DIGITAL ANGEL CORP
Form 10-Q
May 03, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2004

or

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

For the transition period from to

Commission File Number: 1-15177

DIGITAL ANGEL CORPORATION

(Exact name of registrant as specified in its charter)

DELAWARE	**52-1233960**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

490 Villaume Avenue, South Saint Paul, Minnesota, 55075
(Address of registrant s principal executive offices)

(651) 455-1621
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ý No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule12b-2 of the Exchange Act).

Yes o No ý

As of the close of business on April 29, 2004, there were 32,560,511 shares outstanding of the issuer s $0.005 per share par value common stock.

DIGITAL ANGEL CORPORATION

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Item 1. Financial Statements.

DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value)

	March 31, 2004 (Unaudited)	December 31, 2003
Assets		
Current Assets		
Cash	**$ 1,690**	$ 894
Restricted cash	**785**	765
Accounts receivable (net of allowance for doubtful accounts of $216 in 2004 and $212 in 2003)	**6,264**	3,853
Inventories	**5,989**	6,589
Deferred costs	**72**	
Applied Digital Solutions, Inc. common stock (Note 7)	**3,913**	
Other current assets	**1,056**	828
Total Current Assets	**19,769**	12,929
Property and Equipment, net	**7,544**	7,665
Goodwill and Other Intangible Assets, net	**53,865**	45,608
Other Assets, net	**1,204**	1,105
	$ 82,382	$ 67,307
Liabilities and Stockholders Equity		
Current Liabilities		
Line of credit and current maturities of long-term debt	**$ 7,158**	$ 5,918
Accounts payable	**4,583**	5,297
Accrued expenses and other current liabilities	**4,293**	3,232
Deferred revenue	**1,367**	1,212
Due to Applied Digital Solutions, Inc.	**115**	347
Total Current Liabilities	**17,516**	16,006
Long-Term Debt And Notes Payable	**2,543**	2,818
Deferred Revenue	**347**	

Total Liabilities		**20,406**		18,824
Commitments And Contingencies				
Minority Interest		**6**		
Stockholders Equity				
Preferred stock: Authorized 1,000 shares, of $1.75 par value, 100 shares issued and outstanding in 2004 and 0 issued and outstanding in 2003		**175**		
Common stock: Authorized 95,000 shares, of $.005 par value; 32,626 shares issued and 32,576 shares outstanding in 2004 and 28,891 shares issued and 28,841 outstanding in 2003		**163**		144
Additional paid-in capital		**188,925**		171,909
Accumulated deficit		**(127,261)**		(123,517)
Treasury stock (carried at cost, 50 shares)		**(43)**		(43)
Accumulated other comprehensive income (loss)		**11**		(10)
Total Stockholders Equity		**61,970**		48,483
	$	**82,382**	$	67,307

See the accompanying notes to condensed consolidated financial statements.

DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(Unaudited)

	For the Three Months Ended March 31,			
		2004		**2003**
Product revenue	**$**	**10,676**	$	10,865
Service revenue		**450**		533
Total net revenue		**11,126**		11,398
Cost of products sold		**6,195**		5,639
Cost of services sold		**348**		395
		6,543		6,034
Gross profit		**4,583**		5,364
Selling, general and administrative expenses		**4,824**		4,280
Research and development expenses		**669**		911
Operating (loss) income		**(910)**		173
Interest income		**8**		
Interest expense		**(293)**		(138)
Realized and unrealized losses on Applied Digital Solutions, Inc. common stock		**(2,586)**		
Other income		**43**		42
(Loss) income before taxes and minority interest share of (income) losses		**(3,738)**		77
Provision for income taxes				
(Loss) income before minority interest share of (income) losses		**(3,738)**		77
Minority interest share of (income) losses		**(6)**		33
Net (loss) income	**$**	**(3,744)**	$	110
Net (loss) income per common share - basic	**$**	**(0.12)**	$	
Net (loss) income per common share - diluted		**(0.12)**		
Weighted average number of common shares outstanding - basic		**30,468**		26,663
Weighted average number of common shares outstanding diluted		**30,468**		30,638

See the accompanying notes to condensed consolidated financial statements.

DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

For The Three Months Ended March 31, 2004

(In Thousands)

(Unaudited)

	Preferred Stock		Common Stock		Additional Paid-In Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders Equity
	Number	Amount	Number	Amount					
Balance - December 31, 2003		$	28,891	$ 144	$ 171,909	$ (123,517)	$ (43)	$ (10)	$ 48,483
Net loss						(3,744)			(3,744)
Comprehensive loss - Foreign currency translation								21	21
Total comprehensive income (loss)						(3,744)		21	(3,723)
Merger consideration-OuterLink Corporation	100	175			8,125				8,300
Issuance of common stock to Applied Digital Solutions, Inc.			3,000	15	7,905				7,920
Exercise of stock options			735	4	986				990
Balance March 31, 2004	100	$ 175	32,626	$ 163	$ 188,925	$ (127,261)	$ (43)	$ 11	$ 61,970

See the accompanying notes to condensed consolidated financial statements.

DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	For the Three Months Ended March 31,	
	2004	**2003**
Cash Flows From Operating Activities		
Net (loss) income	**$ (3,744)**	$ 110
Adjustments to reconcile net (loss) income to net cash used in operating activities:		
Equity-based compensation		86
Amortization of debt discount and deferred financing charges	**96**	
Depreciation and amortization	**573**	434
Minority interest	**6**	(33)
Loss on ADS common stock	**2,586**	
Loss on disposal of equipment		8
Change in assets and liabilities:		
Increase in restricted cash	**(20)**	
Increase in accounts receivable	**(1,928)**	(3,607)
Decrease (increase) in inventories	**935**	(974)
Increase in deferred costs	**(72)**	
(Increase) decrease in other current assets	**(122)**	375
Decrease in due to ADS	**(232)**	(139)
(Decrease) increase in accounts payable, accrued expenses and deferred revenue	**(352)**	651
Net Cash Used In Operating Activities	**(2,274)**	(3,089)
Cash Flows From Investing Activities		
Proceeds from sale of ADS common sotck	**1,421**	
Decrease in other assets	**(126)**	9
Payments for property and equipment	**(100)**	(250)
Cash acquired through acquisition, net of acquisition costs	**85**	
Net Cash Provided by (Used In) Investing Activities	**1,280**	(241)
Cash Flows From Financing Activities		
Amounts borrowed on line of credit	**8,640**	8,677
Amounts paid on line of credit	**(7,826)**	(5,677)
Net amounts borrowed on notes payable	**367**	
Payments on long-term debt	**(323)**	(20)
Exercise of stock options	**990**	175
Net Cash Provided By Financing Activities	**1,848**	3,155

Effect of Exchange Rate Changes on Cash		**(58)**		(39)
Net Increase (Decrease) In Cash		**796**		(214)
Cash - Beginning Of Period		**894**		214
Cash - End Of Period	**$**	**1,690**	$	

See the accompanying notes to condensed consolidated financial statements.

DIGITAL ANGEL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands)

(Unaudited)

1. Basis of Presentation

On March 27, 2002, Digital Angel Acquisition Co. (Acquisition), then a wholly-owned subsidiary of Medical Advisory Systems, Inc. (MAS), merged with and into Digital Angel Corporation, which was then a 93% owned subsidiary of Applied Digital Solutions, Inc. (ADS). In the merger, the corporate existence of Acquisition ceased, Digital Angel Corporation became a wholly-owned subsidiary of MAS and was renamed Digital Angel Technology Corporation (DATC), and MAS was renamed Digital Angel Corporation. In connection with the merger transaction, ADS contributed to MAS all of its stock in Timely Technology Corp., a wholly-owned subsidiary, and Signature Industries, Limited, an 85% owned subsidiary based in the United Kingdom. These two subsidiaries, along with DATC, comprised the Advanced Wireless Group (AWG). As a result of this contribution by ADS, Timely Technology Corp. became a wholly-owned subsidiary of the Company and Signature Industries, Limited became an 85% owned subsidiary. Prior to the merger with DATC, ADS owned 850,000 shares of MAS stock, representing approximately 16.3% of the outstanding stock of MAS. (Unless the context otherwise requires, the term Company means Digital Angel Corporation and its subsidiaries). In the merger, the shares of DATC owned by ADS were converted into a total of 18,750,000 shares of MAS common stock. As a result of the merger, ADS owned 19,600,000 shares or 77.15% of the Company s common stock. The merger was treated as a reverse acquisition for accounting purposes, with AWG treated as the accounting acquirer.

The accompanying unaudited condensed consolidated financial statements of Digital Angel Corporation and subsidiaries as of March 31, 2004 and for the three month periods ended March 31, 2004 and 2003 have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X under the Securities Exchange Act of 1934. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of the Company s management, all adjustments (including normal recurring adjustments) considered necessary to present fairly the financial statements have been made.

The consolidated statements of operations for the three months ended March 31, 2004 and 2003 are not necessarily indicative of the results that may be expected for the entire year. These statements should be read in conjunction with the Digital Angel Corporation s audited consolidated financial statements and related notes thereto for the year ended December 31, 2003 which are included in the Company s Annual Report on Form 10-K.

The Company develops and deploys sensor and communications technologies that enable rapid and accurate identification, location tracking, and condition monitoring of high-value assets. Prior to January 22, 2004, the Company operated in four segements: Animal Applications, Wireless and Monitoring, GPS and Radio Communications and Medical Systems. With the acquisition of OuterLink Corporation in January 2004, the Company reorganized into three segments: Animal Applications, GPS and Radio Communications and Medical Systems. The GPS and Radio Communications segment, the Wireless and Monitoring segment and the OuterLink Corporation business, which was acquired on January 22, 2004, were combined to form the new GPS and Radio Communications segment, which is now managed as a single business unit.

Animal Applications develops, manufactures, and markets a broad line of electronic and visual identification devices for the companion animal, livestock, laboratory animal, fish and wildlife markets worldwide. The tracking of cattle and hogs are crucial both for asset management and for disease control and food safety. The principal technologies employed by Animal Applications are electronic ear tags and implantable microchips that use radio frequency transmission.

GPS and Radio Communications-consists of the design, manufacture and support of GPS enabled equipment. Applications for the segment s products include location tracking and message monitoring of vehicles and aircraft in remote locations through systems that integrate GPS and geosynchronous satellite communications and GPS enabled equipment and intelligent communications products and services for telemetry, mobile data and radio communications applications serving commercial and military markets. This segment is also developing technology, which it refers to as its Digital Angel technology. The Digital Angel technology is the integration and miniaturization into marketable products of three technologies: wireless communications (such as cellular), sensors (including bio-sensors) and position location technology (including global positioning systems (GPS) and other systems).

Medical Systems consists of a staff of logistics specialists and physicians that provide medical assistance services and interactive medical information services to people traveling anywhere in the world. It also sells a variety of kits containing pharmaceutical and medical supplies. See Note 14 for the subsequent sale of the assets of the Medical Systems segment.

2. Principles of Consolidation

The March 31, 2004 and 2003 condensed consolidated financial statements include the accounts of the Company and its wholly-owned and majority-owned subsidiaries (OuterLink Corporation from the date of acquisition on January 22, 2004). All significant intercompany accounts and transactions have been eliminated in consolidation.

3. Revenue Recognition

The Company, except for its subsidiary OuterLink Corporation, recognizes product revenue at the time product is shipped and title has transferred, provided that a purchase order has been received or a contract has been executed, there are no uncertainties regarding customer acceptance, the sales price is fixed and determinable and collectibility is deemed probable. If uncertainties regarding customer acceptance exists, revenue is recognized when such uncertainties are resolved. There are no significant post-contract support obligations at the time of revenue recognition. Digital Angel Corporation s accounting policy regarding vendor and post contract support obligations is based on the terms of the customers contracts, billable upon occurrence of the post-sale support. Costs of products sold and services provided are recorded as the related revenue is recognized. Digital Angel Corporation offers a warranty on its products. For non-fixed fee jobs, revenue is recognized based on the actual direct labor hours in the job multiplied by the standard billing rate and adjusted to net realizable value, if necessary. Revenues from contracts that provide services are recognized ratably over the term of the contract. Fixed fee revenues from contracts for services are recorded when earned and exclude reimbursable costs. Reimbursable costs incurred in performing such services are presented on a net basis and include transportation medical and communication costs. Other revenue is recognized at the time service or goods are provided. It is the Company s policy to record contract losses in their entirety in the period in which such losses are foreseeable.

The Company s subsidiary, OuterLink Corporation, earns revenue from messaging services, which generally provide for service on a month-to month basis and from the rental or sale of related products to customers (communication terminals and software). OuterLink Corporation s messaging service is only available through use of its products, such products have no alternative use. Accordingly, service revenue is recognized as the services are performed. OuterLink Corporation s product revenue, for which title and risk of loss transfers to the customer on shipment, is deferred upon shipment and is recognized ratable over the estimated customer service period, currently 30 months. Product rental revenue is recognized over the rental period.

4. Stock-Based Compensation

The Company applies APB Opinion No. 25 and related Interpretations in accounting for all the plans. Accordingly, no compensation cost has been recognized under these plans. The Company has adopted the disclosure-only provisions of SFAS No. 123, Accounting for Stock-Based Compensation and SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure, which was released in December 2002 as an amendment to SFAS No. 123. The following table illustrates the effect on net income (loss) and earnings per share if the fair value based method had been applied to all awards (in thousands, except per share data):

	Three Months Ended March 31,	
	2004	**2003**
Reported net (loss) income	**$ (3,744)**	$ 110

Stock-based employee compensation expense in reported net income (loss), net of related tax effects				86
Stock-based employee compensation expense determined under the fair value based method, net of related tax effects		**(1,501)**		(702)
Pro forma net loss	**$**	**(5,245)**	$	(506)
(Loss) income per share (basic and diluted)				
As reported	**$**	**(0.12)**	$	
Pro forma	**$**	**(0.17)**	$	(0.02)

6. Inventory (in thousands)

		March 31, 2004		December 31, 2003
Raw materials	**$**	**2,314**	$	1,976
Work in process		**139**		94
Finished goods		**5,546**		6,340
		7,999		8,410
Allowance for excess and obsolescence		**(2,010)**		(1,821)
Net inventory	**$**	**5,989**	$	6,589

7. Stock Exchange with Applied Digital Solutions, Inc.

On March 1, 2004, the Company issued 3,000,000 shares of its common stock to ADS pursuant to the Stock Purchase Agreement (Stock Purchase Agreement) with ADS dated August 14, 2003. The Stock Purchase Agreement provided for ADS to purchase 3,000,000 shares of the Company s common stock at a price of $2.64 per share and a warrant (the ADS Warrant) to purchase up to 1,000,000 shares of the Company s common stock, which is exercisable for five years beginning February 1, 2004, at a price per share of $3.74 payable in cash or shares of common stock of ADS. The consideration for the sale of the Company s 3,000,000 shares and the warrant was payable in 1,980,000 shares of ADS common stock. The Company expects to sell the stock of ADS to generate additional funds which the Company believes will be necessary to sustain its operations for the next twelve months. As of March 31, 2004, the Company has sold 530,000 shares of ADS common stock. The Company has accounted for the ADS stock as a trading security under SFAS 115, Accounting for Certain Investments in Debt and Equity Securities . In the quarter ended March 31, 2004 the Company recorded realized losses of $702,000 on the 530,000 shares of ADS common stock sold and an unrealized loss of $1,884,000 on the remaining 1,450,000 shares held by the Company. Fair value of the ADS common stock is determined by quoted values reported on NASDAQ. Realized and unrealized losses on the ADS common stock are included as Other Expenses in the Company s statement of operations for the three months ended March 31, 2004.

8. Income (Loss) Per Share

The following is a reconciliation of the numerator and denominator of basic and diluted income (loss) per share (in thousands, except per share data):

	Three Months Ended March 31,			
		2004		2003
Numerator:				
Net income (loss)	**$**	**(3,744)**	$	110
Denominator:				
Denominator for basic income (loss) per share-				
Weighted-average shares		**30,468**		26,663
Basic income (loss) per share	**$**	**(0.12)**	$	
Denominator for diluted income (loss) per share-				

Weighted-average shares		**30,468**		26,663
Potentially dilutive securities, calculated on the treasury method (1)				3,975
Denominator for diluted income (loss) per share		**30,468**		30,638
Diluted income (loss) per share	**$**	**(0.12)**	$	

(1) Potentially dilutive securities are excluded from the computation of diluted loss per share for the three months ended March 31, 2004 because to include them would have been anti-dilutive.

9. Segment Information

The Company is an advanced technology company in the field of rapid and accurate identification, location tracking, and condition monitoring of high-value assets. Prior to January 22, 2004, the Company operated in four segements: Animal Applications, Wireless and Monitoring, GPS and Radio Communications and Medical Systems. With the acquisition of OuterLink Corporation in January 2004, the Company reorganized into three segments: Animal Applications, GPS and Radio Communications and Medical Systems. The GPS and Radio Communications segment, the Wireless and Monitoring segment and the OuterLink Corporation business, which was acquired on January 22, 2004, were combined to form the new GPS and Radio Communications segment, which is now managed as a single business unit. Prior period segment information has been restated to reflect the Company s current segment structure. See Note 14 for the subsequent sale of the assets of the Medical Systems segment.

It is on this basis that management utilizes the financial information to assist in making internal operating decisions. The Company evaluates performance based on stand-alone segment operating income.

Following is the selected segment data as of and for the three months ended March 31, 2004 (in thousands):

	Animal Applications	GPS and Radio Communications	Medical Systems	Consolidated
Net revenue from external customers:				
Product	$ 7,009	$ 3,502	$ 165	$ 10,676
Service	63	197	190	450
Total revenue	$ 7,072	$ 3,699	$ 355	$ 11,126
(Loss) before income taxes and minority interest share of (income) losses	$ (2,643)	$ (717)	$ (378)	$ (3,738)
Total assets	$ 65,320	$ 16,498	$ 564	$ 82,382

Following is the selected segment data as of and for the three months ended March 31, 2003 (in thousands):

	Animal Applications	GPS and Radio Communications	Medical Systems	Consolidated
Net revenue from external customers:				
Product	$ 7,801	$ 2,699	$ 365	$ 10,865
Service		154	379	533
Total revenue	$ 7,801	$ 2,853	$ 744	$ 11,398

Income (loss) before income taxes and minority interest share of losses	$	1,459	$	(1,257)	$	(125)	$	77
Total assets	$	60,178	$	6,462	$	4,885	$	71,525

10. Acquisition

The following describes the acquisition by the Company (in thousands):

Company Acquired	Date Acquired	Acquisition Price	Value of Series A Preferred Stock	Series A Preferred Shares Issued	Goodwill and Other Intangibles Acquired	Other Net Assets and Liabilities	Business Description
OuterLink Corporation	1/22/04	$ 8,400	$ 8,300	100	$ 8,393	$ 7	Provider of real-time, satellite-based automated tracking, wireless data transfer and two-way messaging with large fleets of vehicles.

On January 22, 2004, the Company acquired OuterLink Corporation. OuterLink Corporation became a wholly-owned subsidiary of Digital Angel Corporation. The acquisition was accounted for under the purchase method of accounting. The excess of purchase price over the fair value of the assets and liabilities of OuterLink Corporation has been recorded as goodwill. Identifiable intangible assets have been recorded based upon preliminary estimates as of the date of the acquisition. Any changes to the preliminary estimates during the allocation period will be reflected as an adjustment to goodwill.

The cost of the acquisition consisted of 100,000 shares of Series A preferred stock valued at $8.3 million and acquisition costs of $0.1 million. The Series A preferred stock is convertible into four million shares of the Company s common stock when the volume weighted average price of the Company s common stock equals or exceeds $4.00 per share for ten consecutive trading days. The valuation of the stock is primarily based on historical trading history and stock prices of the Company s common stock and a marketability discount of 30%. The cost of the acquisition consists of legal and accounting related services that were direct costs of acquiring these assets.

In considering the benefits the OuterLink Corporation acquisition, the management of Digital Angel Corporation recognized the strategic complement of OuterLink Corporation s technologies and customer base with Digital Angel Corporation s existing animal applications and military GPS business lines. This complement provides for a strong platform for further development of Digital Angel Corporation s capabilities in the area of high-value asset identification, tracking and condition monitoring.

The results of OuterLink Corporation have been included in the consolidated financial statements since the date of acquisition of January 22, 2004. Unaudited pro forma results of operations for the three months ended March 31, 2004 and 2003 are included below. Such pro forma information assumes that the above acquisition had occurred as of January 1, 2004 and 2003, and revenue is presented in accordance with the Company s accounting policies. This summary is not necessarily indicative of what the result of operations of the Company would have been had it been a combined entity during such periods, nor does it purport to represent results of operations for any future periods.

(In thousands)	For the quarter ended March 31, 2004	2003
Net revenue	$ 11,213	$ 11,663
Net loss	$ (4,447)	$ (1,078)
Net loss per common share - basic and diluted	$ (0.15)	$ (0.04)

11. Contingencies

Wurts Litigation

In February 2003, an action was filed in the Middlesex County Superior Court in the Commonwealth of Massachusetts. The Company s subsidiary, OuterLink Corporation, as well as a significant stockholder of OuterLink and a principal of the significant stockholder are named as defendants. Such principal was a director of OuterLink. The complaint alleged breach of an August 25, 1999 employment contract. The plaintiff was President and CEO of OuterLink Corporation from July 1999 through August 2002.

The Complaint seeks damages based principally on a contractual severance provision that allegedly provided for four months of compensation for every year or fraction thereof served prior to termination. At the time of termination, the complaint alleges that the plaintiff s salary was $250,000 per year. The defendants answered denying all liability and counterclaimed. Discovery will be completed in this matter shortly and the Defendants intend to vigorously defend this matter and pursue their counterclaims. The ultimate outcome of this proceeding cannot be predicted at this time and the Company is currently unable to determine the potential effect of this litigation on its consolidated financial position, results of operation or cash flows.

E-Research Litigation

In June, 2002, eResearch Technology, Inc. f/k/a Premier Research Worldwide, Ltd. (ERT) commenced a proceeding against U.S. Bank National Association, subsequently intervened in by the Company in the New Jersey state court and subsequently removed to the United States District Court for the District of New Jersey. This suit was commenced to pursue alleged damages of approximately $350,000 due to the Company s and US Bank s alleged failure to register transfers of restricted Digital Angel shares sold by ERT in May 2002. The Company has agreed to indemnify US Bank for all damages and reasonable costs relating to this litigation. The Company has asserted a counterclaim against ERT based on ERT s breach of a license agreement and services agreements between the parties that resulted in the original issuance of 550,000 restricted Digital Angel common shares to ERT. The damages to the Company exceed $4 million and this amount does not include the share of profits which the Company seeks to recover had its relationship with the ERT venture not been breached by ERT. Furthermore, the alleged damages sought by the Plaintiff in this matter do not take into account plaintiff s duty to mitigate damages which if discharged would have resulted in a profit to ERT. The ultimate outcome of this proceeding cannot be predicted at this time and the Company is currently unable to determine the potential effect of this litigation on its consolidated financial position, results of operation or cash flows.

Electronic Identification Devices Litigation

In February 2004, Electronic Identification Devices, Ltd. (EID) commenced a Declaratory Judgment Action against the Company in the United States District Court for the Western District of Texas. This action seeks a declaration of patent non-infringement relating to the Company s patented syringe implantable identification transponder. The lawsuit alleges that EID has developed a new transponder that it believes does not infringe on the Company s patent. The lawsuit acknowledges that the Company obtained a Judgment of infringement and two contempt orders against EID based on selling certain systems that infringed the Company s patent in 1997, 1998 and 1999. On March 10, 2004 the Company filed a motion seeking the dismissal of the Declaratory Judgment Complaint or, in the alternative, that the action be transferred to Minnesota. The Court has not yet ruled on the Company s motion. Given the very early stage of this matter, the ultimate outcome of this proceeding cannot be predicted at this time. The Company is currently unable to determine the potential effect of this litigation on its consolidated financial position, results of operation or cash flows.

12. Supplemental Cash Flow Information (in thousands)

	Three Months Ended March 31,	
	2004	2003
Interest paid	**$ 132**	$ 128
Taxes paid	**9**	
Non-cash activity:		
Issuance of preferred stock for business acquisition	**$ 8,300**	
Issuance of common stock for ADS common stock	**7,920**	

13. Related Party Activity

In 2003, ADS charged the Company for research expenses and directors and officers insurance. Amounts due to ADS were offset by receivables due from ADS resulting from the Distribution and Licensing Agreement with Verichip Corporation, a wholly-owned subsidiary of ADS. At March 31, 2004, these transactions resulted in a net amount due to ADS of $0.1 million.

The Company has executed an exclusive eleven year Distribution and Licensing Agreement dated March 4, 2002 with Verichip Corporation (Verichip), a wholly-owned subsidiary of ADS, covering the manufacturing, purchasing and distribution of Verichip s implantable microchip and the maintenance of the Verichip Registry by the Company. The agreement includes a license for the use of the Company s technology in Verichip s identified markets. The Company will be the sole manufacturer and supplier to Verichip. Revenue recognized under the Distribution and Licensing Agreement was $49,000 and $108,000 for the three months ended March 31, 2004 and 2003, respectively.

See Note 7 for a description of the stock exchange transaction with Applied Digital Solutions, Inc.

14. Subsequent Event

On April 19, 2004, the Company sold certain assets of its Medical Systems segment s medical services business pursuant to an Asset Purchase Agreement dated April 8, 2004 by and between Digital Angel Corporation and MedAire, Inc. Assets sold include all of the tangible and intangible intellectual property developed for the operation of the Medical Systems segment s medical services business, pharmaceutical supplies and other inventory items, customer and supplier contracts, computer software licenses, internet website and domain name and mailing lists.

Under the terms of the agreement, the purchase price, in addition to MedAire, Inc. s assumption of certain liabilities was $420,000 plus any prepaid deposits and the cost of the pharmaceutical inventory and supplies reduced by any pre-billing to or pro-rata prepayment by the Company s customers.

In connection with exiting this activity, the Company recognized obligations and expects to record a loss of approximately $300,000. Further, the Company also expects to sell the segment s land and buildings in a separate transaction and expects the sale proceeds to be above its carrying cost.

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 accompanying financial statements and related notes thereto.

We consist of Digital Angel Corporation and its four subsidiaries - Digital Angel Technology Corporation (DATC), Timely Technology Corp., Signature Industries Limited, and OuterLink Corporation.

RESULTS OF OPERATIONS

The following table summarizes our results of operations as a percentage of net operating revenue for the three months ended March 31, 2004 and 2003 and is derived from the accompanying consolidated statements of operations included in this report.

	Three Months Ended March 31,	
	2004 %	2003 %
Product revenue	96.0	95.3
Service revenue	4.0	4.7
Total net revenue	100.0	100.0
Cost of products sold	55.7	49.5
Cost of services sold	3.1	3.5
Total cost of products and services sold	58.8	53.0
Gross profit	41.2	47.0
Selling, general and administrative expenses	43.4	37.5
Research and development expenses	6.0	8.0
Operating (loss) income	(8.2)	1.5
Interest income	0.1	0.0
Interest expense	(2.6)	(1.2)
Realized and unrealized losses on ADS common stock	(23.3)	
Other income	0.4	0.4
(Loss) income before provision for income taxes and minority interest share of (income)losses	(33.6)	0.7
Provision for income taxes	0.0	0.0
(Loss) income before minority interest share of losses (income)	(33.6)	0.7
Minority interest share of (income) losses	(0.1)	0.3
Net (loss) income	(33.7)	1.0

Three Months Ended March 31, 2004 Compared to the Three Months Ended March 31, 2003

Revenue

Revenue from operations for the three months ended March 31, 2004 decreased $0.3 million, or 2.4%, to $11.1 million when compared to $11.4 million in revenue for the three months ended March 31, 2003.

Revenue for each of the operating segments was as follows (in thousands):

	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003
Animal Applications	$ 7,072	$ 7,801
GPS and Radio Communications	3,699	2,853
Medical Services	355	744
Total	$ 11,126	$ 11,398

The Animal Applications segment s revenue decreased $0.7 million, or 9.3%, in the three months ended March 31, 2004 compared to the three month period ended March 31, 2003. The majority of the decrease was due to lower sales to fishery industry customers. Shipments to fishery industry customers were lower in the first quarter of 2004 when compared to sales in the first quarter of 2003.

The GPS and Radio Communications segment s revenue increased $0.8 million, or 29.7% to $3.7 million in the three months ended March 31, 2004 from $2.9 million in the three months ended March 31, 2003. We attribute the increase primarily to increased sales in the Clifford and Snell division of our subsidiary Signature Industries Ltd., increases in the exchange rate and the inclusion of $0.3 million of revenue from OuterLink Corporation. We acquired OuterLink Corporation on January 22, 2004. We expect revenue to continue to increase in 2004 due to the introduction of a new pilot locator beacon in the second quarter of 2004 and the inclusion of OuterLink Corporation s revenue.

The Medical Systems segment s revenue decreased $0.4 million, or 52.3%, to $0.4 million in the three months ended March 31, 2004. Sales in the first quarter of 2003 included pharmaceutical sales to vessels directly related to the war in Iraq. These pharmaceutical sales did not occur in the first quarter of 2004. On April 19, 2004, the Medical Systems segment s medical services business was sold to MedAire, Inc. We do not expect any revenue from the Medical Systems segment after the date of the sale.

Gross Profit and Gross Profit Margin

Gross profit for the three month period ended March 31, 2004 was $4.6, a decrease of $0.8 million, or 14.6%, compared to $5.4 million in the three month period ended March 31, 2003. As a percentage of revenue, the gross profit margin decreased to 41.2% for the three months ended March 31, 2004 from 47.0% for the three months ended March 31, 2003.

Gross profit from operations for each operating segment was as follows (in thousands):

	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003
Animal Applications	$ 2,806	$ 3,660
GPS and Radio Communications	1,723	1,464
Medical Services	54	240
Total	$ 4,583	$ 5,364

Gross profit margin from operations for each operating segment was:

	Three Months Ended March 31, 2004 %	Three Months Ended March 31, 2003 %
Animal Applications	39.7	46.9
GPS and Radio Communications	46.6	51.3
Medical Services	15.2	32.3
Total	41.2	47.0

The Animal Applications segment s gross profit decreased $0.9 million, or 23.3%, in the three month period ended March 31, 2004 compared to the three months ended March 31, 2003. We attribute $0.6 million of the decrease to lower gross profit margin in 2004 and $0.3 million of the decrease to the previously mentioned sales decrease. The gross margin percentage decreased to 39.7% in the three month period ended March 31, 2004 as compared to 46.9% in the three month period ended March 31, 2003 due to high margin revenue in the first quarter of 2003 that did not occur in the first quarter of 2004.

The GPS and Radio Communications segment s gross profit increased $0.3 million, or 17.7%, in the three month period ended March 31, 2004 as compared to the three month period ended March 31, 2003. The gross margin percentage decreased to 46.6% in the three month period ended March 31, 2004 as compared to 51.3% in the three month period ended March 31, 2003. The increase in gross profit relates primarily to increased sales at our subsidiary in the United Kingdom, Signature Industries, Ltd, offset by a decrease in gross profit of $0.1 million related to the cancellation of a software support contract acquired by Timely Technology in the first quarter of 2003. The decrease in gross profit margin results from lower margins on OuterLink Corporation sales and a slight decrease in gross profit margin on Signature Industries, Ltd. s sales from 50.6% in the first quarter of 2003 to 49.8% in the first quarter of 2004. Decrease in gross profit margin at Signature Industries, Ltd relates to product mix in the first quarter of 2003 compared to the first quarter of 2004

The Medical Services segment s gross profit decreased $0.2 million, or 77.5%, in the three month period ended March 31, 2004 as compared to the three month period ended March 31, 2003. The gross margin percentage decreased to 15.2% in the three month period ended March 31, 2004 compared to 32.3% in the three month period ended March 31, 2003. The gross profit and gross margin percentage decreased due to high margin pharmaceutical sales in the first quarter of 2003 that did not occur in the first quarter of 2004.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased $0.5 million, or 12.7%, in the three month period ended March 31, 2004 as compared to the three month period ended March 31, 2003. As a percentage of revenue, selling, general and administrative expenses were 43.4% and 37.5% for the three months ended March 31, 2004 and 2003, respectively.

Selling, general and administrative expenses for each of the operating segments were as follows (dollars in thousands):

	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003
Animal Applications	$ 2,157	$ 1,590
GPS and Radio Communications	2,267	2,359
Medical Services	400	331
Total	$ 4,824	$ 4,280

Selling, general and administrative expenses as a percentage of revenue for each of the operating segments were:

	Three Months Ended March 31, 2004 %	Three Months Ended March 31, 2003 %
Animal Applications	30.5	20.4
GPS and Radio Communications	61.3	82.7
Medical Services	112.7	44.5
Total	43.4	37.5

The Animal Applications segment s selling, general and administrative expenses increased $0.6 million in the three month period ended March 31, 2004 as compared to the three month period ended March 31, 2003 and as a percentage of revenue increased to 30.5% from 20.4% in the same respective period. The increase in selling, general and administrative expenses relate to increased consulting expenses, travel, and investor relations expense.

The GPS and Radio Communications segment s selling, general and administrative expenses decreased $0.1 million to $2.3 million in the three month period ended March 31, 2004 from $2.4 million in the three month period ended March 31, 2003. The decrease in the selling, general and administrative expenses relate primarily to the reduction of general and administrative expense related to the continued scaleback of Digital Angel™ techonology development, offset by increased expenses at our subsidiary in the United Kingdom, Signature Industries Ltd and $0.4 million of expense related to OuterLink Corporation. OuterLink Corporation was acquired on January 22, 2004. As a percentage of revenue, selling, general and administrative expenses decreased to 61.3% in the three month period ended March 31, 2004 from 82.7% in the three month period ended March 31, 2003. The decrease in selling, general and administrative expenses as a percentage of revenue relates primarily to the reduction of general and administrative expense related to the continued scaleback of Digital Angel™ techonology development.

The Medical Services segment s selling, general and administrative expenses increased to $0.4 million, or 20.8%, in the three month period ended March 31, 2004 as compared to $0.3 million in the three month period ended March 31, 2003. The increase results from increased personnel costs of $0.1 million offset by decreased depreciation and amortization expense of $0.04 million. As a percentage of revenue, selling, general and administrative expenses increased to 112.7% in the three month period ended March 31, 2004 compared to 44.5% in the three month period ended March 31, 2003. The increase as a percentage of sales relates to increased expenses and decreased sales in the first quarter of 2004.

Research and Development Expense

Research and development expense was $0.7 million in the three month period ended March 31, 2004, a decrease of $0.2 million, or 26.6%, from $0.9 million for the three month period ended March 31, 2003. As a percentage of revenue, research and development expense was 6.0% and 8.0% for the three months ended March 31, 2004 and 2003, respectively.

Research and development expense for each of the operating segments was as follows (in thousands):

	Three Months Ended March 31, 2004		Three Months Ended March 31, 2003	
Animal Applications	$	523	$	550
GPS and Radio Communications		146		361
Medical Services				
Total	$	669	$	911

The decrease in research and development expense is due primarily to the continued scaleback of research and development on the Digital Angel™ technology in the Wireless and Monitoring segment and completion of development on the GPS and Radio Communications segment s pilot locator beacon.

Interest Expense

Interest expense was $0.3 million and $0.1 million for the three month periods ended March 31, 2004 and 2003, respectively. The increase relates to an increase in total debt of $2.6 million from $7.1 million as of March 31, 2003 to $9.7 million as of March 31, 2004 and the amortization of deferred financing costs related to the 2003 financings.

Loss on ADS Common Stock

On March 1, 2004, Digital Angel Corporation issued 3,000,000 shares of its common stock and a warrant to purchase up to 1,000,000 shares of the Company s common stock to ADS in exchange for 1,980,000 shares of ADS s common stock, exclusive of the proceeds which may be received when the warrant is exercised. As of March 31, 2004, the Company has sold approximately 530,000 shares of ADS common stock. The Company has accounted for the ADS stock as a trading security under SFAS 115, Accounting for Certain Investments in Debt and Equity Securities . In the quarter ended March 31, 2004, the Company recorded realized losses of $702,000 on the approximately 530,000 shares of ADS common stock sold and unrealized losses of $1,884,00 on the 1,450,000 shares held by the Company. Fair value of the ADS common stock is determined by quoted values reported on NASDAQ.

Income Taxes

The Company had an effective income tax rate of 0.0% for the three month periods ended March 31, 2004 and 2003. The Company accounts for income taxes under the asset and liability approach. Deferred tax assets and liabilities are recognized for the expected future tax consequences attributed to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse. A valuation allowance is provided against net deferred tax assets when it is more likely than not that a tax benefit will not be realized. Income taxes included U.S. and foreign taxes.

LIQUIDITY AND CAPITAL RESOURCES

As of March 31, 2004, the Company had cash of $1.7 million compared to $0.9 million at December 31, 2003. Cash used in operating activities totaled $2.3 million and $3.1 million in the first three months of 2004 and 2003, respectively.

In the first three months of 2004, the use of cash was due primarily to the net loss of $3.7 million and a significant increase in accounts receivable of $1.9 million. Accounts receivable, net of allowance for doubtful accounts, increased by $2.4 million, or 62.6%, to $6.3 million at March 31, 2004 from $3.9 million at December 31, 2003. This increase relates to $0.5 million of accounts receivable acquired in the acquisition of OuterLink Corporation and an increase in shipments in the first quarter of 2004 compared to the fourth quarter of 2003. Offsetting these uses of cash were a decrease in inventory of $0.9 million, depreciation and amortization of $0.6 million and realized and unrealized losses on ADS common stock of $2.6 million.

Inventory levels decreased by $0.6 million to $6.0 million at March 31, 2004 from $6.6 million at December 31, 2003 due to an accumulation of inventory in December 2003, offset by $0.4 million of inventory acquired in the OuterLink Corporation acquisition.

Accounts payable decreased by $0.7 million to $4.6 million at March 31, 2004 from $5.3 million at December 31, 2003.

Accrued expenses and other current liabilities increased by $1.0 million, or 32.8%, to $4.3 million at March 31, 2004 from $3.2 million at December 31, 2003. The increase was due primarily to accrued expenses and other current liabilities acquired in the OuterLink Corporation acquisition in January 2004.

Investing activities provided cash of $1.3 million in the first quarter of 2004 and used cash of $0.2 million in the first quarter of 2003. In the first quarter of 2004, cash provided was primarily from the sale of Applied Digital Solutions, Inc. stock. Expenditures for plant, property and equipment were $0.1 million and $0.3 million in the first quarter of 2004 and 2003, respectively.

Financing activities provided cash of $1.8 million and $3.1 million in the first three months of 2004 and 2003, respectively. In the first quarter of 2004, cash was provided primarily from net borrowings on our line of credit $0.8 million and proceeds from stock option exercises of $1.0 million.

Debt, Covenant Compliance and Liquidity

The following table summarizes the Company s fixed cash obligations as of March 31, 2004 over various future years (in thousands):

		Payments Due by Period			
Contractual cash obligations	**Total**	**Less than 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 Years**
Notes Payable and Long-Term Debt	$ 9,701	$ 7,158	$ 331	$ 124	$ 2,088
Operating Leases	18,753	808	1,180	993	15,772
Employment Contracts	1,912	865	1,047		
	$ 30,366	$ 8,831	$ 2,558	$ 1,117	$ 17,860

Convertible Note-On July 31, 2003, we entered into a Securities Purchase Agreement (Purchase Agreement) to sell to Laurus Master Fund, Ltd. (Laurus) a two-year Secured Convertible Note (the Convertible Note) in the original principal amount of $2,000,000 and a five-year warrant to purchase up to 125,000 shares of our common stock. The per share exercise price of the warrant is $2.68 for 75,000 shares, $2.91 for 35,000 shares and $3.38 for 15, 000 shares. The Convertible Note is convertible, at Laurus s option, into shares of our common stock at a per share price of $2.33. Laurus is not entitled to convert the amount evidenced by the Convertible Note into a number of shares of common stock which would exceed the difference between the number of shares of common stock beneficially owned by Laurus and 4.99% of the outstanding shares of common stock of us. However, Laurus may acquire more than 4.99% of our outstanding common stock upon 75 days notice to the Company. The Convertible Note accrues interest at an annual rate equal to the higher of the prime rate plus 1.75% or 6% per annum. We allocated $143,000 of the proceeds to the warrant issued. The amount allocated represents the fair value of the warrant calculated under the Black-Scholes method. The value of the warrant is included in additional paid in capital and is being amortized to interest expense over the life of the Convertible Note.

In connection with the Convertible Note, we and Laurus entered into a Security Agreement granting to Laurus a lien and security interest in our assets. Additionally, the Securities Purchase Agreement includes default provisions should an Event of Default (as defined in the agreement) occur.

Revolving Note and Minimum Borrowing Note- On August 28, 2003, we entered into a Security Agreement with Laurus under which the Company may borrow from Laurus the lesser of $5,000,000 or an amount that is determined based on percentages of the Company s eligible accounts receivable and inventory as prescribed by the terms of the Security Agreement. Under the Security Agreement, the Company issued to Laurus a three-year Secured Revolving Convertible Note (Revolving Note) in the original principal amount of $3,500,000 and a three-year Secured Minimum Borrowing Convertible Note (Minimum Borrowing Note) in the original principal amount of $1,500,000. We used proceeds from the Revolving Note and Minimum Borrowing Note to satisfy in full our credit facility from Wells Fargo Business Credit. The Revolving Note and Minimum Borrowing Note accrue interest at an annual rate equal to the prime rate plus 2.5%.The availability under the Revolving Note was $379,000 at March 31, 2004.

Beginning May 28, 2004, the Minimum Borrowing Note and the Revolving Note are convertible, at Laurus s option, into shares of the Company s common stock at a per price share of $2.64 (the Fixed Conversion Price). The Fixed Conversion Price is adjusted upward following each conversion of $2,000,000, as defined. Laurus is not entitled to convert the amount evidenced by the Minimum Borrowing Note and the Revolving Note into a number of shares of common stock which would exceed the difference between the number of shares of the Company s common stock beneficially owned by Laurus or issuable upon the exercise of warrants held by Laurus and 4.99% of the outstanding shares of the Company s common stock. However, Laurus may acquire more than 4.99% of the Company s outstanding common stock upon 75 days notice to the Company. Additionally, the Securities Purchase Agreement includes default provisions should an Event of Default (as defined in the agreement) occur; furthermore, under a related registration rights agreement, the Company has agreed to register the common stock underlying the Revolving Note and Minimum Borrowing Note.

The Company also issued to Laurus a five-year warrant to purchase up to 115,000 shares of the Company s stock. The per share exercise price of the warrant is $2.55 for 70,000 shares, $2.75 for 35,000 shares, and $2.95 for 10,000 shares. The Company allocated $133,000 of the proceeds to the warrant issued. The amount allocated represents the fair value of the warrant calculated under the Black-Scholes method. The value of the warrant is included in additional paid in capital and is being amortized to interest expense over the life of the Revolving Note and Minimum Borrowing Note.

*Working Capital Loan-*On March 7, 2003, Signature Industries Ltd., our subsidiary in the United Kingdom, entered into a Loan Agreement with The Royal Bank of Scotland for £500,000 to finance the working capital requirements of their Indian Air Force contract. The Loan bears interest at 2.25% above the base rate, as defined in the agreement. The base rate may vary from time to time. On January 22, 2004 the agreement was amended to increase the loan amount to £1,000,000 ($1,830,000). Repayment of £200,000 is required by May 30, 2004 and each month thereafter until the loan is repaid in full.

Invoice Discounting Agreement-On April 9, 2003, Signature Industries Ltd. entered into a two-year Invoice Discounting Agreement with The Royal Bank of Scotland Commercial Services Limited (RBS). The Invoice Discounting Agreement, as amended October 28, 2003, provides for Signature to sell with full title guarantee most of its receivables, as defined in the Invoice Discounting Agreement, as amended. RBS prepays 80% of the receivables sold, not to exceed an outstanding balance of £750,000 ($1,333,500) at any given time. RBS pays Signature the remainder of the receivable upon collection of the receivable. Receivables which remain outstanding 90 days from the end of the invoice month become ineligible and RBS may require Signature to repurchase the receivable back. The discounting charge accrues daily at an annual rate 2.25% above the base rate, as defined in the amended Invoice Discounting Agreement. Signature pays a commission charge to RBS of 0.2% of each receivable balance sold. The Invoice Discounting Agreement, as amended, requires a minimum commission charge of £833 per month. Discounting charges of $32,000 are included in interest expense in the 2003 statement of operations. Amount of receivables financed at March 31, 2004 was $1,100,000.

Stock Issuance to ADS-On March 1, 2004, the Company issued 3,000,000 shares of its common stock to ADS pursuant to the Stock Purchase Agreement (Stock Purchase Agreement) with ADS dated August 14, 2003. The Stock Purchase Agreement provided for ADS to purchase 3,000,000 shares of our common stock at a price of $2.64 per share and a warrant (the ADS Warrant) to purchase up to 1,000,000 shares of our common stock, which is exercisable for five years beginning February 1, 2004, at a price per share of $3.74 payable in cash or shares of common stock of ADS. The purchase price for the sale of the Company s 3,000,000 shares and the warrant was payable in 1,980,000 shares of ADS common stock. The Company expects to generate cash for operations by selling the shares of stock received by ADS. As of March 31, 2004, the Company has sold 530,000 shares of ADS common stock resulting in aggregate net proceeds of approximately $1,400,000.

As part of this transaction , the Company issued five-year warrants to purchase up to 500,001 shares of the Company s stock at an exercise price of $2.64 per share anytime on or after February 1, 2004 to the holders of the ADS 8.5% Convertible Exchangeable Debentures.

Since January 1, 2004, the Company received aggregate proceeds of $990,000 on the exercise of stock options.

Forward - Looking Statements and Associated Risk

This Form 10-Q contains forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 with respect to our financial condition, results of operations and business, and it includes statements relating to:

- our growth strategies including, without limitation, our ability to deploy new products and services;
- anticipated trends in our business and demographics;

our ability to successfully integrate the business operations of recently acquired companies;

our future profitability and liquidity; and

regulatory, competitive or other economic influences.

Words such as anticipates, expects, intends, plans, believes, seeks, estimates and similar expressions also identify forward-looking stat
These forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties that could cause actual results to differ materially from estimates or forecasts contained in the forward-looking statements. Some of these risks and uncertainties are beyond our control.

Risk Factors

You should carefully consider the risk factors listed below. These risk factors may cause our future earnings to be less or our financial condition to be less favorable than we expect. You should read this section together with the other information contained herein.

Recent changes in our senior management could have an adverse effect on our financial results.

We have recently experienced numerous changes with respect to our senior management. On September 4, 2003, Randolph K. Geissler resigned as Chief Executive Officer of Digital Angel Corporation after serving in such position since the March 2002 merger between Digital Angel Corporation and Medical Advisory Systems. From September 2000 until March 2002, Mr. Geissler served as Chief Executive Officer of Digital Angel Corporation, the predecessor corporation to our Company.

Following Mr. Geissler s resignation, the Company appointed Kevin McLaughlin as the interim Chief Executive Officer of Digital Angel Corporation while the Company conducted a formal search for a permanent Chief Executive Officer. At the time of his appointment as interim Chief Executive Officer, Mr. McLaughlin was serving as President and Chief Operating Officer of Applied Digital Solutions. On November 3, 2003, the Company announced that it had agreed to appoint Van Chu as Chief Executive Officer of the Company. At the time of this announcement, Mr. Chu was Chief Executive Officer of OuterLink Corporation, a company that was acquired by Digital Angel Corporation on January 22, 2004. Mr. Chu assumed his duties as Chief Executive Officer of Digital Angel Corporation on November 7, 2003.

Mr. Chu was terminated as Chief Executive Officer of the Company on January 12, 2004. On January 12, 2004, the Company s board of directors appointed Kevin N. McGrath as President and Chief Executive Officer of the Company.

Since we depend heavily on the skills of those persons holding senior management positions, the loss of any senior executive could materially adversely affect our financial results. These senior executives, in many cases, have strong relationships with our customers and suppliers. Therefore, the loss of the services of such senior executives or any general instability in the composition of our senior management could have a negative impact on our relationship with these customers and suppliers. We cannot ensure that we will be able to retain our senior executives and this uncertainty could have a material negative impact on our business.

As of March 31, 2004, our majority stockholder, Applied Digital Solutions, owns 68.5% of our common stock, is able to completely control the board of directors and may support actions that conflict with the interests of the other stockholders.

As of March 31, 2004, Applied Digital Solutions is the beneficial owner of 68.5% of our common stock, and it controls us with respect to all matters upon which our stockholders may vote, including the selection of the Board of Directors, mergers, acquisitions and other significant corporate transactions. There can be no assurance as to how Applied Digital Solutions may support actions that are contrary to or conflict with the interests of the other stockholders.

Our stockholders will experience dilution in the event Laurus Master Fund exercises its right to convert certain debt owed by us into shares of our common stock.

On July 31, 2003, the Company issued to Laurus Master Fund a two-year secured convertible note in the original principal amount of $2,000,000. The secured convertible note is convertible, at Laurus Master Fund s option, into shares of the Company s common stock at a per share price of $2.33. In connection with the issuance of the secured convertible note, we also issued to Laurus Master Fund a five-year warrant to purchase 125,000 shares of our common stock at exercise prices ranging from $2.68 to $3.38 per share. The Company has the ability to prepay the secured convertible note at 110% to 125% of the prepayment amount.

On August 28, 2003, we issued a three-year secured revolving convertible note in the principal amount of $3,500,000 and a three-year secured minimum borrowing convertible note in the principal amount of $1,500,000 to Laurus Master Fund. Beginning May 28, 2004, each of these notes is convertible, at Laurus Master Fund s option, into shares of our common stock at $2.64 per share. In connection with the issuance of these notes, Laurus Master Fund also acquired a five-year warrant to purchase 115,000 shares of our common stock at exercise prices ranging from $2.55 to $2.95 per share. The Company has the ability to prepay the secured minimum convertible note for a 1% to 3% fee.

Our issuance of shares to Laurus Master Fund from any conversion of these notes, or exercise of the warrants may result in substantial dilution to other Digital Angel Corporation stockholders. In addition, Laurus Master Fund may offer and sell any and all of the shares of our common stock received in connection with conversion of the notes, or exercise of the warrants at prices and times to be determined in its sole discretion. There is no independent or third-party underwriter involved in the offering of the shares of our common stock acquired by Laurus Master Fund and there can be no guarantee that any disposition of those shares will be completed in a manner that is not disruptive to the trading market for our common stock.

Our stockholders will experience dilution upon conversion of the Series A Preferred Stock issued by the Company in the OuterLink Corporation acquisition.

On January 22, 2004, the Company acquired OuterLink Corporation of Concord, Massachusetts, in a merger. In connection with the acquisition, Digital Angel Corporation issued 100,000 shares of its Series A Preferred Stock. The Series A Preferred Stock is convertible into four million shares of Digital Angel Corporation common stock when the volume-weighted average price of Digital Angel Corporation s common stock equals or exceeds $4.00 per share for ten consecutive trading days. The issuance of Digital Angel common stock upon conversion of the Series A Preferred Stock issued to the OuterLink stockholders will result in dilution to our current stockholders.

The terms of our debt obligations to Laurus Master Fund subject us to the risk of foreclosure on substantially all of our assets.

We may not have sufficient funds to repay Laurus Master Fund when the obligations on the convertible note, minimum borrowing note and revolving note mature. Accordingly, we may be required to obtain the funds necessary to repay these obligations either through refinancing, the issuance of additional equity or debt securities or the sale of assets. There can be no assurance that we can obtain the funds needed, if any, to repay the obligations from any one or more of these other sources on favorable economic terms or at all. If we are unable to obtain funds to repay this indebtedness, we may be forced to dispose of assets or take other actions on disadvantageous terms, which could result in losses to Digital Angel Corporation and could have a material adverse effect on our financial condition.

To secure the payment of all debts, liabilities and obligations owed to Laurus Master Fund we have granted to Laurus Master Fund a security interest in and lien upon all of our property and assets, whether real or personal, tangible or intangible, whether now owned or hereafter acquired, or in which we now have, or at any time in the future may acquire, any right, title or interest. The occurrence of an event of default under the convertible note, minimum borrowing note or revolving note would subject us to foreclosure by Laurus Master Fund on substantially all of our assets to the extent necessary to repay any amounts due. Any such default and resulting foreclosure will have a material adverse effect on our financial condition.

Our earnings will decline if we write off goodwill and other intangible assets.

As of March 31, 2004, we had recorded goodwill of $48.4 million. On January 1, 2002, we adopted SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 requires that goodwill and certain intangibles no longer be amortized but instead tested for impairment at least annually by applying a fair value based test. During the fourth quarter of 2003, the Company performed the annual impairment test for goodwill using a fair value based approach, primarily discounted cash flows. An evaluation of the Medical Systems reporting unit indicated that $2.4 million of goodwill was impaired. Additionally, management estimated that certain intangible assets at our Medical Systems reporting unit were impaired by $0.6 million. Accordingly, the Company recorded an impairment charge of $3.0 million in the fourth quarter of 2003, which is included in asset impairment in the 2003 statement of operations. During the fourth quarter of 2002, we recorded an impairment charge of $57.4 million for goodwill at our GPS and Radio Communications and Medical Systems reporting units.

We will assess the fair value of our goodwill annually or earlier if events occur or circumstances change that would more likely than not reduce the fair value of our goodwill below its carrying value. These events or circumstances would include a significant change in business climate, including a significant, sustained decline in an entity s market value, legal factors, operating performance indicators, competition, sale or disposition of a significant portion of the business, or other factors. If we determine that significant impairment has occurred, we would be required to write off the impaired portion of goodwill. Impairment charges could have a material adverse effect on our financial condition and results of operations.

The exercise of options and warrants outstanding and available for issuance may adversely affect the market price of our common stock.

As of March 31, 2004, we had 10,102,000 options and 3,029,000 warrants outstanding to purchase from us a total of 13,131,000 shares of common stock at exercise prices ranging from $0.05 to $10.50 per share. In addition, we are requesting our stockholders approve an amendment to one of our stock plans at our May 6, 2004 Annual Meeting which would allow for 4,527,00 additional shares of common stock which may be issued in the future under our stock option plans. The exercise of outstanding options and warrants and the sale in the public market of the shares purchased upon such exercise may adversely affect the market price of our common stock.

We may continue to incur losses.

We incurred a net loss of $3.7 million for the quarter ended March 31, 2004. We also recorded a net loss of $9.5 million, $92.4 million and $17.4 million for the years ended December 31, 2003, 2002 and 2001, respectively. Included in the $92.4 million loss for the year ended December 31, 2002 is a goodwill impairment charge of $57.4 million, an asset impairment charge of $6.4 million, and a $18.7 million charge arising from the remeasurement of options in connection with the 2002 merger. No assurance can be given as to whether we will achieve profitability, if at all. Profitability depends on many factors, including the success of marketing programs, the maintenance and reduction of expenses, and the ability to coordinate successfully the operations of our business units. If we fail to achieve and maintain sufficient profitability within the time frame expected by investors, the market price of our common stock may be adversely affected.

The Digital Angel™ technology is not proven, and we may not be able to develop products from this unproven technology.

We have invested approximately $15.6 million in the Digital Angel™ technology for the period from April 1998 through March 31, 2004. The Digital Angel™ technology depends on the development, integration, miniaturization and successful marketing of several advanced technologies that have not previously been integrated or used. The Digital Angel™ technology depends upon advanced technology, including wireless communication, biosensors, motion determination and global positioning system capabilities. Many of these technologies are unproven or relatively new. The Digital Angel technology continues to be in the development stage and the Company is uncertain when this technology will be incorporated into any products. This technology has not generated any significant revenue through March 31, 2004. No assurances can be given as to when or if a Digital Angel™ technology will be successfully marketed. Our ability to develop and commercialize products based on our proprietary technology will depend on our ability to develop products internally on a timely basis or to enter into arrangements with third parties to provide these functions. Our failure to develop and commercialize products successfully could have a material adverse effect on our financial condition and results of operations.

Infringement by third parties on our intellectual property or development of substantially equivalent proprietary technology by our competitors could negatively affect our business.

Our success depends significantly on our ability to maintain patent and trade secret protection, to obtain future patents and licenses, and to operate without infringing on the proprietary rights of third parties. There can be no assurance that the measures we have taken to protect our intellectual property will prevent its misappropriation or circumvention of our intellectual property. In addition, there can be no assurance that any patent application, when filed, will result in an issued patent, or that our existing patents, or any patents that may be issued in the future, will provide us with significant protection against competitors. Moreover, there can be no assurance that any patents issued to or licensed by us will not be infringed upon or circumvented by others. Litigation to establish the validity of patents, to assert infringement claims against others, and to defend against patent infringement claims can be expensive and time-consuming, even if the outcome is in our favor. We also rely to a lesser extent on unpatented proprietary technology, and no assurance can be given that others will not independently develop substantially equivalent proprietary information, techniques or processes or that we can meaningfully protect our rights to such unpatented proprietary technology. Infringement on our intellectual property or the development of substantially equivalent technology by our competitors could have a material adverse effect on our business.

Domestic and foreign government regulation and other factors could impair our ability to develop and sell our products in certain markets.

The electronic animal identification market can be negatively affected by such factors as food safety concerns, consumer perceptions regarding cost and efficacy, international technology standards, national infrastructures, and slaughterhouse removal of microchips.

We are also subject to federal, state and local regulation in the United States, including regulation by the FDA, FCC and the USDA, and in other countries. We cannot predict the extent to which we may be affected by further legislative and regulatory developments concerning our products and markets. We are required to obtain regulatory approval before marketing most of our products. The regulatory process can be very time-consuming and costly, and there is no assurance that we will receive the regulatory approvals necessary to sell our products under development. Regulatory authorities also have the authority to revoke approval of previously approved products for cause, to request recalls of products and to close manufacturing plants in response to violations. Any such regulatory action, including the failure to obtain such approval, could prevent us from selling, or materially impair our ability to sell, our products in certain markets and could negatively affect our business.

We rely heavily on sales to government contractors of our animal identification products, and any decline in the demand by these customers for our products could negatively affect our business.

The principal customers for electronic identification devices for fish are government contractors that rely on funding from the United States government. Since these contractors rely heavily on government funds, any decline in the availability of such funds could result in a decreased demand by these contractors for our products. Any decrease in demand by such customers could have a material adverse effect on our financial condition and results of operations and result in a decline in the market value of our common stock.

We depend on a single production arrangement with Raytheon Microelectronics Espana, SA for our patented syringe-injectable microchips, and the loss of or any significant reduction in the production could have an adverse effect on our business.

We rely solely on a production arrangement with Raytheon Microelectronics Espana, SA for the manufacture of our patented syringe-injectable microchips that are used in all of our implantable electronic identification products. In addition, we have no formal written agreement with Raytheon for the production of our microchips. Raytheon utilizes our proprietary technology and our equipment in the production of our syringe-injectable microchips. The termination, or any significant reduction, by Raytheon of the assembly of our microchips or a material increase in the price charged by Raytheon for the assembly of our microchips could have an adverse effect on our financial condition and results of operations. In addition, Raytheon may not be able to produce sufficient quantities of the microchips to meet any significant increased demand for our products or to meet any such demand on a timely basis. Any inability or unwillingness of Raytheon to meet our demand for microchips would require us to utilize an alternative production arrangement and remove our automated assembly production machinery from the Raytheon facility, which would be costly and could delay production. Moreover, if Raytheon terminates our production arrangement, we cannot ensure that the assembly of our microchips from another source would be on comparable or acceptable terms. The failure to make such an alternative production arrangement could have an adverse effect on our business.

We depend on principal customers.

For the quarter ended March 31, 2004, we had one customer which accounted for 12.6% of our consolidated revenue. Our four largest customers, in aggregate, accounted for 33.0% of our consolidated revenue in the quarter ended March 31, 2004. Our subsidiary, Signature Industries, Ltd. is heavily dependent on contracts with domestic government agencies and foreign governments, including the United Kingdom, primarily relating to military applications. The loss of, or a significant reduction in, orders from these or our other major customers could have a material adverse effect on our financial condition and results of operations.

We compete with other companies in the visual and electronic identification market, and the products sold by our competitors could become more popular than our products or render our products obsolete.

The market for visual and electronic identification products is highly competitive. We believe that our principal competitors in the visual identification market for livestock are AllFlex USA and Y-Tex Corporation and that our principal competitors in the electronic identification market are AllFlex USA, Datamars SA and Avid Identification Systems, Inc..

In addition, other companies could enter this line of business in the future. Certain of our competitors have substantially greater financial and other resources than us. We may not be able to compete successfully with these competitors, and those competitors may develop or market technologies and products that are more widely accepted than ours or that would render our products obsolete or noncompetitive.

Currency exchange rate fluctuations could have an adverse effect on our sales and financial results.

We generate a portion of our sales and incur a portion of our expenses in currencies other than U.S. dollars. To the extent that we are unable to match revenues received in foreign currencies with costs paid in the same currency, exchange rate fluctuations in any such currency could have an adverse effect on our financial results.

We depend on a small team of senior management, and we may have difficulty attracting and retaining additional personnel.

Our future success will depend in large part upon the continued services and performance of senior management and other key personnel. If we lose the services of any member of our senior management team, our overall operations could be materially and adversely affected. In addition, our future success will depend on our ability to identify, attract, hire, train, retain and motivate other highly skilled technical, managerial, marketing, purchasing and customer service personnel when they are needed. Competition for these individuals is intense. We cannot ensure that we will be able to successfully attract, integrate or retain sufficiently qualified personnel when the need arises. Any failure to attract and retain the necessary technical, managerial, marketing, purchasing and customer service personnel could have a material adverse effect on our financial condition and results of operations.

IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

In June 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 requires recording costs associated with exit or disposal activities at their fair values when a liability has been incurred. Under previous guidance, certain exit costs were accrued upon management s commitment to an exit plan. The Company adopted SFAS No. 146 on January 1, 2003. The adoption of SFAS No. 146 did not have a material impact on the results of operations or financial position.

Effective January 1, 2003, the Company adopted the recognition and measurement provisions of FASB Interpretation No. 45 (Interpretation 45), Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. This interpretation elaborates on the disclosures to be made by a guarantor in interim and annual financial statements about the obligations under certain guarantees. Interpretation 45 also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The initial recognition and initial measurement provisions of this interpretation are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The Company does not currently provide significant guarantees on a routine basis. As a result, this interpretation has not had a material impact on the Company s financial statements.

In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003) (Interpretation 46), Consolidation of Variable Interest Entities. Application of this interpretation is required in the Company s financial statements for interests in variable interest entities that are considered to be special-purpose entities for the year ended December 31, 2003. The Company determined that it does not have any arrangements or relationships with special-purpose entities.

Interpretation 46 addresses the consolidation of business enterprises to which the usual condition (ownership of a majority voting interest) of consolidation does not apply. This interpretation focuses on controlling financial interests that may be achieved through arrangements that do not involve voting interests. It concludes that in the absence of clear control through voting interests, a company s exposure (variable interest) to the economic risks and potential rewards from the variable interest entity s assets and activities are the best evidence of control. If an enterprise holds a majority of the variable interests of an entity, it would be considered the primary beneficiary. The primary beneficiary is required to include assets, liabilities and the results of operations of the variable interest entity in its financial statements. The adoption of FIN 46 did not have an impact on the financial position or operations of the Company.

In May 2003, the FASB issued SFAS 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity (SFAS No. 150). SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. It is to be implemented by reporting the cumulative effect of a change in accounting principle for financial instruments created before the issuance date of the statement and still existing at the beginning of the interim period of adoption. Restatement is not permitted. The Company adopted the provisions of SFAS No.150 effective July 1, 2003. The adoption of SFAS No. 150 did not have an impact on the Company s financial position or results of operations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We have operations and sales in various regions of the world. Additionally, we may export and import to and from other countries. Our operations may therefore be subject to volatility because of currency fluctuations, inflation, and changes in political and economic conditions in these countries. Sales and expenses may be denominated in local currencies and may be affected as currency fluctuations affect our product prices and operating costs or those of our competitors.

We presently do not use any derivative financial instruments to hedge our exposure to adverse fluctuations in interest rates, foreign exchange rates, fluctuations in commodity prices or other market risks, nor do we invest in speculative financial instruments.

Due to the nature of our borrowings and our short-term investments, we have concluded that there is no material market risk exposure and, therefore, no quantitative tabular disclosures are required.

Item 4. Controls and Procedures

Within the 90 days prior to the date of this report, the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures pursuant to Exchange Act Rule 13a-14 under the Securities Exchange Act of 1934. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company s periodic SEC filings with the Securities and Exchange Commission. Since the date of their evaluation, there have been no significant changes in our internal controls or in other factors that could significantly affect the Company s internal controls.

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

Wurts Litigation

In February 2003, an action was filed in the Middlesex County Superior Court in the Commonwealth of Massachusetts. Our subsidiary, OuterLink Corporation, as well as a significant stockholder of OuterLink and a principal of the significant stockholder are named as defendants. Such principal was a director of OuterLink. The complaint alleged breach of an August 25, 1999 employment contract. The plaintiff was President and CEO of OuterLink Corporation from July 1999 through August 2002. The Complaint seeks damages based principally on a contractual severance provision that allegedly provided for four months of compensation for every year or fraction thereof served prior to termination. At the time of termination, the complaint alleges that the plaintiff s salary was $250,000 per year. The defendants answered denying all liability and counterclaimed. Discovery will be completed in this matter shortly and the Defendants intend to vigorously defend this matter and pursue their counterclaims. The ultimate outcome of this proceeding cannot be predicted at this time and we are currently unable to determine the potential effect of this litigation on our consolidated financial position, results of operation or cash flows.

E-Research Litigation

In June 2002, eResearch Technology, Inc. f/k/a Premier Research Worldwide, Ltd. (ERT) commenced a proceeding against U.S. Bank National Association, subsequently intervened in by us in the New Jersey state court and subsequently removed to the United States District Court for the District of New Jersey. This suit was commenced to pursue alleged damages of approximately $350,000 due to the Company s and US Bank s alleged failure to register transfers of restricted Digital Angel shares sold by ERT in May 2002. The Company has agreed to indemnify US Bank for all damages and reasonable costs relating to this litigation. We asserted a counterclaim against ERT based on ERT s breach of a license agreement and services agreements between the parties that resulted in the original issuance by us of 550,000 restricted common shares to ERT. The damages to us exceed $4 million and this amount does not include the share of profits which we seek to recover had ERT not breached the agreements. Further, the alleged damages sought by the plaintiff in this matter do not take into account plaintiff s duty to mitigate damages which if discharged would have resulted in a profit to ERT. The ultimate outcome of this proceeding cannot be predicted at this time and we are is currently unable to determine the potential effect of this litigation on our consolidated financial position, results of operation or cash flows.

Electronic Identification Devices Litigation

In February 2004, Electronic Identification Devices, Ltd. (EID) commenced a Declaratory Judgment Action against us in the United States District Court for the Western District of Texas. This action seeks a declaration of patent non-infringement relating to our syringe implantable identification transponders. The lawsuit alleges that EID has developed a new transponder that it believes does not infringe on our patent. The lawsuit acknowledges that we obtained a Judgment of infringement and two Contempt Orders against EID based on selling certain systems that infringed our patent in 1997, 1998 and 1999. On March 10, 2004 the Company filed a motion seeking the dismissal of the Declaratory Judgment Complaint or, in the alternative, that the action be transferred to Minnesota. The Court has not yet ruled on the Company s motion. Given the very early stage of this matter, the ultimate outcome of this proceeding cannot be predicted at this time. We are currently unable to determine the potential effect of this litigation on its consolidated financial position, results of operation or cash flows.

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

On March 1, 2004, the Company issued 3,000,000 unregistered shares of its common stock, $0.005 par value, to its majority shareholder, Applied Digital Solutions, Inc. pursuant to a previously announced transaction. The Company exchanged 3,000,000 shares of its common stock, $0.005 par value, for 1,980,000 shares of Applied Digital Solutions, Inc. common stock, $0.01 par value. The shares received from Applied Digital Solutions, Inc. were registered with the Securities and Exchange Commission pursuant to a registration statement on Form S-1 that was declared effective February 17, 2004. As reported in this Form 10-Q, the Company expects to sell the shares received and apply the proceeds to general working capital. As of the date hereof, the Company has sold 910,350 shares in normal agency transactions at market through a registered broker-dealer and received net proceeds of $2.6 million.

Item 6. Exhibits and Reports on Form 8-K.

(a) Exhibits

The following exhibits are hereby incorporated into this Quarterly Report on Form 10-Q by reference to the reports and schedules identified below filed with the Securities and Exchange Commission (Commission):

3.1 Amended and Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to Amendment No. 1 to our Registration Statement on Form S-3 (No. 333-110817) filed on January 23, 2004)

3.2 Bylaws (incorporated by reference to Exhibit 3.2 to Amendment No. 1 to our Registration Statement on Form S-3 (No. 333-110817) filed on January 23, 2004)

The following exhibits are filed with this Quarterly Report on Form 10-Q:

31.1 Certification of Chief Executive Officer under Rules 13a-14(a)/15d-14(a) under the Securities and Exchange Act and Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer under Rules 13a-14(a)/15d-14(a) under the Securities and Exchange Act and Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

During the three months ended March 31, 2004, the Company filed the following Current Reports on Form 8-K:

(i) On March 15, 2004 the Company filed a Current Report on Form 8-K dated March 15, 2004 to report its financial results for the year ended December 31, 2004.

(ii) On March 8, 2004 the Company filed a Current Report on Form 8-K dated March 3, 2004 to report the resignation of Richard J. Sullivan from the Company s Board of Directors.

(iii) On February 3, 2004 the Company filed a Current Report on Form 8-K dated January 27, 2004 to report the appointment of John R. Block to the Company s Board of Directors.

(iv) On January 23, 2004 the Company filed a Current Report on Form 8-K dated January 22, 2004 to announce the completion of the OuterLink Corporation acquisition.

(v) On January 15, 2004 the Company filed a Current Report on Form 8-K dated January 15, 2004 to announcing the appointment of Kevin N. McGrath as President and Chief Executive Officer

SIGNATURE

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.

	DIGITAL ANGEL CORPORATION (Registrant)	
Dated: May 3, 2004	By:	/S/ JAMES P. SANTELLI James P. Santelli Vice President - Finance and Chief Financial Officer