DIGITAL ANGEL CORP
Form 10-K
March 08, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2005

OR

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 (State or other jurisdiction of incorporation or organization)	**52-1233960** (I.R.S. Employer Identification No.)
490 Villaume Avenue, South St. Paul, MN (Address of principal executive offices)	**55075** (Zip Code)

(651) 455-1621

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $.005 par value per share	**American Stock Exchange**

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes o No ý

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ý No o

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. Large accelerated filer o

Accelerated filer o Non-accelerated filer ý

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No ý

As of June 30, 2005, the aggregate market value of the registrant s common stock held by non-affiliates of the registrant was $73,931,436 based on the closing sale price as reported on the American Stock Exchange.

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at March 1, 2006**
Common Stock, $.005 par value per share	43,847,314 shares

DOCUMENTS INCORPORATED BY REFERENCE

Document		**Parts Into Which Incorporated**
Proxy Statement for the Annual Meeting of Stockholders to be held May 4, 2005	Part III	

DIGITAL ANGEL CORPORATION

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PART I

Item 1. Business

References in this Form 10-K to we, us, our, our company, and Digital Angel Corporation mean Digital Angel Corporation and our subsidia unless the context otherwise requires.

Overview

We were incorporated in Delaware on December 1, 1981 as Medical Advisory Systems, Inc. to provide medical assistance and technical products and services. On March 27, 2002, we completed a merger pursuant to which the former Digital Angel Corporation became a wholly-owned subsidiary of Medical Advisory Systems and was renamed Digital Angel Technology Corporation, and Medical Advisory Systems was renamed Digital Angel Corporation. In connection with the merger, Applied Digital Solutions, Inc. contributed to Medical Advisory Systems all of its stock in Timely Technology, a wholly-owned subsidiary, and Signature Industries Limited, then an 85.0%-owned subsidiary. These two subsidiaries, along with Digital Angel Corporation, comprised Applied Digital s Advanced Wireless Group (AWG). As a result of this contribution, Timely Technology became a wholly-owned subsidiary of Digital Angel Corporation and Signature Industries Limited became an 85.0%-owned subsidiary. In 2004, Applied Digital, pursuant to the contractual agreement with the sellers of Signature Industries Limited, received an additional 5.9% interest in Signature Industries Limited for no additional consideration. Applied Digital contributed this interest to the Company. Further, on January 22, 2004 and February 28, 2005, we acquired our wholly-owned subsidiaries, OuterLink Corporation and DSD Holdings A/S, respectively. As of March 1, 2006, Applied Digital owns 24,291,673 shares (or 55.4%) of our outstanding shares of common stock and we own 90.9% of Signature Industries Limited.

Our corporate headquarters are located at 490 Villaume Avenue, South St. Paul, MN 55075. Our telephone number is 651-455-1621. Our corporate website is www.digitalangelcorp.com. Copies of our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13 (a) or 15 (d) of the Securities and Exchange Act of 1934 are available free of charge on our website as soon as reasonably practicable after such materials are filed with the Securities and Exchange Commission.

We presently operate two business segments: Animal Applications and GPS and Radio Communications.

Animal Applications

Our Animal Applications segment develops, manufactures and markets electronic radio frequency and visual identification devices for the companion animal, fish and wildlife, and livestock markets worldwide.

The Animal Applications segment s radio frequency identification products consist of miniature electronic microchips, scanners and for some applications, injection systems. We hold patents on our syringe-injectable microchip, which is encased in a glass or glass-like material capsule and incorporates an antenna and a microchip with a unique permanent identification code. The injectable microchip is typically injected under the skin using a hypodermic syringe, without requiring surgery. An associated scanner device uses radio frequency to interrogate the microchip and read the identification code.

The Animal Applications segment s pet identification system involves the insertion of a microchip with identifying information in the animal. Scanners at animal shelters, veterinary clinics and other locations can read the microchip s unique identification number. Through the use of a database, the unique identification number identifies the animal, the animal s owner and other information. This pet identification system is marketed in the United States pursuant to a multi-year exclusive license by Schering-Plough Animal Health Corporation under the brand name Home Again , in Europe by Merial Pharmaceutical, and in Japan by Dainippon Pharmaceutical. We have distribution agreements with a variety of other companies outside the United States to market our products. We also have an established infrastructure with scanners placed in approximately 75,000 global animal shelters and veterinary clinics. Over 3 million companion animals have been enrolled in the database in the United States, and a pet is recovered approximately every six minutes.

The Animal Applications segment s miniature electronic microchips are also used for the tagging of fish, especially salmon, for identification in migratory studies and other purposes. The electronic microchips are accepted as a safe, reliable alternative to traditional identification methods because the fish can be identified without capturing or sacrificing the fish. Our fisheries business is conducted both through direct contracts with government agencies and through distributors.

In addition to pursuing the market for permanent identification of companion animals and tracking microchips for fish, the Animal Applications segment also produces visual and electronic identification products for livestock producers. The positive identification and tracking of cattle and hogs are crucial for asset management, disease control and food safety. Visual identification products for livestock typically include numbered ear tags which we have marketed since the 1940s under, among other names, the

Destron Fearing name. Currently, sales of visual identification products represent a substantial percentage of our sales to livestock producers. However, the use of electronic identification products by livestock producers has been steadily increasing, and we expect the trend toward electronic identification products to continue. Our livestock products are distributed though direct sales as well as through a variety of third party distributors.

In addition, the Company s implantable radio frequency microchip was cleared by the Food and Drug Administration (FDA) for medical applications in humans in the United States in October 2004. The Company has a long-term exclusive distribution and licensing agreement with Verichip Corporation, a wholly-owned subsidiary of Applied Digital, covering the manufacturing, purchasing and distribution of the implantable microchip. Sales to Verichip Corporation were $0.7 million, $0.1 million, and $0.5 million in the years ended December 31, 2005, 2004 and 2003, respectively.

On February 28, 2005, the Company acquired Denmark-based DSD Holdings A/S and its wholly-owned subsidiaries Daploma International A/S and Digital A/S. DSD Holdings A/S became a wholly-owned subsidiary of Digital Angel Corporation. DSD Holdings A/S produces visual and radio frequency identification tags. DSD Holdings A/S s operations are included from the date of acquisition.

During 2005 the Company formed subsidiaries in Argentina and Brazil for development of the livestock market in Latin America.

In the year ended December 31, 2005, the Animal Applications segment represented 63.3% of our consolidated revenue.

GPS and Radio Communications

The GPS and Radio Communications segment includes the operations of OuterLink Corporation, located in Massachusetts, and Signature Industries Limited, located in the United Kingdom. This segment primarily 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, aircraft and people in remote locations through systems that integrate 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.

Technology development in this segment includes the integration and miniaturization into marketable products of two technologies: wireless communications and position location technology (including GPS and other systems). Signature Industries businesses also include high grade communication equipment leasing and complementary data systems that customers can use to monitor their assets and alarm sounder manufacturing.

In the year ended December 31, 2005, our GPS and Radio Communications segment represented 36.7% of our consolidated revenue.

Medical Systems

We sold substantially all of the assets of our Medical Systems segment in 2004. We no longer operate or own any of this business segment s assets. This segment consisted of a staff of logistics specialists and physicians operating from our medical telecommunications response center that provided medical assistance services and interactive medical information services to people traveling anywhere in the world, 24 hours per day, 7 days per week. Services included coordination of medical care, provision of general medical information, physician consultation, translation assistance, claims handling and cost containment on behalf of assistance companies, insurance companies or managed care organizations. This segment also sold a variety of kits containing pharmaceutical and medical supplies.

Financial Information About Segments

Revenues from our various segments over the prior three years can be broken down as follows, excluding revenue from our discontinued Medical Systems segment:

	For the Years Ended December 31,		
(In thousands)	**2005**	**2004**	**2003**
Animal Applications	$ 35,972	$ 25,871	$ 23,948
GPS and Radio Communications	20,854	20,431	10,484

Refer to the segment information in Note 20 and discontinued operations information in Note 12 to our Financial Statements.

Competition

Principal methods of competition in all of our segments include geographic coverage, service and product performance.

Animal Applications

The animal identification market is highly competitive. The principal competitors in the U.S. visual identification market are AllFlex USA, Inc., Y-Tex Corporation and The Farnum Companies, and the principal competitors in the electronic identification market are AllFlex, USA, Inc., Datamars SA and Avid Identification Systems, Inc. We believe that our strong intellectual property position and our reputation for high quality products are our competitive advantages.

The principal competitors for our European subsidiary, DSD Holdings, are Allflex and Merko. We believe that our efficient low cost production, reputation for high quality ear tags and our clear focus on the market are our competitive advantages in this market.

GPS and Radio Communications

The principal competitors for our subsidiary, Signature Industries Limited, are Boeing North American Inc., General Dynamics Decision Systems, Tadiran Spectralink Ltd., Becker Avionic Systems, and ACR Electronics, Inc. We believe that being first to market with GPS in our search and rescue beacons and the use of our search and rescue beacons in over forty countries are competitive advantages. In addition, the barriers to entry in this market are high due to the technical demands of the market.

The principal competitors for our subsidiary, OuterLink, are Blue Sky Networks, Sky Connect and Comtech Mobile Data Com. We believe our competitive advantages are lower cost communications, more frequent reporting on a near real time basis and the ability to provide additional messaging capabilities in addition to vehicle tracking.

Raw Materials

We did not experience any significant or unusual problems in the purchase of raw materials or commodities during the past three years. We depend on a single production arrangement with a Raytheon Microelectronics Espana, SA (Raytheon) for the manufacture of our patented syringe-injectable microchips that are used in our implantable electronic identification products. If Raytheon terminates our production arrangement, we would need to relocate our production equipment from Raytheon s facility. While we are dependent, in certain situations, on a limited number of vendors to provide certain raw materials and components, during the recent past, we have not experienced significant problems or issues procuring any essential materials, parts or components.

Patents and Trademarks

We own various patents and trademarks which we consider in the aggregate to constitute a valuable asset. We consider several of our patents offer a significant competitive advantage and/or barriers to entry in the Animal Applications segments.

Backlog

We generally produce goods to fill orders received and anticipated orders based on distributors forecasts, and we also maintain inventories of finished goods to fill customer orders with short lead times. As a result, we generally do not have a significant backlog of orders, and any such backlog is not indicative of future sales.

Research and Development

During 2005, we spent $4.7 million ($3.0 million in the Animal Applications segment and $1.7 million in the GPS and Radio Communications segment) on research and development activities relating to the development of new products or improvements of existing products. We spent $2.8 million ($2.2 million in the Animal Applications segment and $0.6 million in the GPS and Radio Communications segment) in 2004 and $4.9 million in 2003 ($3.0 million in the Animal Applications segment and $1.9 million in the GPS and Radio Communications segment) on research and development activities.

Environmental Matters

We do not anticipate any material effect on our capital expenditures, earnings or competitive position due to compliance with government regulations involving environmental matters.

Seasonality and Reliance on Principal Customers

Our Animal Applications segment s revenues and operating income can be affected by the timing of animal reproduction cycles. Our other business segments are not considered to be seasonal. The sales of products manufactured by our GPS and Radio Communications segment, while not seasonal, vary significantly based on government procurement cycles and technological development.

For the year ended December 31, 2005, we had one customer, Schering Plough Animal Health, Inc. which accounted for 10% of our consolidated revenues. The loss of, or a significant reduction in, orders from this customer could have a material adverse effect on our financial condition and results of operations.

Government Agreements

Customers for our electronic identification devices for fish include 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. The GPS and Radio Communications segment 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.

Employees

As of March 1, 2006 we have 307 full time employees, including 11 in management, 20 in sales positions, 64 in administrative positions, 24 in technical positions and 188 in production positions. Our Animal Applications production workforce is party to a collective bargaining agreement which expires May 31, 2008. We believe our relations with our employees are good.

Government Regulation

We are subject to federal, state and local regulation in the United States, including the U.S. Food and Drug Administration (FDA), the U.S. Department of Agriculture (USDA) and the U.S. Federal Communications Commission (FCC). We are also subject to regulation by government entities in other countries.

United States Regulation

Animal products for food producing animals have been reviewed by the FDA s Center for Veterinary Medicine, and the FDA has determined that our product, as presently configured, is unregulated. Our products coated with insecticide require approval by the United States Environmental Protection Agency, which has been obtained. In October 2004, the FDA issued a letter stating that our product, Verichip ™, a radio frequency microchip for human use, had been cleared for medical applications in the United States.

The USDA is involved in the development and implementation of a planned National Animal Identification System (NAIS) as well as in the regulation of certain aspects of the companion animal business. While the regulations governing these activities are not yet finalized, such regulations could have a material impact on our operations in the livestock and companion animal markets.

The Company is subject to periodic inspections by the FDA, whose primary purpose is to audit the Company s compliance with quality system regulations established by the FDA. Regulatory action may be initiated in response to audit deficiencies or to address performance problems. The Company believes that its manufacturing and quality control procedures are in compliance with the requirements of the FDA regulations.

We are licensed by the FCC to transmit at specified frequencies on satellites. Our aviation equipment must meet the approval of the Federal Aviation Authority and Transport Canada for manufacturing, installation and repair.

Regulation Abroad

Our products are subject to compliance with applicable regulatory requirements in those foreign countries where our products are sold. The contracts we maintain with our distributors in these foreign countries generally require the distributor to obtain all necessary regulatory approvals from the governments of the countries in which these distributors sell our products.

Financial Information About Geographic Areas

Information concerning principal geographic areas as of and for the years ended December 31, 2005, 2004 and 2003 was as follows:

(In thousands)	United States	United Kingdom/Denmark	All Other Foreign Countries	Consolidated
2005				
Net revenue from external customers	$ 37,813	$ 5,108	$ 13,905	$ 56,826
Long-lived assets excluding goodwill and other intangible assets, net	4,508	3,824	270	8,602
2004				
Net revenue from external customers	$ 29,743	$ 4,369	$ 12,190	$ 46,302
Long-lived assets excluding goodwill and other intangible assets, net	4,569	1,101	277	5,947
2003				
Net revenue from external customers	$ 26,828	$ 3,367	$ 4,237	$ 34,432
Long-lived assets excluding goodwill and other intangible assets, net	5,150	1,115	263	6,528

Item 1A. **Risk Factors**

Forward-Looking Statements and Associated Risks

We make written and oral statements from time to time regarding our business and prospects, such as projections of future performance, statements of management s plans and objectives, forecasts of market trends, and other matters that are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21F of the Securities Exchange Act of 1934, as amended. Statements containing the words or phrases *will likely result, are expected to, will continue, is anticipated, estimates, projects, believes, expects, anticipates, intends, target, goal, plans, objective, should* or similar expressions identify forward-looking statements, which may appear in documents, reports, filings with the Securities and Exchange Commission, news releases, written or oral presentations made by officers or other representatives made by us to analysts, stockholders, investors, news organizations and others, and discussions with management and other representatives of us. For such statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

Our future results, including results related to forward-looking statements, involve a number of risks and uncertainties. No assurance can be given that the results reflected in any forward-looking statements will be achieved. Any forward-looking statement made by or on behalf of us speaks only as of the date on which such statement is made. Our forward-looking statements are based on assumptions that are sometimes based upon estimates, data, communications and other information from suppliers, government agencies and other sources that may be subject to revision. Except as required by law, we do not undertake any obligation to update or keep current either (i) any forward-looking statement to reflect events or circumstances arising after the date of such statement, or (ii) the important factors that could cause our future results to differ materially from historical results or trends, results anticipated or planned by us, or which are reflected from time to time in any forward-looking statement which may be made by or on behalf of us.

In addition to other matters identified or described by us from time to time in filings with the SEC, there are several important factors that could cause our future results to differ materially from historical results or trends, results anticipated or planned by us, or results that are reflected from time to time in any forward-looking statement that may be made by or on behalf of us. Some of these important factors, but not necessarily all important factors, include the following:

As of March 1, 2006, Applied Digital Solutions, Inc. owns 55.4% of our common stock.

As of March 1, 2006, Applied Digital Solutions, Inc. (NASDAQ CM: ADSX) is the beneficial owner of 55.4% 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.

As the Company is controlled by Applied Digital Solutions, Inc., the Company is not required to comply with certain rules and requirements of the American Stock Exchange (AMEX Rules). Specifically, the Company is not required to have a majority of independent directors or a Nominating Committee. Instead, its full Board of Directors considers and nominates candidates proposed for election. Therefore, certain independence protections provided by the AMEX Rules are not currently in place.

New accounting pronouncements regarding expensing of share based compensation may impact our future results of operations

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment. The provisions of SFAS 123R became effective for the Company beginning January 1, 2006. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. All of the Company s out-of-the-money, unvested stock options issued to current employees, officers and directors prior to November 15, 2005 vested on December 30, 2005, and, therefore, we do not expect that the initial adoption of SFAS 123R will have a material impact on our consolidated results of operations and earnings (loss) per share. However, going forward, as we grant more options or other share based compensation to our employees, we expect that the impact may be material.

We may continue to incur net losses.

We incurred a net loss of $9.5 million for the year ended December 31, 2005. We also incurred a net loss of $5.0 million and $9.5 million for the years ended December 31, 2004 and 2003, respectively. No assurance can be given as to whether we will be profitable in future periods. 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.

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, which is often uncertain, 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, price, consumer perceptions regarding cost and efficacy, international technology standards, government regulation, and slaughterhouse removal of microchips.

The USDA is involved in the development and implementation of a planned National Animal Identification System (NAIS) as well as in the regulation of certain aspects of the companion animal business. While the regulations governing these activities are not yet finalized, such regulations could have a material impact on our operations in the livestock and companion animal markets.

We are also subject to federal, state and local regulation in the United States, including regulation by the FDA, FCC and the USDA, and similar regulatory bodies 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 on sales to government contractors of our animal identification and search and rescue beacon products, and any decline or delay in the demand by these customers for our products could negatively affect our business.

Certain 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 or delay 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 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 on a sole production arrangement with Raytheon Microelectronics Espana, SA (Raytheon) for the manufacture of our patented syringe-injectable microchips that are used in all of our implantable electronic identification products. 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 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 potentially remove our automated assembly production machinery from the Raytheon facility, which would be costly and could delay production. Moreover, if Raytheon terminated the production arrangement, we may be required to relocate our production equipment from Raytheon s facility. If we were required to move the production equipment, 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.

Technological change could cause our products and technology to become obsolete or require us to redesign our products, which could have a material adverse effect on our business.

Technological changes within the industries that we conduct business may require us to expend substantial resources in an effort to develop new products and technology. We may not be able to anticipate or respond to technological changes in a timely manner, and our response may not result in successful product development and timely product introductions. If we are unable to anticipate or respond to technological changes, our business could be adversely affected.

Loss of our principal customers could negatively affect our net revenue.

For the year ended December 31, 2005, we had one customer, Schering Plough Animal Health, Inc., which accounted for 10% of our consolidated revenues. The GPS and Radio Communications segment 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 this 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 and pilot locator beacon markets, and the products sold by our competitors could become more popular than our products or render our products obsolete.

The markets for visual and electronic identification and pilot locator beacon products are highly competitive. We believe that our principal competitors in the visual identification market for livestock are AllFlex USA and Y-Tex Corporation, that our principal competitors in the electronic identification market are AllFlex USA, Datamars SA and Avid Identification Systems, Inc. and that our principal competitors in the pilot locator beacon market are Boeing North American Inc., General Dynamics Decision Systems, Tadiran Spectralink Ltd., Becker Avionic Systems and ACR Electronics, 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.

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

As of December 31, 2005, we had recorded goodwill of $48.5 million. On January 1, 2002, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 requires that goodwill and certain intangibles no longer be amortized but instead be tested for impairment at least annually by applying a fair value based test. There was no impairment of goodwill upon the adoption of SFAS 142 on January 1, 2002. Based upon the Company s annual review for impairment, the Company recorded an impairment charge of $7.1 million in the fourth quarter of 2005. The impairment charge related to $3.8 million of goodwill and $3.3 million of intangible assets at our OuterLink Corporation reporting unit. The Company recorded impairment charges of $0, $3.0 million and $57.4 million in the fourth quarters of 2004, 2003, and 2002, respectively (of which $3.0 million and $25.9 million in 2003 and 2002, respectively, related to our Medical Systems segment and are included in discontinued operations).

We 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 reported net income.

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

As of March 1, 2006, we had 9,955,000 options and 530,000 warrants outstanding to purchase from us a total of 10,485,000 shares of common stock at exercise prices ranging from $0.05 to $10.50 per share. As of March 1, 2006, the weighted average exercise price of the options and warrants outstanding was $3.94. 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.

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

In 2005, we generated approximately 40% of our sales and incurred 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 certain members 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.

Item 1(B). Unresolved Staff Comments

None

Item 2. Properties

We own a 79,692 square foot (gross building area) masonry and steel industrial two-building complex located in South St. Paul, Minnesota that is currently occupied by the Animal Application segment s administrative, sales, engineering and manufacturing operations. The buildings have 6,000 square feet of office area, nine loading docks, one drive in door and 13 to 16 foot clear ceilings. The property is encumbered by a mortgage in the aggregate principal amount of $2.2 million.

We lease 2,600 square feet in an office building located in Delray Beach, Florida. The lease expires in January 2011.

Our subsidiary DSD Holdings A/S leases a 13,600 square foot building located in Hvidovre, Denmark. The building is occupied by DSD Holdings administrative and production operations. The lease agreement has no expiration but includes a three month termination notice that can be utilized by the owner or DSD Holdings A/S. DSD Holdings A/S leases the building from LANO Holding ApS. LANO Holding Aps is 100% owned by Lasse Nordfjeld, DSD Holdings CEO. In addition, DSD Holdings leases a 1,900 square foot building in Warsaw, Poland. The lease agreement has no expiration but includes a one month termination notice that can be utilized by the owner or DSD.

Our subsidiary Signature Industries Limited leases, under a long-term lease expiring September, 2042, a 60,000 square foot building located in Thamesmead, London that is currently occupied by administrative, sales, engineering and manufacturing personnel. In addition, this subsidiary leases three single-story buildings totaling 5,400 square feet within a small industrial estate in Springburn, Glasgow for repair and servicing operations.

Our subsidiary OuterLink Corporation leases 5,400 square feet in an office building located in Lowell, Massachusetts. The lease expires on July 31, 2009 with no renewal options.

We consider our properties to be suitable and adequate for their present purposes, well maintained and in good operating condition.

Item 3. Legal Proceedings

Refer to legal proceedings discussion in Note 18 to our Financial Statements.

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

No matters were submitted to a vote of our security holders during the fourth quarter of the fiscal year covered by this report.

PART II

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

Market Information

Our common stock is traded on the American Stock Exchange (AMEX) under the symbol DOC. The following table shows the high and low sales prices for our common stock as reported on AMEX for the periods indicated. On March 1, 2006, the last reported sale price of our common stock was $3.96. As of March 1, 2006, there were 43,847,314 shares of our common stock issued and outstanding, and we had approximately 188 stockholders of record.

	High	Low
YEAR ENDED DECEMBER 31, 2005		
Fourth Quarter	$ 3.43	$ 2.32
Third Quarter	$ 4.52	$ 2.87
Second Quarter	$ 5.49	$ 3.66
First Quarter	$ 8.55	$ 3.80
YEAR ENDED DECEMBER 31, 2004		
Fourth Quarter	$ 8.80	$ 2.64
Third Quarter	$ 3.15	$ 2.33
Second Quarter	$ 3.63	$ 2.72
First Quarter	$ 4.24	$ 2.97

We did not declare or pay dividends on our common stock in the years ended December 31, 2005 or 2004. We have never paid dividends on our common stock and do not anticipate paying dividends in the foreseeable future.

Stock Issuances

On February 25, 2005, the Company entered into a Stock Purchase Agreement with Applied Digital Solutions. Pursuant to the agreement, the Company issued 644,140 shares of its common stock to Applied Digital. The Company received 684,543 shares of Applied Digital common stock as consideration. The value of the stock exchanged was $3.5 million. The Applied Digital common stock received by the Company was used as partial consideration for the acquisition of DSD Holdings A/S and its wholly-owned subsidiaries, Daploma International A/S and Digitag A/S.

On June 8, 2005, the Company issued 7,500 unregistered shares of its common stock to a former employee pursuant to an agreement with the Company s Board of Directors for his services in connection with the sale of the Medical Systems segment s assets.

The sales described above were made by the Company in reliance upon exemptions, among others, provided by Section 4(2) of the Securities Act of 1933, as amended (Securities Act) and Rule 506 of Regulation D under the Securities Act.

Stock Repurchases

On March 29, 2005, the Company s Board of Directors approved the repurchase of up to 1.5 million shares of its common stock over a ninety day period commencing on March 30, 2005. The following table illustrates issuer purchases of equity securities during the year ended December 31, 2005:

Period	Total Number of Shares Purchased		Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Number of Shares that May Yet Be Purchased Under the Plans
Month 1 (January 1 January 31, 2005)					
Month 2 (February 1 February 28, 2005)					
Month 3 (March 1 March 31, 2005)	50,000	$	4.62	50,000	1,450,000
Month 4 (April 1 April 30, 2005)	264,100		4.71	264,100	1,185,900
Month 5 (May 1 May 31, 2005)	14,000		3.86	14,000	1,171,900
Month 6 (June 1 June 30, 2005)					
Month 7 (July 1 July 31, 2005)					
Month 8 (August 1 August 31, 2005)					
Month 9 (September 1 September 30, 2005)					
Month 10 (October 1 October 31, 2005)					
Month 11 (November 1 November 30, 2005)					
Month 12 (December 1 December 31, 2005)					
Total	328,100	$	4.62	328,100	

Item 6. **Selected Financial Data**

The following selected financial data should be read in conjunction with our financial statements and related notes, Management s Discussion and Analysis of Financial Condition and Results of Operations, and other financial information appearing elsewhere in this annual report on Form 10-K. We derived the following historical financial information from the consolidated financial statements of Digital Angel Corporation for the years ended December 31, 2005, 2004, 2003 and 2002 which have been audited by Eisner LLP and the combined financial statements of the Advanced Wireless Group (AWG) for the year ended December 31, 2001, which have been audited by PricewaterhouseCoopers LLP.

All periods presented have been restated to reflect the discontinued operations of the Medical Systems division.

(Amounts in thousands, except per share data)	For the Years Ended December 31, 2005(1)		2004 (2)		2003		2002 (3)		2001
Results of Operations Data:									
Product revenue	$	54,320	$	44,274	$	32,873	$	30,401	$	33,220
Service revenue		2,506		2,028		1,559		2,115		2,691
Total net revenue		56,826		46,302		34,432		32,516		35,911
Cost of products sold		30,181		25,024		19,712		18,023		20,252
Cost of services sold		1,150		1,204				1,394		2,047

Gross profit	25,495	20,074	14,720	13 ,099	13,612
Selling, general and administrative expense (4)	23,067	18,516	15,496	36,360	22,798
Research and development expense	4,674	2,759	4,898	3,034	5,244
Asset impairment charge (5)	7,141			37,871	726
Operating loss	(9,387)	(1,201)	(5,674)	(64,166)	(15,156)
Interest income	(347)	(41)	(15)	(1)	(17)
Interest expense-Applied Digital				1,806	1,591
Interest expense-others	366	1,343	772	256	528
Realized losses on Applied Digital common stock		1,231			
Other income	(63)	(112)	(157)	(584)	
Loss from continuing operations before provision for taxes, minority interest and equity in net loss of affiliate	(9,343)	(3,622)	(6,274)	(65,643)	(17,258)
Income tax (benefit) provision	(41)				41
Loss from continuing operations before minority interest and equity in net loss of affiliate	(9,302)	(3,622)	(6,274)	(65,643)	(17,299)
Minority interest share of losses (income)	(351)	(249)	298	96	217
Equity in net loss of affiliate				(291)	(327)
Net loss before discontinued operations	(9,653)	(3,871)	(5,976)	(65,838)	(17,409)
Net income (loss) from discontinued operations	177	(1,086)	(3,482)	(26,521)	
Net loss	$ (9,476)	$ (4,957)	$ (9,458)	$ (92,359)	$ (17,409)
Loss per common share basic and diluted:					
Loss from continuing operations	$ (0.22)	$ (0.12)	$ (0.22)	$ (2.68)	$ (0.93)
Income (loss) from discontinued operations		(0.03)	(0.13)	(1.08)	
Net loss per common share-basic and diluted	$ (0.22)	$ (0.15)	$ (0.35)	$ (3.76)	$ (0.93)
Weighted average common shares outstanding-basic and diluted (6) (7)	43,820	33,173	26,959	24,578	18,750
Balance Sheet Data:					
Cash	$ 10,049	$ 17,492	$ 894	$ 206	$ 596
Property and equipment, net	8,602	5,947	6,528	6,379	14,476
Goodwill and other intangibles, net	50,304	53,008	45,119	45,084	72,876
Total assets	90,207	92,673	66,227	64,558	107,379
Long-term debt and notes payable	3,656	2,285	2,818	2,404	2,425
Total debt	6,036	2,384	7,826	3,170	85,227
Minority interest	618	249		298	394
Total stockholders equity	72,446	79,762	48,483	55,012	16,116
Other Financial Data:					
Depreciation and amortization	$ 2,412	$ 2,007	$ 1,234	$ 3,229	$ 12,331
Net cash (used in) provided by operating activities	(3,207)	2,525	(4,683)	(2,676)	(3,196)
Net cash (used in) provided by investing activities	(2,352)	912	(1,352)	(629)	(1,307)
Net cash (used in) provided by financing activities	(1,605)	13,046	6,595	2,593	4,893
Capital expenditures	1,382	584	1,157	1,434	1,310

(1) Includes the results of operations of DSD Holdings A/S from February 28, 2005

(2) Includes the results of operations of OuterLink Corporation from January 22, 2004

(3) Includes the results of operations of Medical Advisory Systems from March 27, 2002 as net loss from discontinued operations.

(4) Selling, general and administrative expense includes management fees paid to Applied Digital of $193 and $771 for the years ended December 31, 2002 and 2001.

(5) Asset impairment expense for 2005 consists of a goodwill impairment charge of $3,854 and intangible asset impairment charge of $3,287. Asset impairment expense for 2002 consists of a goodwill impairment charge of $31,460 and an intangible asset impairment charge of $6,411. Asset impairment expense for 2001 relates to a goodwill impairment.

(6) Potentially dilutive securities of 10,639, 7,263, 13,603 and 9,105 are excluded from the number of weighted average shares outstanding in 2005, 2004, 2003 and 2002, respectively. Including the dilutive securities would have had an anti-dilutive effect on our net loss per common share. Weighted average shares outstanding for the years ended December 31, 2001 have been restated to reflect the number of common shares received by the former shareholders of the Advanced Wireless Group in the March 27, 2002 merger.

(7) Total number of shares outstanding were 43,847, 43,375, 28,841, 26,518 and 18,750, at December 31, 2005, 2004, 2003, 2002 and 2001, respectively. Shares outstanding for the years ended December 31, 2001 have been restated to reflect the number of common shares received by the former shareholders of the Advanced Wireless Group in the March 27, 2002 merger.

Effective January 1, 2002, we adopted Statement of Financial Accounting Standard No. 142, Goodwill and Other Intangible Assets (SFAS No. 142). SFAS No. 142 requires that goodwill and certain intangibles no longer be amortized but instead tested for impairment at least annually.

The following table presents the impact of SFAS No. 142 on our summary financial data as indicated:

(In thousands, except per share data)	For the Years Ended December 31, 2005	2004	2003	2002	2001
Net loss:					
Net loss as reported	$ (9,476)	$ (4,957)	$ (9,458)	$ (92,359)	$ (17,409)
Goodwill amortization					8,629
Equity method investment amortization					1,161
Adjusted net loss	$ (9,476)	$ (4,957)	$ (9,458)	$ (92,359)	$ (7,619)
Basic and diluted loss per share:					
Net loss per share, basic and diluted, as reported	$ (0.22)	$ (0.15)	$ (0.35)	$ (3.76)	$ (0.93)
Goodwill amortization					0.46
Equity method investment amortization					0.06
Adjusted loss per share, basic and diluted	$ (0.22)	$ (0.15)	$ (0.35)	$ (3.76)	$ (0.41)

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the accompanying financial statements and related notes thereto.

We consist of Digital Angel Corporation and our subsidiaries Digital Angel Technology Corporation (DATC), Fearing Manufacturing, Inc., Timely Technology Corp., Signature Industries Limited (90.9% owned subsidiary), OuterLink Corporation, DSD Holdings A/S and its subsidiaries Daploma International A/S and Digitag A/S, Digital Angel Holdings, LLC and Digital Angel International, Inc. and its subsidiaries Digital Angel S.A. and Digital Angel do Brasil Produtos de Informatica LTDA.

Overview

The Company develops and deploys sensor and communication technologies that enable rapid and accurate identification, location tracking, and condition monitoring of high value assets. With the acquisition of OuterLink Corporation in January 2004, the Company reorganized into three segments: Animal Applications, GPS and Radio Communications and Medical Systems. During 2004, the Company sold substantially all of the assets of its Medical System s segment s medical services business.

The Company is currently comprised of two segments: (1) Animal Applications and (2) GPS and Radio Communications.

Animal Applications develops, manufactures and markets electronic radio frequency and visual identification devices for the companion animal, fish and wildlife, and livestock markets worldwide. The Animal Applications segment includes Denmark based DSD Holdings and its subsidiaries, which were acquired on February 28, 2005.

GPS and Radio Communications designs, manufactures and supports GPS enabled equipment. The GPS and Radio Communications segment consists of the Company s subsidiaries Signature Industries Limited and OuterLink Corporation. Signature Industries Limited businesses also include high grade equipment leasing and complementary data systems that customers can use to locate and monitor their assets and alarm sounder manufacturing.

In 2005, the Company reported record net revenue of $56.8 million, an increase of $10.5 million or 22.7% from $46.3 million in the prior year. The Company s year over year revenue growth was principally due to growth in the Animal Applications segment. The Animal Applications segment s revenue increased $10.1 million or 39.0% to $36.0 million in 2005 from $25.9 million in 2004. The increase in the Animal Application segment s revenue was principally due to an increase in electronic identification and visual product sales to livestock customers of approximately $2.6 million, an increase in microchip sales to companion animal customers of approximately $1.5 million, an increase in microchip sales to fish and wildlife customers of approximately $1.3 million, an increase in sales to Verichip Corporation of approximately $0.6 million and the inclusion of approximately $3.8 million of revenue from DSD Holdings A/S, which was acquired on February 28, 2005.

Gross profit increased $5.4 million, or 27.0%, to $25.5 million in 2005 from $20.1 million in 2004. The Company s Animal Applications segment contributed to the majority of the growth primarily due to increased sales.

In 2005, the Company reported a net loss of $9.5 million compared to a net loss of $5.0 million in 2004. In 2005, the Company s net results were negatively impacted by a $7.1 million goodwill and intangible asset impairment charge related to assets at our OuterLink Corporation subsidiary.

As of December 31, 2005, the Company s cash was $10.0 million as compared to $17.5 million at December 31, 2004. During 2005, $3.2 million of cash was used in operating activities, compared to cash provided by operating activities of $2.5 million in 2004 and cash used in operating activities of $4.7 million in 2003. Net cash used in investing activities totaled $2.4 million in 2005 compared to net cash provided by investing activities of $0.9 million in 2004 and net cash used by investing activities of $1.4 million in 2003. The principal uses of cash from investing activities in 2005 were $1.4 million for the purchase of DSD Holdings A/S and $1.4 million for purchase of property and equipment. Net cash used in financing activities totaled $1.6 million in 2005 compared to net cash provided by financing activities of $13.0 million and $6.6 million in 2004 and 2003, respectively. Cash used by financing activities during 2005 related primarily to the purchase of 328,100 treasury shares for approximately $1.5 million. Total debt at December 31, 2005 amounted to $6.0 million compared to $2.4 million at December 31, 2004. The increase in debt related to the debt acquired in the DSD Holdings acquisition in February 2005 and capital leases entered into in 2005.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate these estimates, including those related to inventory obsolescence, goodwill, intangibles and other long-lived assets and income taxes. We base these estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies reflect our more significant estimates and assumptions used in the preparation of the financial statements.

Goodwill, Intangibles and Other Long-Lived Assets

Goodwill and other intangible assets are carried at cost net of accumulated amortization. On January 1, 2002, the Company adopted Statement of Financial Accounting Standards (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. There was no impairment of goodwill upon the adoption of SFAS 142 on January 1, 2002. Based upon the Company s annual review for impairment, the Company recorded an impairment charge of $7.1 million in the fourth quarter of 2005. The impairment charge related to $3.8 million of goodwill and $3.3 million of intangible assets at our OuterLink Corporation reporting unit. The Company recorded an impairment charge of $3.0 million in the fourth quarter of 2003 which related to our Medical Systems segment and is included in discontinued operations.

In accordance with FAS 142, we are required to allocate goodwill to the various reporting units. As of December 31, 2005, the reporting units consisted of the following (the reporting units listed below are those businesses which have goodwill and for which discrete financial information is available and upon which management makes operating decisions):

Animal Applications (goodwill of $44.0 million as of December 31, 2005)

Signature Industries Limited (goodwill of $1.1 million as of December 31, 2005)

DSD Holdings A/S (goodwill of $3.4 million as of December 31, 2005)

Since the adoption of SFAS No. 142 on January 1, 2002, we engage an independent valuation firm to review and evaluate the goodwill as reflected on our books as of each December 31. Independently, the valuation firm reviewed the goodwill of the various reporting units. The Company s management compiled the cash flow forecasts, growth rates, gross margin, fixed and variable cost structure, depreciation and amortization expenses, corporate overhead, tax rates, and capital expenditures, among other data and assumptions related to the financial projections upon which the valuation reports were based. The valuation firm s methodology including residual or terminal enterprise values was based on the following factors: risk free rate of 10 years; current leverage (E/V); leveraged beta Bloomberg; unleveraged beta; risk premium; cost of equity; after-tax cost of debt; and weighted average cost of capital. These variables generated a discount rate calculation.

The assumptions used in the determination of fair value using discounted cash flows were as follows:

Cash flows were generated for 5 years based on the expected recovery period for the goodwill;

Adjusted earnings before interest, taxes, depreciation and amortization as the measure of cash flow; and

Discount rates ranging from 15% to 22.5%. The rate was determined based on the risk free rate of the 10-year U.S. Treasury Bond plus a market risk premium of 7.5%. (The discount rate utilized by the Company was the rate of return expected from the market or the rate of return for a similar investment with similar risks).

The independent valuation firm performed a company comparable analysis utilizing financial and market information on publicly traded companies that are considered to be generally comparable to the Company s reporting units. Each analysis provided a benchmark for determining the terminal values for each business unit to be utilized in its discounted cash flow analysis. The analysis generated a multiple for each reporting unit, which was incorporated into the appropriate business unit s discounted cash flow model.

Future goodwill impairment reviews may result in additional write-downs. Such determination involves the use of estimates and assumptions, which may be difficult to accurately measure or value. In preparing the five year financial projections for the 2005 goodwill impairment analysis, the Company assumed annual revenue growth for its Animal Applications, Signature Industries Limited and DSD Holdings reporting units. Additionally, based upon the best information available at the time of the valuation, the Company assumed overall gross margin improvement. Based upon the historic performance of these reporting units, although actual and estimated future results may be less than projected at the date of the most recent valuation, the Company does not presently anticipate that such results would result in an impairment charge for any of these reporting units.

We 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.

On February 28, 2005, we acquired DSD Holdings A/S. In accordance with SFAS No. 142, DSD Holdings A/S is considered a separate reporting unit. The excess purchase price over the fair value of the tangible and intangible assets and liabilities of DSD Holdings A/S, approximately $2.8 million, has been preliminarily recorded as goodwill. The acquisition of DSD Holdings A/S has been recorded based on preliminary estimates. Any changes to the preliminary estimates during the allocation period will be reflected as an adjustment to goodwill or other intangible assets. In considering the benefits of the DSD acquisition, the management of Digital Angel recognized the synergies available with DSD s highly automated and efficient manufacturing facility, as well as DSD s presence in successfully developed markets in the European Union (EU) and the Middle East. The acquisition provides Digital Angel with immediate expansion of its existing business in the significant EU market for livestock tagging and tracking. The Company has not incurred or does not expect to incur significant costs to integrate DSD Holdings, A/S.

Property, plant and equipment and definite-lived intangible assets are depreciated or amortized over their useful lives. Useful lives are based on management s estimates of the period that the assets will generate revenue. Long-lived assets are evaluated for impairment whenever events and circumstances indicate an asset may be impaired. There were no write downs of any long-lived assets in 2005, 2004 or 2003.

Inventories

Estimates are used in determining the likelihood that inventory on hand can be sold. Historical inventory usage and current revenue trends are considered in estimating both obsolescence and slow-moving inventory. Inventory is stated at lower of cost or market, determined by the first-in, first-out method, net of any reserve for obsolete or slow-moving inventory.

Deferred Taxes

We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. While we have considered future taxable income and tax planning strategies in assessing the need for the valuation allowance, in the event we were to subsequently determine that we would be able to realize our deferred tax assets in the future in excess of our net recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made. Similarly, should we determine that we would not be able to realize all or part of our deferred tax assets in the future, an adjustment to the deferred tax asset would reduce income in the period such determination was made.

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 exist, 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 and fixed fee jobs, service 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. Other revenue is recognized at the time the 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 location and messaging services, which generally provide for service on a month-to-month basis and from the sale of related products to customers (communication terminals and software). OuterLink Corporation s services are 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 ratably over the estimated customer service period, which has historically been 30 months. The Company recently reassessed the estimated customer service period based on additional experience and will begin recognizing product revenue over 42 months in 2006.

Results of Operations

The following table summarizes our results of operations as a percentage of net operating revenues and is derived from the accompanying consolidated and combined statements of operations included in this report.

		For the Years Ended December 31,	
	2005	**2004**	**2003**
	%	**%**	**%**
Product revenue	**95.6**	95.6	95.5
Service revenue	**4.4**	4.4	4.5
Total net revenue	**100.0**	100.0	100.0
Cost of products sold	**53.1**	54.0	57.2
Cost of services sold	**2.0**	2.6	0.0
Gross profit	**44.9**	43.4	42.8
Selling, general and administrative expense	**40.6**	40.0	45.0
Research and development expense	**8.2**	6.0	14.3
Asset impairment	**12.6**	0.0	0.0
Loss from operations	**(16.5)**	(2.6)	(16.5)
Interest income	**(0.6)**	(0.1)	0.0
Interest expense	**0.6**	2.9	2.2
Realized losses on Applied Digital common stock	**0.0**	2.7	0.0
Other income	**(0.1)**	(0.2)	(0.5)
Loss from continuing operations before minority interest	**(16.4)**	(7.9)	(18.2)
Income tax benefit	**0.0**	0.0	0.0
Loss from continuing operations before minority interest	**(16.4)**	(7.9)	(18.2)
Minority interest share of (income) losses	**(0.6)**	(0.5)	0.8
Net loss before discontinued operations	**(17.0)**	(8.4)	(17.4)
Income (loss) from discontinued operations	**0.3**	(2.3)	(10.1)
Net loss	**(16.7)**	(10.7)	(27.5)

Year Ended December 31, 2005 Compared to the Year Ended December 31, 2004

Revenue

Revenue from operations for the year ended December 31, 2005 was $56.8 million, an increase of approximately $10.5 million, or 22.7%, from $46.3 million in the year ended December 31, 2004. Revenue for the years ended December 31, 2005 and 2004 for each of the operating segments was as follows (in thousands):

		2005		2004
Animal Applications	$	35,972	$	25,871
GPS and Radio Communications		20,854		20,431
Total	$	56,826	$	46,302

The Animal Applications segment s revenue increased approximately $10.1 million, or 39.0%, in the year ended December 31, 2005 as compared to the year ended December 31, 2004. The increase in revenue was principally due to an increase in electronic identification and visual product sales to livestock customers of approximately $2.6 million, an increase in microchip sales to companion animal customers of approximately $1.5 million, an increase in microchip sales to fish and wildlife customers of approximately $1.3 million, an increase in sales to Verichip Corporation of approximately $0.6 million and the inclusion of approximately $3.8 million of revenue from DSD Holdings A/S. DSD Holdings was acquired on February 28, 2005. The establishment of a national electronic identification program for livestock is being considered by the USDA and various industry groups. We expect a national electronic identification program will be implemented in the United States by January 1, 2009. We cannot estimate the impact a national identification program would have on the Animal Application segment s revenue. However, if implemented, we expect the impact would be favorable.

The GPS and Radio Communications segment s revenue increased approximately $0.4 million, or 2.1%, in the year ended December 31, 2005 as compared to the year ended December 31, 2004. The increase primarily relates to increased revenue at our subsidiary OuterLink Corporation of approximately $0.5 million. The increase in revenue at OuterLink Corporation relates primarily to the deferral of product revenue which is recognized over the estimated customer service period. The increase in sales by OuterLink is offset by a decrease in sales at our subsidiary Signature Industries Limited of approximately $0.1 million. Sales in Signature s Radio products division and Clifford and Snell division increased approximately $0.6 million and approximately $0.4 million, respectively, when compared to 2004. Sales in Signature s Sarbe division decreased approximately $1.2 million primarily due to the completion of the G2R contract with the Indian Air Force in May 2005 which had increased sales over the last two years. Sales at Signature s Sarbe division have increased over the last two years as a result of the G2R contract with the Indian Air Force. Continued growth at Signature may depend on Signature s ability to win a large contract similar to the contract with the Indian Air Force.

Gross Margin

Gross profit for the year ended December 31, 2005 was $25.5 million, an increase of approximately $5.4 million, or 27.0%, from $20.1 million in the year ended December 31, 2004. As a percentage of revenue, the gross profit margin increased 1.5% to 44.9% for the year ended December 31, 2005 from 43.4% for the year ended December 31, 2004.

Gross profit for the years ended December 31, 2005 and 2004 for each operating segment was as follows (in thousands):

		2005		2004
Animal Applications	$	14,610	$	10,108
GPS and Radio Communications		10,885		9,966
Total	$	25,495	$	20,074

Gross profit margin for the years ended December 31, 2005 and 2004 for each operating segment was as follows:

	2005 %	2004 %
Animal Applications	40.6	39.1
GPS and Radio Communications	52.2	48.8

The Animal Applications segment s gross profit of $14.6 million in the year ended December 31, 2005 increased approximately $4.5 million compared to $10.1 million in the year ended December 31, 2004. The increase in gross profit relates primarily to increased sales. Gross profit margin increased to 40.6% in 2005 from 39.1% in 2004 primarily due to decreased material costs in 2005.

The GPS and Radio Communications segment s gross profit of $10.9 million in the year ended December 31, 2005 increased approximately $0.9 million compared to $10.0 million in the year ended December 31, 2004. Gross profit margin increased to 52.2% in 2005 from 48.8% in 2004.

The increase in gross margin relates to increased margins at all four divisions of our subsidiary Signature Industries Limited and increased margins at our subsidiary OuterLink Corporation.

Selling, General and Administrative Expense

Selling, general and administrative expense increased $4.6 million, or 24.6%, in the year ended December 31, 2005 as compared to the year ended December 31, 2004. As a percentage of revenue, selling, general and administrative expense was 40.6% and 40.0% for the years ended December 31, 2005 and 2004, respectively.

Selling, general and administrative expenses for the years ended December 31, 2005 and 2004 for each of the operating segments was as follows (in thousands):

		2005		2004
Animal Applications	$	12,650		8,682
GPS and Radio Communications		10,417		9,834
Total	$	23,067	$	18,516

Selling, general and administrative expense as a percentage of revenue for each of the operating segments for the years ended December 31, 2005 and 2004 was as follows:

	2005 %	2004 %
Animal Applications	35.2	33.6
GPS and Radio Communications	50.0	48.1

The Animal Applications segment s selling, general and administrative expenses increased approximately $4.0 million in the year ended December 31, 2005 compared to the year ended December 31, 2004 and, as a percentage of revenue, increased to 35.2% from 33.6% in the same respective period. The increase in selling, general and administrative expense relates primarily to a charge of approximately $1.2 million in legal expenses related to the maintenance and protection of the Company s intellectual property, approximately $1.3 million of compensation expense and approximately $1.2 million of expense related to DSD Holdings A/S. DSD Holdings A/S was acquired on February 28, 2005

The GPS and Radio Communications segment s selling, general and administrative expense increased approximately $0.6 million in the year ended December 31, 2005 to $10.4 million as compared to $9.8 million in the year ended December 31, 2004 due primarily to increased compensation and sales and marketing expenses at our subsidiary Signature Industries Limited. As a percentage of revenue, selling, general and administrative expenses increased to 50.0% in 2005 from 48.1% in 2004.

Research and Development Expense

Research and development expense was $ 4.7 million in the year ended December 31, 2005, an increase of $1.9 million, or 69.4%, from $2.8 million for the year ended December 31, 2004. As a percentage of revenue, research and development expense was 8.2% and 6.0% for the years ended December 31, 2005 and 2004, respectively.

Research and development expense for the years ended December 31, 2005 and 2004 for each of the operating segments was as follows (in thousands):

	2005	2004
Animal Applications	$ 2,951	$ 2,222
GPS and Radio Communications	1,723	537
Total	$ 4,674	$ 2,759

The Animal Applications segments research and development expense increased approximately $0.7 million in the year ended December 31, 2005 as compared to the year ended December 31, 2004. The increase relates primarily to the development of new large scale radio frequency identification (RFID) antenna detection system for a fish and wildlife customer.

The GPS and Radio Communications segment s research and development expense was approximately $1.7 million for the year ended December 31, 2005, an increase of approximately $1.2 million when compared to approximately $0.5 million in the year ended December 31,

2004. Of the approximately $1.2 million increase, approximately $0.6 million related to research and development expenses at our OuterLink subsidiary for the continued development of its next generation of communication system hardware and approximately $0.6 million related to product development programs.

Interest Expense

Interest expense was $0.4 million and $1.3 million for each of the years ended December 31, 2005 and 2004, respectively. Included in interest expense for the year ended December 31, 2004 is approximately $0.8 million of discount amortization and deferred debt cost amortization associated with the Laurus Master Fund financings.

Income Taxes

The Company had an income tax benefit of $41,000 in 2005 compared to no income tax benefit in 2004. At December 31, 2005, the Company had aggregate U.S. Federal net operating loss carryforwards of approximately $ 70.1 million for income tax purposes. The net operating loss carryforwards expire in various amounts through 2025. Approximately $31.8 million of the net operating loss carryforwards were acquired in connection with various acquisitions and are limited as to use in any particular year. A valuation allowance is provided against the net deferred tax assets that more than likely will not be realized.

Discontinued Operations

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. The purchase price was approximately $384,000.

In addition, on July 30, 2004, the Company sold the Medical Systems segment s land and building for $1.5 million. The Company recorded a gain of approximately $0.3 million on the sale of the land and building. Net cash received on the sale of the land and building, after paying off the related building mortgage, was approximately $0.4 million. The net loss recorded by the Company in the year ended December 31, 2004 in connection with exiting this activity was $1.1 million. The income recognized in 2005 relates primarily to a gain on the sale of an investment.

The following discloses the income and loss from discontinued operations for the year ended December 31, 2005 and 2004, all of which is attributable to the Medical Systems segment:

	Year Ended December 31,			
		2005		2004
Product revenue	$		$	204
Service revenue				223
Total revenue				427
Cost of products sold				87
Cost of services sold				317
Total cost of products and services sold				404
Gross profit				23
Selling, general and administrative expenses				1,294
Other (income) expense		(177)		(185)
Income (loss) from discontinued operations	$	177	$	(1,086)

Year Ended December 31, 2004 Compared to the Year Ended December 31, 2003

Revenue

Revenue from operations for the year ended December 31, 2004 was $46.3 million, an increase of $11.9 million, or 34.5%, from $34.4 million in the year ended December 31, 2003. Revenue for the years ended December 31, 2004 and 2003 for each of the operating segments was as follows (in thousands):

		2004		2003
Animal Applications	$	25,871	$	23,948
GPS and Radio Communications		20,431		10,484
Total	$	46,302	$	34,432

The Animal Applications segment s revenue increased $1.9 million, or 8.0%, in the year ended December 31, 2004 as compared to the year ended December 31, 2003. The increase in revenue was principally due to an increase in microchip sales to companion animal customers of $1.4 million and an increase in electronic identification and visual product sales to livestock customers of $2.3 million. The increase in sales was offset by a decrease in microchip sales to fish and wildlife and other customers of $1.8 million.

The GPS and Radio Communications segment s revenue increased $9.9 million, or 94.9%, in the year ended December 31, 2004 as compared to the year ended December 31, 2003. The increase primarily related to increased revenue at our Signature Industries Limited subsidiary related to the shipments of the G2R pilot locator beacon in connection with the fulfillment of the G2R contract with the Indian Air Force and increased sales at its Clifford and Snell Division. Included in 2004 are sales of $5.9 million of G2R sales compared to no sales in 2003. Sales in Signature s Clifford and Snell division increased $1.7 million in 2004. OuterLink Corporation revenue was $1.8 million for the year ended December 31, 2004. OuterLink Corporation was acquired on January 22, 2004.

Gross Margin

Gross profit for the year ended December 31, 2004 was $20.1 million, an increase of $5.4 million, or 36.4%, from $14.7 million in the year ended December 31, 2003. As a percentage of revenue, the gross profit margin was 43.4% and 42.8% for the years ended December 31, 2004 and 2003, respectively.

Gross profit for the years ended December 31, 2004 and 2003 for each operating segment was as follows (in thousands):

	2004	2003
Animal Applications	$ 10,108	$ 9,740
GPS and Radio		