
Provision for income taxes	614	780	915	1,436
Net income	1,178	2,742	1,761	4,189
Net income (loss) attributable to non-controlling interest	(19)	220	(34)	482
Net income attributable to Heska Corporation	$1,197	$2,522	$1,795	$3,707

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2016	2015	2016
Revenue	100.0 %	100.0%	100.0 %	100.0 %
Gross Profit	43.1 %	42.3 %	43.5 %	42.2 %
Operating expenses	35.4 %	30.5 %	37.5 %	32.6 %
Operating income	7.6 %	11.9 %	6.1 %	9.7 %
Interest and other expense (income), net	0.2 %	0.1 %	0.4 %	(0.2)%
Income before income taxes	7.5 %	11.8 %	5.7 %	9.8 %
Provision for income taxes	2.6 %	2.6 %	2.0 %	2.5 %
Net income	4.9 %	9.2 %	3.8 %	7.3 %
Net income (loss) attributable to non-controlling interest	(0.1)%	0.7 %	(0.1)%	0.8 %
Net income attributable to Heska Corporation	5.0 %	8.4 %	3.8 %	6.5 %

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Revenue

Total revenue increased 22% to $57.1 million in the six months ended June 30, 2016 compared to $46.8 million in the six months ended June 30, 2015 and increased 25% to $30.0 million in the three months ended June 30, 2016 compared to $23.9 million in the three months ended June 30, 2015.

CCA segment revenue increased 19% to $47.9 million in the six months ended June 30, 2016 compared to $40.3 million in the six months ended June 30, 2015. Greater revenue from our digital radiography products, our instrument consumables, our heartworm preventive and our hematology instruments were key factors in the increase. CCA segment revenue increased 18% to $24.5 million in the three months ended June 30, 2016 compared to $20.8 million in the three months ended June 30, 2015. Greater revenue from our heartworm preventative products, our digital radiography products and our instrument consumables were key factors in the improvement.

OVP segment revenue increased 42% to $9.2 million in the six months ended June 30, 2016 compared to $6.5 million in the six months ended June 30, 2015 and increased 74% to $5.5 million in the three months ended June 30, 2016 compared to $3.2 million in the three months ended June 30, 2015. Revenue from sales under our agreement with Elanco was a key factor in both cases.

Gross Profit

Gross profit increased 18% to $24.1 million in the six months ended June 30, 2016 compared to $20.4 million in the six months ended June 30, 2015. Gross Margin, which is gross profit divided by total revenue, decreased to 42.2% in the six months ended June 30, 2016 compared to 43.5% in the six months ended June 30, 2015. Gross profit increased 23% to 12.7 million in the three months ended June 30, 2016 compared to $10.3 million in the three months ended June 30, 2015. Gross Margin decreased to 42.3% in the three months ended June 30, 2016 compared to 43.1% in the three months ended June 30, 2015. Product mix in our OVP segment, as well as lower gross margin on our chemistry consumables, somewhat offset by higher gross margin on our imaging products, were factors in the decline in both cases.

Operating Expenses

Selling and marketing expenses increased 3% to $11.0 million in the six months ended June 30, 2016 compared to $10.7 million in the six months ended June 30, 2015 and increased 3% to $5.4 million in the three months ended June 30, 2016 compared to $5.2 million in the three months ended June 30, 2015. Increased commissions due to higher revenue from our imaging products was a factor in the change in both cases.

Research and development expenses increased 35% to $1.1 million in the six months ended June 30, 2016, compared to $0.8 million in the six months ended June 30, 2015. Increased development project spending related to imaging products and single use diagnostic products were factors in the change. Research and development expenses increased 33% to $0.5 million in the three months ended June 30, 2016, compared to $0.4 million in the three months ended June 30, 2015. Increased development project spending related to single use diagnostic products was a factor in the change.

General and administrative expenses increased 8% to $6.5 million in the six months ended June 30, 2016, compared to $6.0 million in the six months ended June 30, 2015 and increased 13% to $3.2 million in the three months ended June 30, 2016, compared to $2.8 million in the three months ended June 30, 2015. Expense related to the May 2016 acquisition of Cuattro International was a factor in the change in both cases.

Interest and Other Expense (Income), Net

Interest and other expense (income), net, was income of $99 thousand in the six months ended June 30, 2016, as compared to an expense of $174 thousand in the six months ended June 30, 2015. Interest and other expense (income), net, was an expense of $34 thousand in the three months ended June 30, 2016, as compared to an expense of $37 thousand in the three months ended June 30, 2015. This line item can be broken into the following components: net interest income or expense, net foreign currency gains and losses and other income. Net interest was an expense of $13 thousand in the six months ended June 30, 2016, as compared to an expense of $4 thousand in the six months ended June 30, 2015. Net interest was an expense of $8 thousand in the three months ended June 30, 2016, as compared to an expense of $9 thousand in the three months ended June 30, 2015. Net foreign currency gain was $20 thousand in the six months ended June 30, 2016, as compared to a net foreign currency loss of $170 thousand in the six months ended June 30, 2015. A key factor in the difference was the impact of exchange rates between the Euro and the Swiss Franc, which is the functional currency of our Swiss subsidiary. Net foreign currency loss was $26 thousand in the three months ended June 30, 2016, as compared to a net foreign currency loss of $28 thousand in the three months ended June 30, 2015. Other income was $92 thousand in the six months ended June 30, 2016 primarily related to the sale of an equity investment during the first quarter of 2016.

Income Tax Expense

In the six months ended June 30, 2016, we had total income tax expense of $1.4 million, including $1.3 million in domestic deferred income tax expense, a non-cash item primarily related to our domestic NOL position, and $0.2 million in current income tax expense. In the six months ended June 30, 2015, we had total income tax expense of $0.9 million, including $0.8 million in domestic deferred income tax expense, a non-cash item primarily related to our domestic NOL position, and $0.1 million in current income tax expense. In the three months ended June 30, 2016, we had total income tax expense of $0.8 million, including $0.7 million in domestic deferred income tax expense, a non-cash item primarily related to our domestic NOL position, and $0.1 million in current income tax expense. In the three months ended June 30, 2015, we had total income tax expense of $0.6 million, including $0.5 million in domestic deferred income tax expense, a non-cash item primarily related to our domestic NOL position, and $0.1 million in current income tax expense. Greater income before income taxes was a key factor in our higher income tax expense in the six and three month periods ended June 30, 2016 as compared to the corresponding periods in 2015. The impact of greater income before income taxes was somewhat offset by additional tax benefits of $0.5 million in the six and three months ended June 30, 2016 related to employee share-based payment awards which are now recorded as income tax benefit or expense in earnings effective with the adoption of an accounting standard update during the quarter ended June 30, 2016.

Net Income

Net income was $4.2 million for the six months ended June 30, 2016, as compared to net income of $1.8 million in the prior year period. Net income was $2.7 million for the three months ended June 30, 2016, as compared to net income of $1.2 million in the prior year period. Increased revenue, somewhat offset by lower Gross Margin and higher operating expenses, was a factor in the improvement in both cases.

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Net Income attributable to Heska Corporation

Net income attributable to Heska Corporation was $3.7 million for the six months ended June 30, 2016, as compared to a net income attributable to Heska Corporation of $1.8 million in the prior year period. Net income attributable to Heska Corporation was $2.5 million for the three months ended June 30, 2016, as compared to a net income attributable to Heska Corporation of $1.2 million in the prior year period. The difference between this line item and "Net Income" is the net income or loss attributable to our minority interest in US Imaging, which was net income of $482 thousand in the six months ended June 30, 2016 as compared to a loss of $34 thousand in the six months ended June 30, 2015 and net income of $220 thousand in the three months ended June 30, 2016 as compared to a loss of $19 thousand in the three months ended June 30, 2015.

Impact of Inflation

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

Liquidity, Capital Resources and Financial Condition

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

For the six months ended June 30, 2016, we had net income of $4.2 million and net cash provided by operations of $0.3 million. At June 30, 2016, we had $6.7 million of cash and cash equivalents and working capital of $27.1 million. At June 30, 2016, we had a $15.0 million asset-based revolving line of credit with Wells Fargo which has a maturity date of December 31, 2017 as part of our credit and security agreement with Wells Fargo. At June 30, 2016, we had no borrowings outstanding on this line of credit. Our ability to borrow under this line of credit varies based upon available cash, eligible accounts receivable and eligible inventory. Any interest on borrowings due is to be charged at a stated rate of three month LIBOR plus 2.25% and payable monthly. We are required to comply with various financial and non-financial covenants, and we have made various representations and warranties under our agreement with Wells Fargo. A key financial covenant is based on a fixed charge coverage ratio, as defined in our agreement with Wells Fargo. Failure to comply with any of the covenants, representations or warranties could result in our being in default on the loan and could cause all outstanding amounts payable to Wells Fargo to become immediately due and payable or impact our ability to borrow under the agreement. We were in compliance with all financial covenants as of June 30, 2016 and our available borrowing capacity based upon eligible accounts receivable and eligible inventory under our revolving line of credit was approximately $12.0 million.

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

	Six Months Ended June 30,	
	2015	2016
Net cash provided by (used in) operating activities	$(282)	$278
Net cash used in investing activities	(936)	(848)
Net cash provided by financing activities	1,936	327
Effect of currency translation on cash	74	22
Increase (decrease) in cash and cash equivalents	792	(221)
Cash and cash equivalents, beginning of the period	5,855	6,890
Cash and cash equivalents, end of the period	$6,647	$6,669

Net cash provided by operating activities was $0.3 million in the six months ended June 30, 2016, as compared to net cash used by operating activities of $0.3 million in the six months ended June 30, 2015, a favorable increase of approximately $0.6 million. Key factors in the change were a $3.0 million decrease in cash used for inventory, a $2.9 million increase in net income and deferred tax expense, and a $1.7 million increase in cash provided by accounts receivable and other current assets, partially offset by a $4.2 million increase in cash used for accounts payable, accrued liabilities and other short term liabilities and a $3.1 million increase in cash used in deferred revenue and other non-current assets.

Net cash used in investing activities was $0.8 million in the six months ended June 30, 2016 as compared to net cash used in investing activities of $0.9 million in the six months ended June 30, 2015, a favorable decrease of approximately $0.1 million. Proceeds from the disposition of property and equipment and the sale of an equity investment were factors in the change.

Net cash flows from financing activities provided cash of $0.3 million in the six months ended June 30, 2016, as compared to $1.9 million in the six months ended June 30, 2015, which represented a $1.6 million decrease in cash provided by financing activities. The largest factor in the change was net repayments of $1.5 million towards the balance of our revolving line of credit.

At June 30, 2016, Heska Corporation had accounts receivable from US Imaging of $5.0 million, including accrued interest, which eliminates upon consolidation of our financial statements. These monies accrue at the same interest rate as Heska Corporation pays under its asset-based revolving line of credit with Wells Fargo once past due.

At June 30, 2016, we, including the balance sheets of our consolidating subsidiaries, had net prepaid receivables from Cuattro, LLC of $2.0 million. All monies owed accrue interest at the same interest rate Heska Corporation pays under its credit and security agreement with Wells Fargo once past due. These items are listed on our consolidated balance sheets as "Due from – related parties" as Kevin S. Wilson, our Chief Executive Officer and President, Mrs. Wilson and trusts for their children and family hold a 100% interest in Cuattro, LLC.

At June 30, 2016, US Imaging had a $1.5 million note receivable, including accrued interest, from International Imaging, which is due on June 15, 2019 and which eliminated in consolidation of the Company's financial statements. This note was previously listed as "Note receivable – related party" on the Company's consolidated balance sheets. The note receivable was assumed as part of the Company's acquisition of Cuattro International.

At June 30, 2016, we had $487 thousand of borrowings on our consolidated balance sheet related to the borrowings of International Imaging. This debt bears an interest rate of 5.75% per annum and is due in equal monthly payments, including principal and interest, through June 27, 2018. At June 30, 2016, we had other borrowings outstanding totaling $154 thousand, all of which were obligations of a US Imaging loan from De Lage Landen Financial Services, Inc. ("DLL"). The note bears an interest rate of 6% per annum and is due in equal monthly payments, including principal and interest, of $13 thousand through June 2017. The note may be prepaid prior to maturity, but is subject to a surcharge in such a circumstance. Principal associated with these borrowings of approximately $412 thousand is listed as "Other short term borrowings" on our consolidated balance sheets as it is due within a year.

At June 30, 2016, our consolidated balance sheets included $15.9 million in non-controlling interest. This represents the value of the aggregate position in US Imaging of the Imaging Minority. At the time of the Acquisition, we estimated a weighted average valuation for this position and began accreting to this value over a three year period from the date of the Acquisition using a weighted average cost of capital of 18.65%. The cost of capital assumption was provided to us by a third party with expertise in estimating such items. We evaluate the value of this position every reporting period and in 2014 decided to adjust our accretion to a weighted average accretion based on various potential outcomes and our estimate of the likelihood of such outcomes, which had the effect of lowering the accretion from what it otherwise would have been. The accretion is to be recorded as a credit where this line item has increased compared to the prior reporting period, with the corresponding debit to directly reduce additional paid-in-capital as we have an accumulated deficit. If the value of non-controlling interest were to decrease compared to the prior reporting period, we anticipate non-controlling interest would be adjusted with a debit to non-controlling interest and a corresponding credit to additional paid-in-capital.

Our financial plan for 2016 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 2016 and into 2017. However, our actual results may differ from this plan, and we may be required to consider alternative strategies. We may be required to raise additional capital in the future. If necessary, we expect to raise these additional funds through the issuance of new term debt secured by the same assets as the term loans which were fully repaid in 2010, the sale of equity securities or the increased sale of customer leases. There is no guarantee that additional capital will be available from these sources on acceptable terms, if at all, and certain of these sources may require approval by existing lenders. See "Risk Factors" in Item 1A of this Form 10-Q for a discussion of some of the factors that affect our capital raising alternatives.

Under the Operating Agreement, should US Imaging meet certain performance criteria, the Imaging Minority, which has been granted put options, may sell us some or all of the Imaging Minority's remaining 45.4% position in US Imaging following the audit of our 2016 and 2017 financial statements. US Imaging generated $10.8 million in revenue, $4.6 million in gross profit and $1.1 million in operating income in the six months ended June 30, 2016 and $8.6 million in revenue, $3.2 million in gross profit and $17 thousand in operating income in the six months ended June 30, 2015. If US Imaging generates at least $20 million in revenue in either 2016 or 2017 and the Imaging Minority exercises its put right in full, we would be required to purchase the Imaging Minority's position for consideration valued at 9 times US Imaging's operating income, subject to a maximum valuation of $13.6 million – as well as 25% of US Imaging's cash. If US Imaging generates at least $30 million in revenue and $3.0 million in operating income in either 2016 or 2017 and the Imaging Minority exercises its put right in full, we would be required to purchase the Imaging Minority's position for consideration valued at $17.0 million – as well as 25% of US Imaging's cash. Furthermore, should US Imaging meet certain performance criteria, and the Imaging Minority fail to exercise an applicable put to sell us all of the Imaging Minority's position in US Imaging following the audit of our 2016 or 2017 financial statements, we would have a call option to purchase all, but not less than all, of the Imaging Minority's position in US Imaging. If US Imaging generates at least $30 million in revenue and $3.0

million in operating income in either 2016 or 2017 and the Imaging Minority does not exercise its put rights at all, we would have the option to purchase the Imaging Minority's position for consideration valued at $19.6 million – as well as 25% of US Imaging's cash. We believe it is likely that we will have the contractual right to deliver up to 55% of the consideration for these puts and calls in shares of our Public Common Stock. While we intend to meet any related cash payment obligations with funds provided by our ongoing operations and assets, likely supplemented by debt financing and potentially with equity financing, there can be no assurance our results will unfold according to our expectations. These potential cash payment obligations are an important consideration for us in our cash management decisions.

We believe it is likely that US Imaging will meet the required performance criteria for the 2016 lowest strike put, but not the 2016 highest strike put, following the audit of our 2016 financial statements and that we will be able to deliver 55% of the consideration required by the put in our Public Common Stock. In this case, the Imaging Minority would be granted a put following our 2016 audit which could require us to deliver up to $13.6 million as well as 25% of US Imaging's cash, to purchase the 45.4% of US Imaging we do not own. In such a case, while we have the right to deliver up to 55% of the consideration in our Public Common Stock under certain conditions, such stock is to be valued based on 90% of market value (the "Delivery Stock Value") and is limited to approximately 650 thousand shares in any case. If the Delivery Stock Value per share is less than the market value per share of our Public Common Stock at the time of the Acquisition, we will not have the right to deliver any Public Common Stock as consideration. Assuming we deliver the full 55% of the consideration in our Public Common Stock, we could still have an obligation to pay as much as approximately $6.1 million in cash as well as 25% of US Imaging's cash to the Imaging Minority in this circumstance. We believe it is also possible that US Imaging will meet the required performance criteria for the 2016 highest strike put, in which case our cash obligation would be increased as compared to the 2016 lowest strike put as outlined above.

We would consider acquisitions if we felt they were consistent with our strategic direction. We paid $1.6 million in dividends in 2012, and while we may consider paying dividends again in the long term, we do not anticipate the payment of any further dividends for the foreseeable future. We conducted an odd lot tender offer in 2012 which could have led to the repurchase of approximately $400 thousand of our stock if all eligible holders had chosen to participate, and while we may consider stock repurchase alternatives in an opportunistic manner or in the long term, we do not anticipate any stock repurchase programs in the foreseeable future.

Effect of currency translation on cash

Net effect of foreign currency translations on cash changed $52 thousand to a $22 thousand positive impact in the six months ended June 30, 2016 as compared to a $74 thousand positive impact in the six months ended June 30, 2015. These effects are related to changes in exchange rates between the United States dollar and the Swiss Franc, which is the functional currency of our Swiss subsidiary.

Off Balance Sheet Arrangements

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

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with U.S. GAAP requires us to make judgments, assumptions and estimates that affect the amounts reported in the unaudited Condensed Consolidated Financial Statements and accompanying notes. Note 1 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2015 describes the significant accounting policies and methods used in the preparation of these unaudited Condensed

Consolidated Financial Statements. Our critical accounting estimates, discussed in the Management's Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2015, include estimates for revenue recognition, allowances for doubtful accounts, accounting for income taxes, the value of our non-controlling interest and assessing excess and obsolete inventories. Such accounting policies and estimates require significant judgments and assumptions to be used in the preparation of the unaudited Condensed Consolidated Financial Statements and actual results could differ materially from the amounts reported based on variability in factors affecting these estimates.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

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

Interest Rate Risk

At June 30, 2016, there were no outstanding borrowings on our line of credit with Wells Fargo. We had approximately $6.7 million of cash and cash equivalents at June 30, 2016, the majority of which was invested in liquid interest bearing accounts. We had no interest rate hedge transactions in place on June 30, 2016. We completed an interest rate risk sensitivity analysis based on the above and an assumed one-percentage point decrease in interest rates would have an approximate $67 thousand negative impact on our pre-tax earnings based on our outstanding balances as of June 30, 2016.

Foreign Currency Risk

Our investment in foreign assets consists primarily of our investment in our Swiss subsidiary. Foreign currency risk may impact our results of operations. In cases where we purchase inventory in one currency and sell corresponding products in another, our gross margin percentage is typically at risk based on foreign currency exchange rates. In addition, in cases where we may be generating operating income in foreign currencies, the magnitude of such operating income when translated into U.S. dollars will be at risk based on foreign currency exchange rates. Our agreements with suppliers and customers vary significantly in regard to the existence and extent of currency adjustment and other currency risk sharing provisions. We had no foreign currency hedge transactions in place on June 30, 2016.

We have a wholly-owned subsidiary in Switzerland which uses the Swiss Franc as its functional currency. We purchase inventory in foreign currencies, primarily Euros, and sell corresponding products in U.S. dollars. We also sell products in foreign currencies, primarily Euros and Japanese Yen, where our inventory costs are largely in U.S. dollars. Based on our results of operations for the twelve months ending June 30, 2016, currency holdings and currency-related prepaid accounts, accounts receivable and accounts payable (all of which, including currency holdings, we will refer to as "Currency Accounts") as of June 30, 2016 and the functional currency of the accounting entity where such Currency Accounts are held, the expected impact on our consolidated statements of operations, if foreign currency exchange rates were to strengthen/weaken by 25% against the Dollar, would be a resulting gain/loss in operating income of approximately $114 thousand and a currency loss/gain of $258 thousand, if all other currencies were to strengthen/weaken by 25% against the Swiss Franc, would be a resulting loss/gain in operating income of approximately $192 thousand and a currency gain/loss of $420 thousand, and if all other currencies were to strengthen/weaken by 25% against the Euro, would be a resulting loss/gain in operating income of approximately $280 thousand and a currency loss/gain of $671 thousand.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and our chief financial officer, evaluated the effectiveness of our disclosure controls and procedures, as defined by Rule 13a-15 of the Exchange Act, as of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time period 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 disclosure.

Changes in Internal Control over Financial Reporting

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

PART II. OTHER INFORMATION

Item 1 Legal Proceedings.

From time to time, we may be involved in litigation related to claims arising out of our operations. On March 12, 2015, a complaint was filed against us by Shaun Fauley in the United States District Court Northern District of Illinois alleging our transmittal of unauthorized faxes in violation of the federal Telephone Consumer Protection Act of 1991, as amended by the Junk Fax Prevention Act of 2005, as a class action seeking stated damage of the greater of actually monetary loss or five hundred dollars per violation. We intend to defend the Company vigorously in this matter. As of June 30, 2016, we were not a party to any other legal proceedings that are expected, individually or in the aggregate, to have a material adverse effect on our business, financial condition or operating results. Information regarding reportable legal proceedings is contained in Note 11, Commitments and Contingencies, of the unaudited condensed consolidated financial statements in this Quarterly Report on Form 10-Q.

Item 1A. Risk Factors

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

Our February 2013 acquisition of a 54.6% majority interest in Cuattro Veterinary USA, LLC, which has been renamed Heska Imaging US, LLC, could be detrimental to the interests of our shareholders due to related puts, calls or other provisions, or for other reasons including related to conflicts of interest, as could our May 2016 acquisition of Cuattro Veterinary, LLC, which has been renamed Heska Imaging International, LLC, or other acquisitions.

Under the Amended and Restated Operating Agreement of Heska Imaging (the "Operating Agreement"), should Heska Imaging ("US Imaging") meet certain performance criteria, the Imaging Minority

has been granted a put option to sell us some or all of the Imaging Minority's position in US Imaging following the audit of our financial statements for 2016 and 2017. Based on US Imaging's current ownership position, this put option could require us to deliver up to $17.0 million following calendar year 2016 or calendar year 2017 - as well as 25% of US Imaging's cash (any applicable payment in aggregate to be defined as the "Put Payment") to acquire the outstanding minority interest in US Imaging. While we have the right to deliver up to 55% of the consideration in our Public Common Stock under certain circumstances, such stock is to be valued based on 90% of market value (the "Delivery Stock Value") and is limited to approximately 650 thousand shares in any case. If the Delivery Stock Value per share is less than the market value per share of our Public Common Stock at the time of the Acquisition, we do not have the right to deliver any Public Common Stock as consideration. Cash required under any Put Payment could put a significant strain on our financial position or require us to raise additional capital. There is no guarantee that additional capital will be available in such a circumstance on reasonable terms, if at all. We may be unable to obtain debt financing, the public markets may be unreceptive to equity financing and we may not be able to obtain financing from other alternative sources, such as private equity. Any debt financing, if available, may include restrictive covenants and high interest rates and any equity financing would likely be dilutive to stockholders in this scenario. 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.

Under the Operating Agreement, should US Imaging meet certain performance criteria, and the Imaging Minority fail to exercise an applicable put to sell us all of the Imaging Minority's position in US Imaging following the audit of our financial statements for 2016 and 2017, we would have a call option to purchase all, but not less than all, of the Imaging Minority's position in US Imaging. Based on US Imaging's current ownership position, exercising this call option could require us to deliver up to $19.6 million following calendar year 2016 or calendar year 2017 - as well as 25% of US Imaging's cash (any applicable payment in aggregate to be defined as the "Call Payment") to acquire the outstanding minority interest in US Imaging. While we have the right to deliver up to 55% of the consideration in our Public Common Stock under certain circumstances, such stock is to be valued based on 90% of market value (the "Delivery Stock Value") and is limited to approximately 650 thousand shares in any case. If the Delivery Stock Value per share is less than the market value per share of our Public Common Stock at the time of the Acquisition, we do not have the right to deliver any Public Common Stock as consideration. If we believe it is desirable to exercise any one of these calls, cash required under the Call Payment could put a significant strain on our financial position or require us to raise additional capital. There is no guarantee that additional capital will be available in such a circumstance on reasonable terms, if at all. If we believe it is desirable to exercise any such call, determine we are unable to economically finance the Call Payment and do not exercise the call as a result, we could be subject to a more expensive Put Payment less than a year in the future. In this circumstance, unless there is a significant change in our financial position or market conditions, such a Put Payment could have a material adverse effect on our business, financial condition and our ability to continue as a going concern.

Under and as defined in and subject to the terms of the Operating Agreement, should we undergo a change in control, the Imaging Minority will be entitled to sell their US Imaging units to us for cash of up to $13.6 million based on US Imaging's prior year Operating Income (the "Change in Control Payment"). The Change in Control Payment may decrease the interest of third parties in acquiring the Company or a majority of the Company's shares, which could otherwise have occurred at a premium to the Company's then current market price for the benefit of some or all of our shareholders. This could make some investors less likely to buy and hold our stock.

Under the terms of the Operating Agreement, US Imaging is to be managed by a three-person board of managers, two of which are to be appointed by Heska Corporation and one of which is to be appointed by Kevin S. Wilson, a founder of Heska Imaging who has also been Heska Corporation's Chief Executive Officer and President since March 31, 2014. The current board of managers consists of Mr. Wilson, Jason A.

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Napolitano, Heska Corporation's Chief Operating Officer, Chief Financial Officer, Executive Vice President and Secretary and Nancy Wisnewski, Ph.D., Heska Corporation's Executive Vice President, Product Development and Customer Support. Until the earlier of (1) our acquiring 100% of the units of US Imaging pursuant to the puts and/or calls discussed above or (2) the sixth anniversary of the Acquisition, US Imaging may only take the following actions, among others, by unanimous consent of the board of managers: (i) issue securities, (ii) incur, guarantee, prepay, refinance, renew, modify or extend debt, (iii) enter into material contracts, (iv) hire or terminate an officer or amend the terms of their employment, (v) make a distribution other than a tax or liquidation distribution, (vi) enter into a material acquisition or disposition arrangement or a merger, (vii) lease or acquire an interest in real property, (viii) convert or reorganize US Imaging, or (ix) amend its certificate of formation or the Heska Imaging Agreement. This unanimous consent provision may hinder our ability to optimize the value of our investment in US Imaging in certain circumstances.

While the terms of both the Amended and Restated Master License Agreement and the Supply Agreement between US Imaging and Cuattro, LLC were negotiated at arm's length as part of the Acquisition, Mr. Wilson has an interest in these agreements and any time and resources devoted to monitoring and overseeing this relationship may prevent us from deploying such time and resources on more productive matters.

Mr. Wilson's employment agreement with us acknowledges that Mr. Wilson has business interests in Cuattro, LLC, Cuattro Software, LLC and Cuattro Medical, LLC which may require a portion of his time, resources and attention in his working hours. If Mr. Wilson is distracted by these or other business interests, he may not contribute as much as he otherwise would have to enhancing our business, to the detriment of our shareholder value. Mr. Wilson is the spouse of Shawna M. Wilson ("Mrs. Wilson"). Mr. Wilson, Mrs. Wilson and trusts for their children and family own a majority interest in Cuattro Medical, LLC. In addition, including shares held by Mrs. Wilson and by trusts for the benefit of Mr. and Mrs. Wilson's children and family, Mr. Wilson also owns a 100% interest in Cuattro, LLC, the largest supplier to US Imaging. Cuattro, LLC owns a 100% interest in Cuattro Software, LLC.

Cuattro, LLC has charged US Imaging $3.6 million from January 1, 2016 through May 31, 2016 and has charged Global Imaging $0.9 million from June 1, 2016 through June 30, 2016, primarily related to digital imaging products, for which there is an underlying supply contract with minimum purchase obligations, software and services as well as other operating expenses; Heska Corporation has charged US Imaging $2.4 million during the six months ended June 30, 2016, primarily related to sales and other administrative expenses; and Heska Corporation has charged Cuattro, LLC $130 thousand during the six months ended June 30, 2016, primarily related to facility usage and other services.

At May 31, 2016, US Imaging had a $1.5 million note receivable, including accrued interest, from Cuattro Veterinary, LLC, which was due on June 15, 2016 and previously listed as "Note receivable – related party" on the Company's consolidated balance sheets. The note receivable was assumed as part of the Company's acquisition of Cuattro Veterinary. At June 30, 2016 Heska Corporation had accounts receivable from US Imaging of $5.0 million, including accrued interest; Heska Corporation had net accounts receivable from Cuattro, LLC of $25 thousand; Global Imaging had net prepaid receivables from Cuattro, LLC of $1.4 million; and International Imaging had a net receivable due from Cuattro, LLC of $546 thousand. All monies owed accrue interest at the same interest rate Heska Corporation pays under its credit and security agreement with Wells Fargo once past due with the exception of the note receivable, which accrues at this rate to its maturity date.

Mrs. Wilson, Clint Roth, DVM, Mr. Asakowicz, Mr. Lippincott, Mr. Wilson and Cuattro, LLC own approximately 29.75%, 8.39%, 4.09%, 3.07%, 0.05% and 0.05% of US Imaging, respectively, each are a member of US Imaging, and each have an interest in the puts and calls discussed above. If Mr. Wilson, Mr. Asakowicz or Mr. Lippincott is distracted by these holdings or interests, they may not contribute as much

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as they otherwise would have to enhancing our business, to the detriment of our shareholder value. While the Operating Agreement was negotiated at arm's length as part of the Acquisition, and requires that none of the members shall cause US Imaging to operate its business in any manner other than the ordinary course of business, any time and resources devoted to monitoring and overseeing this relationship may prevent us from deploying such time and resources on more productive matters.

In addition, like any acquisition, if US Imaging significantly underperforms relative to our financial expectations, it may serve to diminish rather than enhance shareholder value. Heska US generated operating income of $0.8 million in 2015 and an operating loss of approximately $2.1 million in 2014.

On May 31, 2016, we acquired Cuattro Veterinary, LLC, which we subsequently renamed Heska Imaging International, LLC, and we may acquire other businesses in the future. The success of such transactions will depend on, among other things, our ability to integrate assets and personnel acquired in these transactions and to apply our internal controls process to these acquired businesses. The integration of acquisitions may require significant attention from our management, and the diversion of management's attention and resources could have a material adverse effect on our ability to manage our business. Further more, we may not realize the degree or timing of benefits we anticipated when we first entered into the acquisition transaction. If actual integration costs are higher than amounts originally anticipated, if we are unable to integrate the assets and personnel acquired in an acquisition as anticipated, or if we are unable to fully benefit from anticipated synergies our business, financial condition, results of operations, and cash flows could be materially adversely effected.

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

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

We may become subject to patent infringement claims and litigation in the United States or other countries or interference proceedings conducted in the United States Patent and Trademark Office, or USPTO, to determine the priority of inventions. The defense and prosecution of intellectual property suits, USPTO interference proceedings and related legal and administrative proceedings are likely to be costly, time-consuming and distracting. As is typical in our industry, from time to time we and our collaborators and suppliers have received, and may in the future receive, notices from third parties claiming infringement and invitations to take licenses under third-party patents. Any legal action against us or our collaborators or suppliers may require us or our collaborators or suppliers to obtain one or more licenses in order to market or manufacture effected products or services. However, we or our collaborators or suppliers may not be able to obtain licenses for technology patented by others on commercially reasonable terms, or at all, may not be able to develop alternative approaches if unable to obtain licenses or current and future licenses may not be adequate, any of which could substantially harm our business.

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

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

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

The effect of government regulation may be to delay or to prevent marketing of our products for a considerable period of time and to impose costly procedures upon our activities. We may not be able to estimate the time to obtain required regulatory approvals accurately and such approvals may require significantly more time than we anticipate. We have experienced in the past, and may experience in the future, difficulties that could delay or prevent us from obtaining the regulatory approval or license necessary to introduce or market our products. Such delays in approval may cause us to forego a significant portion of a new product's sales in its first year due to seasonality and advanced booking periods associated with certain products. Regulatory approval of our products may also impose limitations on the indicated or intended uses for which our products may be marketed.

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

Any of these events, alone or in unison, could damage our business.

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

We are party to an agreement with Merck Animal Health, which grants Merck Animal Health exclusive distribution and marketing rights for our canine heartworm preventive product, TRI-HEART Plus Chewable Tablets, ultimately sold to or through veterinarians in the United States and Canada. Historically, a significant portion of our OVP segment's revenue has been generated from the sale of certain bovine vaccines, which have been sold primarily under the Titanium® and MasterGuard® brands. We have a supply agreement with Eli Lilly and its Affiliates operating through Elanco for the production of these vaccines. Either of these marketing partners may not devote sufficient resources to marketing our products and our sales and financial position could suffer significantly as a result. Revenue from Merck & Co., Inc. ("Merck") entities, including Merck Animal Health, represented 11% of our LTM revenue. Revenue from Eli Lilly entities, including Elanco, represented 13% of our LTM revenue. If Merck Animal Health personnel fail to market, sell and support our heartworm preventive sufficiently or if Elanco personnel fail to market, sell and support the bovine vaccines we produce and sell to Elanco sufficiently, our sales could decline significantly. Furthermore, there may be nothing to prevent these partners from pursuing alternative technologies, products or supply arrangements, including as part of mergers, acquisitions or divestitures. For example, we believe a unit of Merck has obtained FDA approval for a canine heartworm preventive product with additional claims compared with our TRI-HEART Plus Chewable Tablets, but which we believe is not currently being marketed actively. Should Merck decide to emphasize sales and marketing efforts of this product rather than our TRI-HEART Plus Chewable Tablets or cancel our agreement regarding canine heartworm preventive distribution and marketing, our sales could decline significantly. In another example, if Elanco were to emphasize sales and marketing efforts for bovine vaccines other than those we produce or cancel our supply agreement and produce the vaccines we supply to them by themselves, our sales could decline significantly. Third-party marketing assistance may not be available in the future on reasonable terms, if at all. If the third parties with marketing rights for our products were to merge or go out of business, the sale and promotion of our products could be diminished.

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

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

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

The loss of access to products from one or more suppliers could have a significant, negative impact on our business. Major suppliers who sell us proprietary products who are responsible for more than 5% of our LTM revenue are FUJIFILM Corporation and Cuattro, LLC. None of these suppliers sold us products which were responsible for more than 25% of our LTM revenue, although products purchased from one of these suppliers was responsible for more than 20% of our LTM revenue and products purchased from another was responsible for more than 10% of our LTM revenue. We often purchase products from our suppliers under agreements that are of limited duration or potentially

can be terminated on an annual basis. In the case

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of our blood testing instruments and our digital radiography solutions, post-termination, we are typically entitled to non-exclusive access to consumable supplies, or ongoing non-exclusive access to products and services to meet the needs of an existing customer base, respectively, for a defined period upon expiration of exclusive rights, which could subject us to competitive pressures in the period of non-exclusive access. Although we believe we will be able to maintain a supply of our major product and service offerings in the near future, there can be no assurance that our suppliers will meet their obligations under any agreements we may have in place with them or that we will be able to compel them to do so. Risks of relying on suppliers include:

- Regulatory risk. Our manufacturing facility and those of some of our third-party suppliers are subject to ongoing periodic unannounced inspection by regulatory authorities, including the FDA, USDA and other federal, state and foreign agencies for compliance with strictly enforced Good Manufacturing Practices, regulations and similar foreign standards. We do not have control over our suppliers' compliance with these regulations and standards. Regulatory violations could potentially lead to interruptions in supply that could cause us to lose sales to readily available competitive products. If one of our suppliers is unable to provide a raw material or finished product due to regulatory issues, it could have a material adverse financial impact on our business and could expose us to legal action if we are unable to perform on contracts to our customers involving related products.
- Inability to meet minimum obligations. Current agreements, or agreements we may negotiate in the future, may commit us to certain minimum purchase or other spending obligations. It is possible we will not be able to create the market demand to meet such obligations, which could create a drain on our financial resources and liquidity. Some such agreements may require minimum purchases and/or sales to maintain product rights and we may be significantly harmed if we are unable to meet such requirements and lose product rights.
- Loss of exclusivity. In the case of our blood testing instruments, if we are entitled to non-exclusive access to consumable supplies for a defined period upon expiration of exclusive rights, we may face increased competition from a third party with similar non-exclusive access or our former supplier, which could cause us to lose customers and/or significantly decrease our margins and could significantly affect our financial results. In addition, current agreements, or agreements we may negotiate in the future, with suppliers may require us to meet minimum annual sales levels to maintain our position as the exclusive distributor of these products. We may not meet these minimum sales levels and maintain exclusivity over the distribution and sale of these products. If we are not the exclusive distributor of these products, competition may increase significantly, reducing our revenues and/or decreasing our margins.
- Changes in economics. An underlying change in the economics with a supplier, such as a large price increase or new requirement of large minimum purchase amounts, could have a significant, adverse effect on our business, particularly if we are unable to identify and implement an alternative source of supply in a timely manner.
- The loss of product rights upon expiration or termination of an existing agreement. Unless we are able to find an alternate supply of a similar product, we would not be able to continue to offer our customers the same breadth of products and our sales and operating results would likely suffer. In the case of an instrument supplier, we could also potentially suffer the loss of sales of consumable supplies, which would be significant in cases where we have built a significant installed base, further harming our sales prospects and opportunities. Even if we were able to find an alternate supply for a product to which we lost rights, we would likely face increased competition from the product whose rights we lost being marketed by a third party or the former supplier and it may take us additional time and expense to gain the necessary approvals and launch an alternative product.

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- High switching costs. In our blood testing instrument products we could face significant competition and lose all or some of the consumable revenues from the installed base of those instruments if we were to switch to a competitive instrument. If we need to change to other commercial manufacturing contractors for certain of our regulated products, additional regulatory licenses or approvals generally must be obtained for these contractors prior to our use. This would require new testing and compliance inspections prior to sale, thus resulting in potential delays. Any new manufacturer would have to be educated in, or develop, substantially equivalent processes necessary for the production of our products. We likely would have to train our sales force, distribution network employees and customer support organization on the new product and spend significant funds marketing the new product to our customer base.
- The involuntary or voluntary discontinuation of a product line. Unless we are able to find an alternate supply of a similar product in this or similar circumstances with any product, we would not be able to continue to offer our customers the same breadth of products and our sales would likely suffer. Even if we are able to identify an alternate supply, it may take us additional time and expense to gain the necessary approvals and launch an alternative product, especially if the product is discontinued unexpectedly.
- Inconsistent or inadequate quality control. We may not be able to control or adequately monitor the quality of products we receive from our suppliers. Poor quality items could damage our reputation with our customers.
- Limited capacity or ability to scale capacity. If market demand for our products increases suddenly, our current suppliers might not be able to fulfill our commercial needs, which would require us to seek new manufacturing arrangements and may result in substantial delays in meeting market demand. If we consistently generate more demand for a product than a given supplier is capable of handling, it could lead to large backorders and potentially lost sales to competitive products that are readily available. This could require us to seek or fund new sources of supply, which may be difficult to find or may require terms that are less advantageous if available at all.
- 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 geographic rights. We typically do not have global geographic rights to products supplied by third parties. If we were to determine a market opportunity in a geography where we did not have distribution rights and were unable to obtain such rights from the supplier, it might hamper our ability to succeed in such geography and our sales and profits would be lower than they otherwise would have been.
- Limited intellectual property rights. We typically do not have intellectual property rights, or may have to share intellectual property rights, to the products supplied by third parties and any improvements to the manufacturing processes or new manufacturing processes for these products.

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

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

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

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

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

Revenue from Butler Animal Health Supply, LLC d/b/a Henry Schein Animal Health ("Henry Schein") represented approximately 13% and 12% of our consolidated revenue for the six and three months ended June 30, 2016 as well as 11% of our consolidated revenue for the three months ended June 30, 2015. Revenue from Merck entities, including Merck Animal Health, represented approximately 11% and 14% of our consolidated revenue for the six and three months ended June 30, 2016, respectively, as well as 11% and 10% for the six and three months ended June 30, 2015, respectively. Revenue from Eli Lilly entities, including Elanco, represented approximately 11% and 14% of our consolidated revenue for the six and three months ended June 30, 2016, respectively. No other single customer accounted for more than 10% of our consolidated revenue for the six and three months ended June 30, 2016 or 2015.

Merck entities accounted for approximately 21% of our consolidated accounts receivable, Eli Lilly entities accounted for approximately 13% of our consolidated accounts receivable and Henry Schein accounted for approximately 12% of our consolidated accounts receivable at June 30, 2016. No other single customer accounted for more than 10% of our consolidated accounts receivable at June 30, 2016.

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

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

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

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

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

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

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

carrying, potentially including those of our competitors. If we fail to be effective with new or existing independent third-party distributors, our financial performance may suffer.

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

We may be required to raise additional capital in the future. If necessary, we expect to raise these additional funds by borrowing under our revolving line of credit, the increased sale of customer leases, the sale of equity securities or the issuance of new term debt secured by the same category of assets as the term loans which we fully repaid in 2010. There is no guarantee that additional capital will be available from these sources on reasonable terms, if at all, and certain of these sources may require approval by existing lenders. Funds we expect to be available under our existing revolving line of credit may not be available and other lenders could refuse to provide us with additional debt financing. Financial institutions and other potentially interested parties may not be interested in purchasing our customer leases on economic terms, or at all. 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. 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.

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

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

Even if we are successful in the development of a product or obtain rights to a product from a third-party supplier, we may experience delays or shortfalls in commercialization and/or market acceptance of the product. For example, veterinarians may be slow to adopt a product, a product may not achieve the anticipated technical performance in field use or there may be delays in producing large volumes of a product. The former is particularly likely where there is no comparable product available or historical precedent for such a product. The ultimate adoption of a new product by veterinarians, the rate of such adoption and the extent veterinarians choose to integrate such a product into their practice are all important factors in the economic success of 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. For example, our VitalPath Blood Gas and Electrolyte Analyzer, supplied under an agreement, the ("Roche Agreement"), with Roche Diagnostics Corporation ("Roche"), generated significantly less revenue than we anticipated following its launch in May 2010 as placements of this product with customers did not occur as we expected.

Our stock price has historically experienced high volatility, and could do so in the future, including experiencing a material price decline resulting from a large sale in a short period of time. In addition, our Public Common Stock has certain transfer restrictions which could reduce trading liquidity from what it otherwise would have been and have other undesired effects.
Should a relatively large shareholder decide to sell a large number of shares in a short period of time, it could lead to an excess supply of our shares available for sale and correspondingly result in a significant decline in our stock price.

The securities markets have experienced significant price and volume fluctuations and the market prices of securities of many microcap and small cap companies have in the past been, and can in the future be expected to be, especially volatile. During the twelve months ended June 30, 2016, the closing stock price of our Public Common Stock has ranged from a low of $26.26 to a high of $40.73. Fluctuations in the trading price or liquidity of our Public Common Stock may adversely affect our ability to raise capital through future equity financings. Factors that may have a significant impact on the market price and marketability of our Public Common Stock include:

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

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

On May 4, 2010, our shareholders approved an amendment (the "Amendment") to our Restated Certificate of Incorporation. The Amendment places restrictions on the transfer of our stock that could adversely affect our ability to use our domestic Federal Net Operating Loss carryforward ("NOL"). In particular, the Amendment prevents the transfer of shares without the approval of our Board of Directors if, as a consequence, an individual, entity or groups of individuals or entities would become a 5-percent holder under Section 382 of the Internal Revenue Code of 1986, as amended, and the related Treasury regulations, and also prevents any existing 5-percent holder from increasing his or her ownership position in the Company without the approval of our Board of Directors. Any transfer of shares in violation of the Amendment (a "Transfer Violation") shall be void ab initio under the our Restated Certificate of Incorporation, as amended (our "Certificate of Incorporation") and our Board of Directors has procedures under our Certificate of Incorporation to remedy a Transfer Violation including requiring the shares causing such Transfer Violation to be sold and any profit resulting from such sale to be transferred to a charitable entity chosen by the Company's Board of Directors in specified circumstances. The Amendment could have an adverse impact on the value and trading liquidity of our stock if certain buyers who would otherwise have bid on or purchased our stock, including buyers who may not be comfortable owning stock with transfer restrictions, do not bid on or purchase our stock as a result of the Amendment. In addition, because some corporate takeovers occur

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through the acquirer's purchase, in the public market or otherwise, of sufficient shares to give it control of a company, any provision that restricts the transfer of shares can have the effect of preventing a takeover. The Amendment could discourage or otherwise prevent accumulations of substantial blocks of shares in which our stockholders might receive a substantial premium above market value and might tend to insulate management and the Board of Directors against the possibility of removal to a greater degree than had the Amendment not passed.

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

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

If our regulators and/or auditors adopt or interpret more stringent standards than we anticipate, we could experience unanticipated changes in our reported financial statements, including but not limited to restatements, which could adversely affect our business due to litigation and investor confidence in our financial statements. In addition, changes in the underlying circumstances to which we apply given accounting standards and principles may affect our results of operations and have a negative impact on us. For example, we review goodwill recognized on our consolidated balance sheets at least annually and if we were to conclude there was an impairment of goodwill, we would reduce the corresponding goodwill to its estimated fair value and recognize a corresponding expense in our statement of operations. This impairment and corresponding expense could be as large as the total amount of goodwill recognized on our consolidated balance sheets, which was $26.7 million at June 30, 2016. There can be no assurance that future goodwill impairments will not occur if projected financial results are not met, or otherwise.

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") has increased our required administrative actions and expenses as a public company since its enactment. The general and administrative costs of complying with Sarbanes-Oxley will depend on how it is interpreted over time. Of particular concern are the level of standards for internal control evaluation and reporting adopted under Section 404 of Sarbanes-Oxley. If our regulators and/or auditors adopt or interpret more stringent standards than we anticipate, we and/or our auditors may be unable to conclude that our internal controls over financial reporting are designed and operating effectively, which could adversely affect investor confidence in our financial statements and cause our stock price to decline. Even if we and our auditors are able to conclude that our internal control over financial reporting is designed and operating effectively in such a circumstance, our general and administrative costs are likely to increase. For example, in 2015, we were required to have our independent registered public accountant conduct an audit of our internal control over financial reporting because as of June 30, 2015 our stock market value was above a certain level prescribed by regulation. This increased our general and administrative costs from what they otherwise would have been.

Similarly, we are required to comply with the SEC's mandate to provide interactive data using the eXtensible Business Reporting Language as an exhibit to certain SEC filings. Compliance with this mandate has required a significant time investment, which has and may in the future preclude some of our employees from spending time on more productive matters. In addition, actions by other entities, such as enhanced rules to maintain our listing on the Nasdaq Capital Market, could also increase our general and administrative costs

or have other adverse effects on us, as could further legislative, regulatory or rule-making action or more stringent interpretations of existing legislation, regulations and rules.

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

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

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

Our Public 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. While we believe we are currently in compliance with all Nasdaq requirements, there can be no assurance we will continue to meet Nasdaq listing requirements, that Nasdaq will interpret these requirements in the same manner we do if we believe we meet the requirements, or that Nasdaq will not change such requirements or add new requirements to include requirements we do not meet in the future. If we are delisted from the Nasdaq Capital Market, our Public Common Stock may be considered a penny stock under the regulations of the SEC and would therefore be subject to rules that impose additional sales practice requirements on broker-dealers who sell our securities. The additional burdens imposed upon broker-dealers may discourage broker-dealers from effecting transactions in our Public Common Stock, which could severely limit market liquidity of the Public Common Stock and any stockholder's ability to sell our securities in the secondary market. This lack of liquidity would also likely make it more difficult for us to raise capital in the future.

We have less than 300 holders of record as of our latest information, a fact which would make us eligible to terminate voluntarily the registration of our common stock with the SEC and therefore suspend our reporting obligations with the SEC under the Exchange Act and become a non-reporting company. If we were to cease reporting with the SEC, we would no longer be eligible to maintain the listing of our common stock on the Nasdaq Capital Market, which we would expect to materially adversely affect the liquidity and market price for our common stock.

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

Prior to 2005, we incurred net losses on an annual basis since our inception in 1988 and, as of June 30, 2016, we had an accumulated deficit of $159.8 million. Relatively small differences in our performance metrics may cause us to generate an operating or net loss in future periods. Our ability to continue to be profitable in future periods will depend, in part, on our ability to increase sales in our CCA segment, including maintaining and growing our installed base of instruments and related consumables, to maintain or increase gross margins and to limit the increase in our operating expenses to a reasonable level as well as avoid or effectively manage any unanticipated issues. We may not be able to generate, sustain or increase profitability on a quarterly or annual basis. If we cannot achieve or sustain profitability for an extended period, we may not be able to fund our expected cash needs, including the repayment of debt as it comes due, or continue our operations.

Many of our expenses are fixed and if factors beyond our control cause our revenue to fluctuate, this fluctuation could cause greater than expected losses, cash flow and liquidity shortfalls.
We believe that our future operating results will fluctuate on a quarterly basis due to a variety of factors which are generally beyond our control, including:

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

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

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

Under our credit and security agreement with Wells Fargo, we are required to comply with various covenants, both financial and non-financial, in order to borrow under the agreement. The availability of borrowings under this agreement is expected to be important to continue to fund our operations. A key financial covenant is based on a fixed charge coverage ratio, as defined in the credit and security agreement with Wells Fargo. Although we believe we will be able to maintain compliance with all these covenants and any covenants we may negotiate in the future, there can be no assurance thereof. We have not always been able to maintain compliance with all covenants under our credit and security agreement with Wells Fargo. Although Wells Fargo has granted us a waiver of non-compliance in each case, there can be no assurance we will be able to obtain similar waivers or other modifications if needed in the future on economic terms, if at all. Failure to comply with any of the covenants, representations or warranties, or failure to modify them to

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allow future compliance, could result in our being in default and could cause all outstanding borrowings under our credit and security agreement to become immediately due and payable, or impact our ability to borrow under the agreement. In addition, Wells Fargo has discretion in setting the advance rates which we may borrow against eligible assets. We may need 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.

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

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

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

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

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

The following table sets forth information about our purchases of our outstanding Public Common Stock during the quarter ended June 30, 2016:

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share (1)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
April 1 - April 30, 2016	2,525	$ 30.60	—	—
May 1 - May 31, 2016	—	—	—	—
June 1 - June 30, 2016	—	—	—	—
Total	2,525	$ 30.60	—	—

(1) Shares of Public Common Stock we purchased between April 1, 2016 and June 30, 2016 were solely for the cancellation of shares of restricted stock to pay withholding taxes.

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

N/A

Item 5. Other Information.

None.

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Item 6. Exhibits.

Exhibit Number	Notes	Description of Document
31.1		Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
31.2		Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
32.1**		Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
10.1+		Assignment and Assumption Agreement (Supply Agreement) between Heska Imaging US, LLC, Heska Imaging Global, LLC, Cuattro, LLC, and Heska Imaging International, LLC, dated as of March 14, 2016.
10.2+		Assignment and Assumption Agreement (License Agreement) between Heska Imaging US, LLC, Heska Imaging Global, LLC, Cuattro, LLC, and Heska Imaging International, LLC, dated as of March 14, 2016.
101.INS		XBRL Instance Document.
101.SCH		XBRL Taxonomy Extension Schema Document.
101.CAL		XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF		XBRL Taxonomy Extension Definition Linkbase Document.
101.PRE		XBRL Taxonomy Extension Presentation Linkbase Document.
101.LAB		XBRL Taxonomy Extension Label Linkbase Document.

Notes

+	Portions of the exhibit have been omitted pursuant to a request for confidential treatment.
**	Furnished with this report.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized on August 8, 2016.

HESKA CORPORATION

By: /s/ KEVIN S. WILSON
Kevin S. Wilson
Chief Executive Officer and President
(Principal Executive Officer)
By: /s/ JASON A. NAPOLITANO
Jason A. Napolitano
Chief Operating Officer, Chief Financial Officer,
Executive Vice President and Secretary
(Principal Financial Officer)
By: /s/ JOHN MCMAHON
John McMahon
Vice President, Financial Operations and Controller
(Principal Accounting Officer)

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Exhibit Index

Exhibit Number	Notes	Description of Document
31.1		Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
31.2		Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
32.1**		Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
10.1+		Assignment and Assumption Agreement (Supply Agreement) between Heska Imaging US, LLC, Heska Imaging Global, LLC, Cuattro, LLC, and Heska Imaging International, LLC, dated as of March 14, 2016.
10.2+		Assignment and Assumption Agreement (License Agreement) between Heska Imaging US, LLC, Heska Imaging Global, LLC, Cuattro, LLC, and Heska Imaging International, LLC, dated as of March 14, 2016.
101.INS		XBRL Instance Document.
101.SCH		XBRL Taxonomy Extension Schema Document.
101.CAL		XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF		XBRL Taxonomy Extension Definition Linkbase Document.
101.PRE		XBRL Taxonomy Extension Presentation Linkbase Document.
101.LAB		XBRL Taxonomy Extension Label Linkbase Document.

Notes

+	Portions of the exhibit have been omitted pursuant to a request for confidential treatment.
**	Furnished with this report.

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