DIGITAL ANGEL CORP
Form 10-K/A
April 06, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A

(Amendment No. 1)

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

Explanatory Note

This Amendment No. 1 on Form 10-K/A to the Annual Report on Form 10-K for the fiscal year ended December 31, 2005, which was originally filed with the Securities and Exchange Commission on March 8, 2006 (the Original Filing), is being filed to amend the Original Filing as follows:

Updates the Raw Materials disclosure included in Part 1, Item 1. Business; Part 1, Item 1A. Risk Factors; the Report of Independent Registered Public Accounting Firm to include a reference to the dual - dated audit report on the consolidated financial statements included in Item 9A. Controls and Procedures; and the second paragraph of Note 21 to the Consolidated Financial Statements included in Part IV, Item 15, Exhibits and Financial Statements Schedules; and

A currently dated consent letter is included from the Company s Independent Registered Public Accounting Firm dated April 5, 2006; and

Currently dated certifications from our Chief Executive Officer and Chief Financial Officer as required by Rules 13a-14(a)or 15d-14(a) and 13a-14(b) or 15d-14(b) under the Securities Exchange Act of 1934 are included as exhibits.

Except for the matters described above, this amendment does not modify or update disclosure in, or exhibits to, the Original Filing. Furthermore, except for the matters described above, this amendment does not change any previously reported financial results, nor does it reflect events occurring after the date of the Original Filing.

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 Raytheon Microelectronics Espana, SA (Raytheon) for the manufacture of our patented syringe-injectable microchips that are used in our implantable electronic identification products. Certain aspects of this arrangement are included in a written agreement with Raytheon which expires in June 2006. Both Raytheon and the Company have expressed an interest in extending this agreement, and the parties have commenced negotiations to renew the expiring agreement. If Raytheon were to terminate the 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 could incur material liabilities pursuant to contractual provisions contained in intellectual property licenses

In the ordinary course of its business, the Company licenses third parties and certain affiliates of the Company to use intellectual property. These licenses typically include provisions indemnifying the licensees against third party claims should the licensed intellectual property licensed by the Company violate intellectual property rights. If it were determined that a license granted by the Company infringed the rights of a third party, the Company could be obligated to indemnify its licensees against items such as damages payable to such third parties, applicable court costs and attorneys fees. In such an event, the liability of the Company pursuant to such provisions could be material, and could have a material adverse effect on the Company s business and financial condition.

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. Certain aspects of this arrangement are included in a written agreement with Raytheon which expires in June 2006. Both Raytheon and the Company have expressed an interest in extending this agreement, and the parties have commenced negotiations to renew the expiring agreement. 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. In the event of such a termination, we cannot ensure that the assembly of our microchips from another source would be possible, and if possible, whether we could obtain such assembly 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.

PART II

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) are our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

We have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2005. Based on that evaluation, our chief executive officer and the chief financial officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports filed by us under the Exchange Act are recorded, processed summarized and reported within the time periods specified in the Commission s rules and forms and are also effective to ensure that information required to be disclosed in the reports filed or submitted by us under the Exchange Act are accumulated and communicated to our management, including our chief executive officer and chief financial officer, to allow timely decisions regarding required disclosure.

Change in Internal Control Over Financial Reporting

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

Our management s assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 has been audited by Eisner LLP, the Company s independent registered public accounting firm, as stated in their report which is immediately below.

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders of
Digital Angel Corporation

We have audited management s assessment, included in the accompanying Management s Report on Internal Controls over Financial Reporting, that Digital Angel Corporation and subsidiaries maintained effective internal control over financial reporting as of December 31, 2005, based on, criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Digital Angel Corporation and subsidiaries management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that Digital Angel Corporation and subsidiaries maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Digital Angel Corporation and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Digital Angel Corporation as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the years in the three-year period ended December 31, 2005, and our report dated March 3, 2006 (with respect to the second paragraph of Note 21, March 31, 2006) expressed an unqualified opinion on those consolidated financial statements.

EISNER LLP

Florham Park, New Jersey

March 3, 2006

PART IV

Item 15. **Exhibits and Financial Statement Schedules**

a) The financial statements filed as part of this report are described on page F-1, entitled Index to Financial Statements.

b) The exhibits to this Amendment No. 1 to the Annual Report on Form 10-K/A are described in the Index to Exhibits beginning on page 15.

c) Financial statement schedules:

Schedule II Valuation and Qualifying Accounts for the Three Years Ended December 31, 2005

All other schedules (Schedules I, III, IV and V) for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instruction or are inapplicable and therefore have been omitted.

SIGNATURES

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

DIGITAL ANGEL CORPORATION

Date: April 6, 2006

/s/ Kevin N. McGrath
Kevin N. McGrath
Chief Executive Officer

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

Name	Title	Date
/s/ Kevin N. McGrath Kevin N. McGrath	President, Chief Executive Officer and Director (Principal Executive Officer)	April 6, 2006
/s/ James P. Santelli James P. Santelli	Senior Vice President-Finance and Chief Financial Officer (Principal Financial Officer)	April 6, 2006
/s/ Scott R. Silverman Scott R. Silverman	Chairman and Director	April 6, 2006
/s/ John R. Block John R. Block	Director	April 6, 2006
/s/ Barry M. Edelstein Barry M. Edelstein	Director	April 6, 2006
/s/ Howard S. Weintraub Howard S. Weintraub	Director	April 6, 2006
/s/ Michael S. Zarriello Michael S. Zarriello	Director	April 6, 2006

INDEX TO EXHIBITS

The following exhibits are filed with this Annual Report on Form 10-K:

23.1 Consent of Independent Registered Public Accounting Firm Eisner LLP

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 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 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.

DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

INDEX TO FINANCIAL STATEMENTS

Consolidated Financial Statements

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders of
Digital Angel Corporation

We have audited the accompanying consolidated balance sheets of Digital Angel Corporation and subsidiaries (the Company) as of December 31, 2005 and 2004 and the related consolidated statements of operations, changes in stockholders equity and cash flows for each of the years in the three year period ended December 31, 2005. Our audits also included the financial statement schedule II - Valuation and Qualifying Accounts. These consolidated financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements and schedule based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Digital Angel Corporation and subsidiaries as of December 31, 2005 and 2004, and the consolidated results of their operations and their consolidated cash flows for each of the years in the three year period ended December 31, 2005 in conformity with U.S. generally accepted accounting principles. Also in our opinion, the referred financial statement schedule, when considered in relation to the financial statements taken as a whole, presents fairly, in all material respects, the information stated therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Digital Angel Corporation s internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 3, 2006 expressed an unqualified opinion on management s assessment of, and the effective operation of, internal control over financial reporting.

Eisner LLP

Florham Park, New Jersey
March 3, 2006
With respect to the second paragraph of Note 21
March 31, 2006

DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except par value)

	December 31, 2005	December 31, 2004
Assets		
Current Assets		
Cash	**$ 10,049**	$ 17,492
Restricted cash	**310**	327
Accounts receivable, net of allowance for doubtful accounts of $212 and $241 in 2005 and 2004, respectively	**10,152**	7,641
Accounts receivable from Verichip Corporation	**232**	
Inventories	**8,657**	6,232
Other current assets	**1,418**	1,235
Net assets from discontinued operations		6
Total Current Assets	**30,818**	32,933
Property and Equipment, net	**8,602**	5,947
Goodwill	**48,491**	48,997
Other Intangible Assets, net	**1,813**	4,011
Other Assets, net	**483**	785
	$ 90,207	$ 92,673
Liabilities and Stockholders Equity		
Current Liabilities		
Line of credit and current maturities of long-term debt	**$ 2,380**	$ 99
Accounts payable	**5,381**	3,936
Accrued expenses and other current liabilities	**3,232**	4,371
Deferred revenue	**1,324**	1,204
Due to Applied Digital Solutions, Inc.		23
Net liabilities from discontinued operations	**84**	
Total Current Liabilities	**12,401**	9,633
Long-Term Debt and Notes Payable	**3,656**	2,285
Other Long Term Liabilities	**1,086**	744
Total Liabilities	**17,143**	12,662
Commitments and Contingencies (Notes 14 and 18)		
Minority Interest	**618**	249
Stockholders Equity (See Note 1)		
Preferred stock: Authorized 1,000 shares, of $1.75 par value, none outstanding in 2005 and 1 outstanding in 2004		1
	223	217

Common stock: Authorized 95,000 shares, of $.005 par value; 44,225 shares issued and 43,847 shares outstanding in 2005 and 43,425 shares issued and 43,375 shares outstanding in 2004				
Additional paid-in capital		**212,564**		207,875
Accumulated deficit		**(137,950)**		(128,474)
Deferred compensation		**(481)**		
Treasury stock (carried at cost, 378 shares in 2005 and 50 shares in 2004)		**(1,580)**		(43)
Accumulated other comprehensive income (loss)		**(330)**		186
Total Stockholders Equity		**72,446**		79,762
	$	**90,207**	$	92,673

See the accompanying notes to financial statements.

DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	For the Years Ended December 31, 2005	2004	2003
Product revenue	**$ 54,320**	$ 44,274	$ 32,873
Service revenue	**2,506**	2,028	1,559
Total net revenue	**56,826**	46,302	34,432
Cost of products sold	**30,181**	25,024	19,712
Cost of services sold	**1,150**	1,204	
Gross profit	**25,495**	20,074	14,720
Selling, general and administrative expenses	**23,067**	18,516	15,496
Research and development expenses	**4,674**	2,759	4,898
Asset impairment	**7,141**		
Loss from operations	**(9,387)**	(1,201)	(5,674)
Interest income	**(347)**	(41)	(15)
Interest expense	**366**	1,343	772
Realized losses on Applied Digital Common Stock		1,231	
Other income	**(63)**	(112)	(157)
Loss from continuing operations before income tax benefit and minority interest	**(9,343)**	(3,622)	(6,274)
Income tax benefit	**41**		
Loss from continuing operations before minority interest	**(9,302)**	(3,622)	(6,274)
Minority interest share of (income) losses	**(351)**	(249)	298
Loss from continuing operations	**(9,653)**	(3,871)	(5,976)
Income (loss) from discontinued operations, including net gain on sale of assets of $163 and $260 in 2005 and 2004	**177**	(1,086)	(3,482)
Net loss	**$ (9,476)**	$ (4,957)	$ (9,458)
Loss per common share-basic and diluted			
Loss from continuing operations	**$ (0.22)**	$ (0.12)	$ (0.22)
Income (loss) from discontinued operations		(0.03)	(0.13)
Net loss per common share - basic and diluted	**$ (0.22)**	$ (0.15)	$ (0.35)
Weighted average number of common shares outstanding - basic and diluted	**43,820**	33,173	26,959

See the accompanying notes to financial statements.

DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

(In thousands)

	Preferred Stock Number	Preferred Stock Amount	Common Stock Number	Common Stock Amount	Additional Paid-In Capital	Accumulated Deficit	Deferred Compensation	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders Equity
Balance - December 31, 2002		$	26,568	$ 133	$ 169,166	$ (114,059)	$	$ (43)	$ (185)	$ 55,012
Net loss						(9,458)				(9,458)
Comprehensive income-foreign currency translation									175	175
Total comprehensive loss						(9,458)			175	(9,283)
Exercise of stock options			2,323	11	2,393					2,404
Stock option repricing					25					25
Fair value of warrants granted in connection with financing arrangements					276					276
Fair value of options granted for services					49					49
Balance - December 31, 2003			28,891	144	171,909	(123,517)		(43)	(10)	48,483
Net loss						(4,957)				(4,957)
Comprehensive income-foreign currency translation									196	196
Total comprehensive loss						(4,957)			196	(4,761)
Merger consideration-OuterLink Corporation	100	175			8,125					8,300
Issuance of common stock to Applied Digital			3,000	15	7,905					7,920
Conversion of debt into stock			1,181	6	2,924					2,930
Conversion of Series A Preferred Stock	(100)	(174)	3,985	20	154					
Shares cancelled on settlement with vendor			(23)							
Issuance of stock for services			10		31					31
Exercise of stock options			4,426	22	12,665					12,687
Exercise of warrants			1,955	10	4,162					4,172
Balance-December 31, 2004		1	43,425	217	207,875	(128,474)		(43)	186	79,762
Net loss						(9,476)				(9,476)
Comprehensive loss-foreign currency translation									(516)	(516)
Total comprehensive loss						(9,476)			(516)	(9,992)
Purchase of treasury stock								(1,537)		(1,537)
Exchange of common stock with Applied Digital (See Note 11)			644	3	3,497					3,500

Conversion of Series A Preferred Stock	(1)	14	1						
Non employee stock grant		7		35					35
Exercise of warrants		115	1	302					303
Exercise of stock options		20		55					55
Restricted stock issued			1	755		(756)			
Amortization of deferred compensation						275			275
Issuance of stock options to non-employees				45					45
Balance-December 31, 2005		$ 44,225	$ 223	$ 212,564	$ (137,950)	$ (481)	$ (1,580)	$ (330)	$ 72,446

See the accompanying notes to financial statements.

DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	For the Years Ended December 31,		
	2005	**2004**	**2003**
Cash Flows From Operating Activities			
Loss from continuing operations	**$ (9,653)**	$ (3,871)	$ (5,976)
Adjustments to reconcile net loss to net cash used in operating activities:			
Income (loss) from discontinued operations	**177**	(1,086)	(3,482)
Proceeds from sale of Applied Digital common stock		6,689	
Equity-based compensation	**355**	31	74
Asset impairment charge	**7,141**		
Depreciation and amortization	**2,412**	2,007	1,234
Amortization of debt discount and financing costs		777	186
Minority interest	**351**	249	(298)
Loss on Applied Digital common stock		1,231	
Loss (gain) on disposal of assets	**15**	(3)	25
Change in assets and liabilities:			
Decrease (increase) in restricted cash		438	(765)
(Increase) decrease in accounts receivable	**(862)**	(4,384)	179
(Increase) in accounts receivable from Verichip	**(232)**		
(Increase) decrease in inventories	**(1,382)**	732	(1,655)
(Increase) decrease in other current assets	**(63)**	(329)	573
(Increase) in deferred tax asset	**(155)**		
Decrease in due to Applied Digital	**(23)**	(324)	(115)
(Decrease) increase in accounts payable, accrued expenses and deferred revenue	**(1,378)**	278	2,010
Net cash provided by discontinued operations	**90**	90	3,327
Net Cash (Used In) Provided By Operating Activities	**(3,207)**	2,525	(4,683)
Cash Flows From Investing Activities			
Proceeds from the sale of assets		18	
Decrease (increase) in other assets	**431**	(225)	(400)
Payments for property and equipment	**(1,382)**	(584)	(1,157)
Acquisition costs, net of cash acquired through acquisition	**(1,401)**	(27)	
Net cash provided by discontinued operations		1,730	205
Net Cash (Used In) Provided By Investing Activities	**(2,352)**	912	(1,352)
Cash Flows From Financing Activities			
Amounts borrowed under line of credit	**4,125**	50,885	33,805
Amounts paid on line of credit	**(3,984)**	(53,261)	(31,534)
Amounts borrowed on debt			2,889
Amounts paid on long-term debt	**(567)**	(426)	(397)
Proceeds from exercise of stock options and warrants	**358**	16,859	2,404
Amounts paid for treasury stock	**(1,537)**		
Payments for financing costs		(101)	(522)
Net cash used in discontinued operations		(910)	(50)
Net Cash (Used in) Provided By Financing Activities	**(1,605)**	13,046	6,595

Effect of exchange rate changes on cash	**(279)**	115	128
Net (Decrease) Increase In Cash	**(7,443)**	16,598	688
Cash - Beginning Of Year	**17,492**	894	206
Cash - End Of Year	**$ 10,049**	$ 17,492	$ 894

See the accompanying notes to financial statements.

DIGITAL ANGEL CORPORATION

NOTES TO FINANCIAL STATEMENTS

1. The Company and Basis of Presentation

The Company is engaged in the business of developing and bringing to market proprietary technology used to identify, locate and monitor people, animals and objects. The Company operates in 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 animals, 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. The Company holds patents on its 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 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 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 by Schering-Plough Animal Health Corporation under the brand name Home Again , pursuant to a multi-year exclusive license, 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.

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.

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. Visual identification products for livestock are typically numbered ear tags, which we have marketed since the 1940s. 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 through direct sales as well as through a variety of third party distributors.

On February 28, 2005, the Company acquired Denmark-based DSD Holdings A/S (DSD) and its wholly-owned subsidiaries. Denmark-based DSD through its subsidiaries manufactures and markets visual and electronic RFID tags for livestock. DSD has a highly automated and efficient manufacturing facility and presence in successfully developed markets in Europe, the Middle East and Asia. The acquisition provides Digital Angel with immediate expansion of its existing business in the significant European market for livestock tagging and tracking.

In addition, the Company s implantable radio frequency microchip was cleared by the 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.

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 (90.9% owned), located in the United Kingdom and OuterLink Corporation, located in Massachusetts. 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. Signature Industries Limited s businesses also include high grade communication equipment leasing and complementary data systems that customers can use to locate and monitor their assets and alarm sounder manufacturing. Technology development in this segment includes the integration and miniaturization into marketable products of two technologies: wireless communications and position location technology (including global positioning systems (GPS) and other systems).

As of December 31, 2005, Applied Digital Solutions, Inc. owned 24,291,673 shares or 55.4% of the Company s common stock, and the Company owned 90.9% of Signature Industries Limited.

Summary of Significant Accounting Policies

Described below are significant accounting policies, which conform to accounting principles generally accepted in the United States and, except for recently issued accounting standards adopted, are applied on a consistent basis among all years presented.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned and majority-owned subsidiaries from the date of acquisition. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of the financial statements in conformity with accounting principles generally accepted in the United States requires management to make certain estimates and assumptions that affect the amounts and disclosures included in the financial statements and accompanying notes. Although these estimates are based on the knowledge of current events and actions that the Company may undertake in the future, they may ultimately differ from actual results. The Company uses estimates, among others, to determine whether any impairment is to be recognized to long lived and intangible assets.

Foreign Currencies

The Company s foreign subsidiaries functional currencies are their local currencies. Results of operations and cash flows are translated at average exchange rates prevailing throughout the period, and assets and liabilities are translated at end of period exchange rates. Translation adjustments resulting from this process are included in accumulated other comprehensive loss which is a component of stockholders equity. Translation gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the functional currency are included in the results of operations as incurred.

Inventories

Inventories consist of raw materials, work in process and finished goods. Inventory is valued at the lower of cost or market, determined by the first-in, first-out method. The Company closely monitors and analyzes inventory for potential obsolescence and slow-moving items based upon the aging of the inventory and inventory turns by product. Inventory items designated as obsolete or slow-moving are reduced to net realizable value.

Property and Equipment, net

Property and equipment are stated at cost, less accumulated depreciation computed using the straight-line method. Building and leasehold improvements are depreciated over periods ranging from 10 to 30 years and software and equipment is depreciated over periods ranging from 2 to 10 years. Additions, improvements or major renewals are capitalized while repairs and maintenance, which do not extend the useful life of the asset, are charged to expense as incurred. Gains and losses on sales and retirements are reflected in results of operations.

Goodwill, net

Goodwill is carried at cost net of accumulated amortization. In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets, the Company tests goodwill for impairment at least annually by applying a fair value based test. Based upon the Company s annual review for impairment, the Company recorded an impairment charge of $3.8 million in the fourth quarter of 2005 related to the goodwill at our OuterLink Corporation reporting unit. The Company recorded an impairment charges $2.4 million in the fourth quarter of 2003 related to the goodwill associated with our discontinued Medical Systems reporting unit.

In accordance with SFAS 142, the Company is required to allocate goodwill to the various reporting units. As of

December 31, 2005, the Company s 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 as of $44.0 million as of December 31, 2005)

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

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

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.

Other Intangible Assets, net

Other intangible assets are carried at cost net of accumulated amortization. In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets, the Company tests intangible assets for impairment at least annually by applying a fair value based test. Based upon the Company s annual review for impairment, the Company recorded an impairment charge of $3.3 million in the fourth quarter of 2005 related to intangible assets at our OuterLink Corporation reporting unit. The Company recorded an impairment charges of $0.6 million in the fourth quarter of 2003 associated with our discontinued Medical Systems reporting unit.

Long-Lived Assets

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the Company continually evaluates whether events or circumstances have occurred that indicate the remaining estimated useful lives of its intangible assets, excluding goodwill, and other long-lived assets may warrant revision or that the remaining balance of such assets may not be recoverable. The Company uses an estimate of the related undiscounted cash flows over the remaining life of the asset in measuring whether the asset is recoverable. There were no write downs of any long-lived assets in 2005, 2004, and 2003.

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 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 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 revenue over 42 months in 2006.

It is Digital Angel Corporation s policy to approve all customer returns before issuing credit to the customer. Digital Angel Corporation incurred returns of $0.3 million, $0.2 million and $0.1 million for 2005, 2004 and 2003, respectively.

The Company records a liability for product warranties at the time it is probable that a warranty liability has been incurred and the amount of loss can reasonably be estimated. The Company s warranty liability was $34,000, $47,000 and $139,000 as of December 31, 2005, 2004 and 2003, respectively. Following is a reconciliation of the Company s product warranties (in thousands):

	Amount of Liability	
Balance as of December 31, 2004	$	47
Accruals for warranties issued during the period		
Accruals related to pre-existing warranties (including changes in estimates)		
Settlements made (in cash or in kind) during the period		(13)
Balance as of December 31, 2005	$	34

Research and Development

Research and development expense consists of personnel costs, supplies, other direct costs and indirect costs, primarily rent and other overhead, of developing new products and technologies and are charged to expense as incurred.

Advertising

The Company expenses advertising costs when incurred. Advertising expense, included in selling, general and administrative expense, was $0.5 million for the year ended December 31, 2005 and $0.3 million for each of the years ended December 31, 2004 and 2003.

Income Taxes

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 bases. 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 include U.S. and foreign taxes.

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 loss and loss per share if the fair value based method had been applied to all awards (in thousands, except per share data):

	December 31, 2005	December 31, 2004	December 31, 2003
Reported net loss	$ (9,476)	$ (4,957)	$ (9,458)
Stock-based employee compensation expense included in reported net loss, net of related tax effects	355	31	25
Stock-based employee compensation determined under the fair value based method, net of related tax effects	(13,152)	(7,436)	(5,741)
Pro forma net loss	$ (22,273)	$ (12,362)	$ (15,174)
Loss per share (basic and diluted)			
As reported	$ (0.22)	$ (0.15)	$ (0.35)
Pro forma	$ (0.51)	$ (0.37)	$ (0.56)

Effective December 30, 2005, the Company s Board of Directors Board approved the acceleration of the vesting of out-of-the-money, unvested stock options issued to current employees, officers and directors prior to November 15, 2005 so that such options vest immediately, provided, however, that the grantee that acquires any shares pursuant to such an option (the vesting of which has been accelerated) will not be permitted to sell such shares until the earlier of (i) the original vesting date applicable to such option or (ii) the date on which such grantee s employment terminates.

The purpose of the accelerated vesting was to enable the Company to avoid recognizing in our statements of operations non-cash compensation expense associated with the options in future periods. As a result of the acceleration, we expect to avoid recognition of up to approximately $8.6 million of compensation expense in our statement of operations over the course of the original vesting periods. Such expense is included in our pro forma stock-based footnote disclosure above for the quarter ended December 31, 2005. The majority of such compensation expense is expected to be avoided in 2006. FASB Financial Interpretation No. 44 requires us to recognize compensation expense under certain circumstances, such as a change in the vesting schedule when such options are in-the-money on the date of acceleration that would allow an employee to vest an option that would have otherwise been forfeited based on the award s original terms. We would be required to begin to recognize compensation expense over the new expected vesting period based on estimates of the number of options that employees ultimately will retain that otherwise would have been forfeited, absent the modifications. The majority of the accelerated options, absent the acceleration, would have been vested in 2006, with a smaller percentage vesting over the next 30 months. Such estimates of compensation expense would be based on such factors as historical and expected employee turnover rates and similar statistics.

We are unable to estimate the number of options that will ultimately be retained that otherwise would have been forfeited, absent the acceleration.

In December 2004, SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R) was issued. SFAS 123R replaced SFAS No. 123 and supercedes APB Opinion No. 25. 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. As discussed above, 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 employees, we expect that the impact may be material.

The fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model. The following weighted average assumptions were used for grants under the option plan in 2005, 2004 and 2003: dividend yield of 0% for the three years; expected volatility of 105% for 2005, 165% for 2004 and 164% for 2003; risk-free interest rate of 3.83%, 3.81% and 3.09% for 2005, 2004 and 2003, respectively; and expected lives of five years for each of the three years. The weighted-average fair value of options granted was $4.97 for the year ended December 31, 2005, $3.57 for the year ended December 31, 2004 and $2.24 for the year ended December 31, 2003.

Loss Per Share

The Company s basic and diluted net loss per share is computed by dividing the net loss by the weighted average number of outstanding common shares. Potential common shares are excluded from the computation of diluted loss per share because their inclusion would be anti-dilutive. Potential common shares are as follows:

	As of December 31,		
(In thousands)	**2005**	**2004**	**2003**
Stock options and restricted stock	**10,109**	6,528	8,707
Warrants	**530**	720	3,029
Convertible debt			1,867
Series A Preferred Stock		15	
	10,639	7,263	13,603

Treasury Stock

Repurchased common stock is stated at cost and is presented as a separate reduction of stockholders equity.

Comprehensive Loss

The Company s comprehensive loss consists of net loss and foreign currency translation adjustments and is reported in the statement of changes in stockholders equity.

Certain items in the consolidated financial statements for 2004 and 2003 have been reclassified for comparative purposes.

Recently Issued Accounting Standards

In December 2004, SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R) was issued. SFAS 123R replaced SFAS No. 123 and supercedes APB Opinion No. 25. 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 were 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 employees, we expect that the impact may be material.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs, an amendment of ARB No. 43, Chapter 4. SFAS No. 151 amends Accounting Research Bulletin (ARB) No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) should be recognized as current-period charges. In addition, SFAS No. 151 requires that allocation of fixed production overhead to inventory be based on the normal capacity of the production facilities. The Company is required to adopt SFAS 151 beginning January 1, 2006. The adoption of SFAS 151 did not have a material impact on the results of its operations, financial position or cash flows.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets (SFAS 153). This Statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS 153 did not have a material impact on the results of its operations or financial position.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB No. 20 and FAS No. 3 (SFAS 154). SFAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS 154 also applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. SFAS 154 is effective for all accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company believes the adoption of SFAS 154 will not have an impact on its financial statements.

Revision

The financial statements have been revised to include disclosure regarding certain agreements. (See Note 21).

2. Acquisitions

The following describes the acquisitions by the Company (in thousands) in the years ended December 31, 2005 and 2004:

Company Acquired	Date Acquired	Acquisition Price	Goodwill and Other Intangibles Acquired	Other Net Assets and Liabilities	Business Description
DSD Holdings A/S	2/28/05	$ 3,902	$ 5,292	$ (1,390)	Manufactures and markets visual and electronic RFID tags for livestock.
OuterLink Corporation	1/22/04	$ 8,501	$ 8,522	$ (21)	Provider of real-time, satellite-based automated tracking, wireless data transfer and two-way messaging with large fleets of vehicles.

On February 28, 2005, the Company acquired DSD Holdings A/S and its wholly-owned subsidiaries Daploma International A/S and Digitag A/S. DSD Holdings A/S became a wholly-owned subsidiary of Digital Angel Corporation. The acquisition was accounted for under the purchase method of accounting. The excess of the purchase price over the fair value of the assets and liabilities of DSD Holdings A/S was recorded as goodwill of $2.8 million and intangible assets of $2.0 million. The intangible assets acquired are being amortized over lives ranging from 3 to 15 years. The acquisition of DSD Holdings A/S has been recorded based on preliminary estimates as of the date of acquisition. Changes to the preliminary estimates during the allocation period may result in an adjustment to goodwill.

Under the terms of the DSD Holdings A/S acquisition, the Company purchased all of the outstanding capital stock of DSD Holdings A/S in consideration for a purchase price of seven times DSD Holdings A/S s average annual EBITDA over the next three years less outstanding indebtedness at the end of the time period and less 30% of compensation expense paid to Lasse Nordfjeld, CEO of DSD Holdings A/S. An initial payment of $3.5 million was made at closing through the delivery of Applied Digital common stock valued at $3.5 million which the Company acquired from Applied Digital in exchange for $3.5 million of Digital Angel Corporation common stock. The cost of the acquisition also included approximately $0.2 million of acquisition costs and additional cash consideration of $0.2 million to account for pre-closing pricing fluctuations. Any additional consideration, when determined, will be recorded as an increase to goodwill.

In addition, Digital Angel entered into employment agreements with the Chief Executive Officer of DSD Holdings A/S and its subsidiaries, and his son, the President of Daploma.

Denmark-based DSD Holdings A/S through its subsidiaries manufactures and markets visual and electronic RFID tags for livestock. 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 Europe, the Middle East and Asia. The acquisition provides Digital Angel with immediate expansion of its existing business in the significant European market for livestock tagging and tracking.

Digital Angel Corporation operates DSD Holdings A/S and its operating subsidiaries from their current headquarters near Copenhagen, Denmark.

The following table summarizes the estimated fair values of the tangible assets acquired and liabilities assumed at the date of acquisition.

		As of February 28, 2005 (in thousands)
Current assets	$	2,631
Property, plant and equipment		2,580
Other assets		33
Total assets acquired		5,244
Current liabilities		3,371
Long-term debt and other liabilities		3,263
Total liabilities assumed		6,634
Net liabilities acquired	$	(1,390)

On January 22, 2004, the Company acquired OuterLink Corporation, which became a wholly-owned subsidiary of Digital Angel Corporation. The acquisition was accounted for under the purchase method of accounting. The excess of the purchase price over the fair value of the assets and liabilities of OuterLink Corporation was recorded as goodwill of $3.8 million and intangible assets of $4.7 million. The intangible assets are customer relationships, trademarks and core technology. The customer relationships and core technology were being amortized over periods ranging from 4 to 8 years. Amortization recorded in the years ended December 31, 2005 and 2004 was $0.7 million and $0.7 million, respectively. The trademark has an indefinite life. In the fourth quarter of 2005, the Company determined that the value of OuterLink Corporation s goodwill and intangible assets were impaired. Accordingly, the Company recorded a $7.1 million asset impairment charge in the fourth quarter of 2005.

The cost of the acquisition consisted of 100,000 shares of Series A preferred stock valued at $8.3 million and acquisition costs of $0.2 million. The Series A preferred stock became convertible into four million shares of the Company s common stock when the volume weighted average price of the Company s common stock was greater than or equal to $4.00 per share for ten consecutive trading days. As of December 31, 2005, 99,976 preferred shares had been converted into 3.9 million shares of the Company s common stock.

The valuation of the stock was primarily based on historical trading history and stock prices of the Company s common stock and a marketability discount of 30%. The acquisition costs consist of legal and accounting related services that were direct costs of the acquisition.

In considering the benefits of 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.

The following table summarizes the estimated fair values of the tangible assets acquired and liabilities assumed at the date of acquisition.

		As of January 22, 2004 (in thousands)
Current assets	$	1,225
Property, plant and equipment		116
Other assets		73
Total assets acquired		1,414
Current liabilities		1,415
Long-term debt and other liabilities		20
Total liabilities assumed		1,435

Net liabilities acquired	$	(21)

The results of DSD Holdings A/S and OuterLink Corporation have been included in the consolidated financial statements since their dates of acquisition, February 28, 2005 and January 22, 2004, respectively. Unaudited pro forma results of operations for the years ended December 31, 2005 and 2004 are included below. Such pro forma information assumes that DSD Holdings A/S was acquired on January 1, 2005 and 2004 and OuterLink Corporation was acquired on January 1, 2004, and revenue is presented in accordance with the Company s accounting policies. This summary is not necessarily indicative of what the results 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.

	Pro Forma For the Year Ended December 31, (In thousands, except per share data) (unaudited)			
	2005		2004	
Net operating revenue	$	57,709	$	50,159
Net loss	$	(9,507)	$	(6,599)
Net loss per common share - basic and diluted	$	(0.22)	$	(0.20)

3. Inventory

	(In thousands)			
	December 31, 2005		December 31, 2004	
Raw materials	**$**	**3,198**	$	3,115
Work in process		**122**		137
Finished goods		**7,006**		4,895
		10,326		8,147
Allowance for excess and obsolescence		**(1,669)**		(1,915)
Net inventory	**$**	**8,657**	$	6,232

Inventory of $3.6 million and $2.6 million was located in Europe as of December 31, 2005 and December 31, 2004, respectively.

4. Other Current Assets

	(In thousands)			
	December 31, 2005		December 31, 2004	
Prepaid expenses and other current assets	**$**	**1,035**	$	1,063
Deferred product costs		**201**		154
Deferred tax asset		**155**		
Deposits		**27**		18
	$	**1,418**	$	1,235

5. Property and Equipment, net

	(In thousands)			
	December 31, 2005		December 31, 2004	
Land	**$**	**278**	$	278
Building and leasehold improvements		**4,842**		4,569
Equipment and furniture		**8,808**		6,083
		13,928		10,930
Less: Accumulated depreciation and amortization		**(5,326)**		(4,983)
	$	**8,602**	$	5,947

Included above are vehicles and equipment acquired under capital lease obligations in the amount of $428,000 and $187,000 at December 31, 2005 and 2004, respectively. Related accumulated depreciation amounted to $104,000 and $68,000 at December 31, 2005 and 2004, respectively.

Depreciation charged against income amounted to $1,526,000, $1,329,000 and $1,178,000 for the years ended December 31, 2005, 2004 and 2003, respectively.

6. Goodwill, net

The components of goodwill are as follows at December 31, (in thousands):

	2005				2004			
	Original Carrying Value	Cumulative Impairment Charges	Accumulated Amortization	Net Carrying Value	Original Carrying Value	Cumulative Impairment Charges	Accumulated Amortization	Net Carrying Value
Goodwill	$ 95,404	$ (35,314)	$ (11,599)	$ 48,491	$ 92,056	$ (31,460)	$ (11,599)	$ 48,997

Goodwill consists of the excess of cost over fair value of net tangible and identifiable intangible assets of companies purchased.

7. Other Intangible Assets, net

The components of other intangible assets are as follows at December 31, (in thousands):

	2005				2004			
	Original Carrying Value	Cumulative Impairment Charges	Accumulated Amortization	Net Carrying Value	Original Carrying Value	Cumulative Impairment Charges	Accumulated Amortization	Net Carrying Value
Other Intangible Assets	$ 6,638	$ (3,287)	$ (1,538)	$ 1,813	$ 4,675	$	$ (664)	$ 4,011

Other intangibles represent assets recognized separately from goodwill and consist primarily of patents, non compete agreements and customer relationships. Other intangibles are being amortized over lives ranging from 3 to 15 years.

Amortization expense amounted to $874,000, $664,000 and $0 for the years ended December 31, 2005, 2004 and 2003, respectively.

8. Accrued Expenses and Other Current Liabilities

	(In thousands)	
	December 31, 2005	**December 31, 2004**
Accrued wages and wage related costs	**$ 2,421**	$ 2,933
Accrued marketing expenses		412
Accrued professional fees	**199**	252
Customer deposits	**141**	173
Other	**471**	601
	$ 3,232	$ 4,371

9. Notes Payable, Line of Credit and Long-Term Debt

Long-term debt consists of the following:

	(In thousands)	
	December 31, 2005	December 31, 2004
Mortgage notes payable-Animal Applications and Corporate facilities	**$ 2,281**	$ 2,331
Line of Credit DSD Holdings	**1,722**	
Note Payable DSD Holdings	**569**	
Equipment Loans-DSD Holdings	**1,186**	
Capital lease obligations	**278**	53
	6,036	2,384
Less: Current maturities	**(2,380)**	(99)
	$ 3,656	$ 2,285

The scheduled maturities of long-term debt, including capitalized leases, at December 31, 2005 are as follows:

Year		Amount (In thousands)
2006	$	2,380
2007		632
2008		553
2009		279
2010		226
Thereafter		1,966
	$	6,036

Interest expense on the above debts amounted to $335,000, $567,000 and $543,000 for the years ended December 31, 2005, 2004 and 2003, respectively.

Mortgage Notes Payable-Animal Applications and Corporate facilities

Mortgage notes payable is collateralized by land and building. Principal and interest payments totaling approximately $30,000 are payable monthly through October 2010. The final payment of $2.0 million is due in November of 2010. The interest rate on the note is fixed at 8.18%.

Equipment Loans-DSD Holdings

DSD Holdings is party to equipment loans which are collateralized by production equipment. Principal and interest payments totaling approximately DKK 0.2 million ($31,600 USD at December 31, 2005) are payable monthly. Payments are due through January 2010. The interest rates on the loans are variable and range from 4.56% to 7.06% as of December 31, 2005.

Line of Credit-DSD Holdings

As of December 31, 2005, DSD Holdings is party to a credit agreement with Danske Bank. The credit facility provides for borrowings up to DKK 12 million ($1,896,000 USD at December 31, 2005). The interest is determined quarterly and is based on the international rates Danske Bank can establish a loan in the same currency on the international market plus 2.0%. At December 31, 2005, the annual interest rate on the facility was 4.6%. Borrowing availability under the credit facility considers guarantees outstanding. Pursuant to the terms of the credit agreement, DSD Holdings entered into a verbal overdraft agreement with Danske Bank in January 2006. The overdraft agreement provides for additional borrowings up to DKK 1 million through March 31, 2006. The credit agreement shall remain effective until further notice. DSD Holdings can terminate the credit agreement and pay the outstanding balance or Danske Bank may demand the credit line be settled immediately at any given time, without prior notice.

Note Payable-DSD Holdings

As of December 31, 2005, DSD Holdings is party to a note payable with Danske Bank. Principal and interest payments of DKK 0.3 million ($47,400 USD at December 31, 2005) plus interest are payable quarterly through December 15, 2008. The interest rate on the note is calculated based on the international rates Danske Bank can establish on a loan in DKK in the international market plus 2.0%. The interest rate on the note payable was 4.23% at December 31, 2005.

Revolving Note and Minimum Borrowing Note

On August 28, 2003, the Company entered into a Security Agreement with Laurus which allowed us to borrow from Laurus the lesser of $5 million or an amount that is determined based on percentages of our eligible accounts receivable and inventory as prescribed by the terms of the Security Agreement. Under the Security Agreement, we issued to Laurus a three-year Secured Revolving Convertible Note (Revolving Note) in the original principal amount of $3.5 million and a three-year Secured Minimum Borrowing Convertible Note (Minimum Borrowing Note) in the original principal amount of $1.5 million. The Revolving Note and Minimum Borrowing Note accrued interest at an annual rate equal to the prime rate plus 2.5%. The Minimum Borrowing Note and the Revolving Note were convertible, at Laurus s option, into shares of our common stock at a price per share of $2.64.

The Company also issued to Laurus a five-year warrant to purchase up to 115,000 shares of our common stock. The per share exercise prices of the warrant are $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 was amortized to interest expense.

As of December 31, 2004, Laurus had converted $1.5 million, the remaining principal amount of the Minimum Borrowing Note, into 0.6 million shares of our common stock, terminating both of the agreements.

Working Capital Loan

On March 7, 2003, Signature Industries Limited entered into a Loan Agreement (Working Capital Loan) with The Royal Bank of Scotland which was repaid on October 29, 2004.

Invoice Discounting Agreement

On April 9, 2003, Signature Industries L 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 and June 21, 2005, provides for Signature to sell with full title guarantee for most of its receivables, as defined in the Invoice Discounting Agreement, as amended. RBS prepays 80% of the receivables sold in the United Kingdom and 75% of the receivables sold in the rest of the world, not to exceed an outstanding balance of £750,000 ($1,300,000 USD at December 31, 2005) 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 at an annual rate of 1.85% above the base rate (the base rate was 4.5% as of December 31, 2005), as defined in the amended Invoice Discounting Agreement. Signature pays a commission charge to RBS of 0.16% of each receivable balance sold. The Invoice Discounting Agreement, as amended, requires a minimum commission charge of £833 per month. Discounting charges of $29,000 are included in interest expense in the 2005 statement of operations. As of December 31, 2005 Signature did not have any receivables financed under the Invoice Discounting Agreement.

10. Fair Value of Financial Instruments

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

Cash and Accounts Receivable

The carrying amount approximates fair value because of the short maturity of those instruments.

Long-Term Debt (mortgages)

The carrying amount approximates fair value because the interest rate approximates the current rate at which the Company could borrow funds on similar debt.

11. Stock Exchanges with Applied Digital Solutions, Inc.

On February 25, 2005, the Company entered into a Stock Purchase Agreement with Applied Digital. The purpose of the stock exchange was to use the shares as partial consideration for the acquisition of DSD Holdings A/S and its wholly-owned subsidiaries, Daploma International A/S and Digitag A/S, as described more fully in note 2. The Company and Applied Digital entered into the share exchange because of the selling shareholders desire, at the time the transaction was negotiated, to receive their consideration in Applied Digital common stock as opposed to the Company s common stock. In addition, the stock purchase represented a strategic investment by Applied Digital whereby Applied Digital could increase its ownership interest in the Company. Pursuant to the agreement, the Company issued 644,140 shares of its common stock to Applied Digital in exchange for 684,543 shares of Applied Digital common stock as consideration. The exchange ratio of shares was based upon the average of the volume-weighted-average price of the Company s common stock and Applied Digital s common stock for the ten trading days immediately preceding, and not including, the transaction closing date which was $5.434 for the Company s common stock and $5.113 for Applied Digital s common stock. The value of the stock exchanged was $3.5 million.

On March 1, 2004, the Company issued 3,000,000 shares of its common stock to Applied Digital pursuant to the Stock Purchase Agreement (Stock Purchase Agreement) with Applied Digital dated August 14, 2003. The Stock Purchase Agreement dated August 14, 2003 was used as a method for the Company to obtain and sell shares of Applied Digital in order to generate cash for operations in a period of time when other capital was scarce or not available. The Company believed the share exchange with Applied Digital, as compared to selling shares of Digital Angel, was beneficial because (i) the net yield on the sale was higher as the Company did not have to pay an underwriting commission and (ii) the Company believed the sale of Applied Digital shares was preferable to the sale of Digital Angel shares because (a) a larger number of Applied Digital shares were outstanding in the hands of unaffiliated holders (b) Applied Digital shares had a much larger volume of stock trading on a daily basis and (c) Applied Digital shares had lower stock price volatility than Digital Angel shares. In addition, the Company and Applied Digital mutually agreed that the stock purchase represented a strategic investment by Applied Digital whereby Applied Digital could increase their ownership interest in the Company.

The purchase price per share for the shares of the Company s stock was based on the closing price of the Company s common stock on June 30, 2003 of $2.64 per share. This price was used because the Company and Applied Digital determined that this was a fair price and because it reflected the fair value of the securities before any impact of the Applied Digital Debenture holders potentially hedging their position in the Company s common stock and thereby affecting the market price of the stock. In connection with this transaction, the Company granted five year warrants to the Applied Digital Debenture holders to acquire up to 500,001 shares of the Company s common stock at an exercise price of $2.64 per share. The warrants were issued in consideration for a waiver from the Applied Digital Debenture holders allowing Applied Digital to register the shares being issued in connection with the Stock Purchase Agreement. The exercise price of the warrants was determined in negotiation with the Applied Digital Debenture holders. The purchase price of the Applied Digital common stock was based on the average of the volume weighted average price of Applied Digital s common stock for the ten trading days immediately preceding (and not including) the closing date. In addition, as part of this transaction, the Company granted a five year warrant to Applied Digital to purchase up to 1 million shares of the Company s common stock. The exercise price of the warrant, $3.74, was based on the daily volume weighted average price of the Company s common stock for the first 10 consecutive trading days of 2004 starting on January 2, 2004.

The Company accounted for this transaction in a manner similar to a private placement whereby the Company issued common stock and warrants in exchange for common stock of Applied Digital. The Company s intention was to sell the shares of Applied Digital to generate cash for its operations. Accordingly, the Company accounted for the Applied Digital stock as a trading security under SFAS 115, Accounting for Certain Investments in Debt and Equity Securities.

As of December 31, 2004, the Company had sold all of the 1,980,000 shares of Applied Digital common stock for $6.7 million. In the year ended December 31, 2004, the Company recorded realized losses on the Applied Digital common stock of $1.2 million. In December 2004, Applied Digital exercised its warrant for 1,000,000 shares of our common stock. Net proceeds to the Company upon exercise of the warrant were $3.74 million.

12. Discontinued Operations

In April 2004, our Board of Directors approved a plan to sell our Medical Systems segment. The Medical Systems segment represented the business operations of Medical Advisory Systems, Inc, which we acquired on March 27, 2002. The Medical Systems segment was one of our reporting units in accordance with SFAS 142, Goodwill and Other Intangible Assets . Accordingly, the financial condition, results of operations and cash flows of our Medical Systems segment have been reported as discontinued operations for all periods presented. The following discloses the operating income and loss from discontinued operations for the years ended December 31, 2005 and 2004, consisting of losses attributable to the Medical Systems segment (in thousands):

	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)	(177)		(185)
Income (loss) from discontinued operations	$ 177	$	(1,086)

The above results do not include any allocated or common overhead expenses. We have not provided a benefit for income taxes on the losses attributable to the Medical Systems division. We do not anticipate the Medical Systems division incurring additional losses in the future. However, in accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets , any additional operating losses or changes in the values of assets or liabilities will be reflected in our financial condition and results of operations as incurred.

The net (liabilities) assets of discontinued operations as of December 31, 2005 and December 31, 2004, were comprised of the following:

	December 31, 2005		December 31, 2004	
	(in thousands)			
Assets				
Accounts receivable, net	$		$	
Inventory				
Other current assets				
Property and equipment, net				
Goodwill and other intangible assets, net				
Other assets				135
Total Assets	$		$	135
Current Liabilities:				
Notes payable and current maturities of long-term debt	$		$	
Accounts payable				
Accrued expenses and deferred revenue		84		129
Total Liabilities	$	84	$	129
Net (Liabilities) Assets	$	(84)	$	6

13. Income Taxes

The provision for income taxes consists of:

	(In thousands)					
	December 31, 2005		December 31, 2004		December 31, 2003	
Current:						
United States at statutory rates	**$**		$		$	
International		114				
Current income tax provision (credit)		114				
Deferred:						
United States						
International		(155)				
Deferred income taxes provision (credit)						
	$	(41)	$		$	

The Company considers earnings from its foreign operations to be indefinitely reinvested and, accordingly, no provision for United States federal and state income taxes has been made for these earnings. Upon distribution of foreign subsidiary earnings, the Company may be subject to United States income taxes (subject to an adjustment for foreign tax credits) and withholding taxes payable to the foreign jurisdiction.

The tax effects of temporary differences and carryforwards that give rise to significant portions of deferred tax assets and liabilities consist of the following:

	(In thousands)	
	December 31, 2005	December 31, 2004
Deferred Tax Assets:		
Liabilities and reserves	**$ 1,288**	$ 1,554
Compensation not currently deductible	**1,278**	1,341
Tangible and Intangible property basis difference	**372**	542
Net operating loss carryforwards	**29,005**	24,229
Gross deferred tax assets	**31,943**	27,666
Valuation allowance	**(31,788)**	(27,666)
	155	
Deferred Tax Liabilities:		
Intangible property basis difference	**541**	
Net deferred tax liability	**$ 386**	$

The deferred tax assets and liabilities are included in the following balance sheet captions:

	(In thousands)	
	December 31, 2005	December 31, 2004
Other current assets	**$ 155**	$
Long term liabilities	**541**	
Net deferred tax liabilities	**$ 386**	$

Domestic and foreign loss from continuing operations before provision for income taxes and minority interest consists of:

	(In thousands)	
	December 31, 2004	December 31, 2003
Domestic	**$ (10,214)**	$ (5,732)
Foreign	**871**	2,110
	$ (9,343)	$ (3,622)

At December 31, 2005, the Company had aggregate United States federal net operating loss carryforwards of approximately $70.1 million for income tax purposes, which expire in various amounts through 2025. Approximately $31.8 million of the net operating loss carryforwards were acquired in connection with various domestic acquisitions and are limited as to use in any particular year based on Internal Revenue Code sections related to change of ownership restrictions. Further, past and future stock issuances may subject the Company to additional limitations on the use of the remaining net operating loss carryforwards under the same Internal Revenue Code provision.

Additionally, net operating loss carryforwards of approximately $3.1 million relate to foreign losses. Of this, $1.6 million was acquired in connection with the acquisition of DSD Holdings A/S during the year. At year end the Company determined that a portion of Signature Industries Limited s UK net operating loss carryforwards will more likely than not be utilized and accordingly released $155,000 of the valuation allowance. A full valuation allowance against all other net deferred tax assets at December 31, 2005 has been recorded. The remaining net deferred tax liability relates primarily to deferred tax liabilities for purchased intangibles for which no tax basis exists.

The valuation allowance increased by $4.1 million during the year ended December 31, 2005. The valuation allowance increased by $5.5 million during the year ended December 31, 2004, including a $9.2 million increase related to the deferred tax assets acquired with Outerlink offset by a decrease in the deferred tax asset related to compensation not currently deductible.

The reconciliation of the effective tax rate with the statutory federal income tax from continuing operations rate is as follows:

	December 31, 2005	December 31, 2004	December 31, 2003
Statutory rate	**(35)%**	(35)%	(35)%
State income taxes, net of federal benefits	**(5)**	(5)	(5)
Goodwill impairment and other permanent differences	**29**	7	14
Benefit from nonqualified stock options		(119)	
Tax gain on sales of Applied Digital stock		77	
Change in deferred tax asset valuation allowance (a)	**10**	75	26
Other	**1**		
	0%	0%	0%

(a) net of deferred tax assets acquired in the DSD acquisition.

14. Commitments and Contingencies

Rental expense for space, vehicles, and office equipment under operating leases amounted to approximately $749,000, $989,000, and $618,000 for the years ended December 31, 2005, 2004 and 2003, respectively.

The approximate minimum payments required under operating leases and employment contracts that have initial or remaining terms in excess of one year at December 31, 2005 are (in thousands):

Year	Minimal Rental Payments	Employment Contracts
2006	$ 720	$ 1,493
2007	640	205
2008	587	205
2009	506	
2010	461	
Thereafter	14,599	
	$ 17,513	$ 1,903

15. Profit Sharing Plan

Applied Digital has a retirement savings plan under section 401(k) of the Internal Revenue Code for the benefit of eligible United States employees. Applied Digital has made no matching contributions to the 401(k) Plan. The Company s employees are eligible to participate in this plan.

In 1994, MAS adopted a Retirement Savings Plan (MAS Plan) in accordance with Section 401(k) of the Internal Revenue Code. The MAS Plan was available to all eligible employees of the Company s Medical Systems segment. The Company provided for discretionary matching contributions to the MAS Plan equal to a percentage of the participant s contributions. The Company made no matching contributions to the MAS Plan during 2004 or 2003. On December 1, 2004, the MAS Plan was terminated and all contributions ceased.

Signature Industries Limited has certain defined contribution pension plans. The Company s expense relating to the plans approximated $107,000, $136,000 and $119,000 for the years ended December 31, 2005, 2004 and 2003, respectively.

16. Stock Options, Restricted Stock, and Warrants

Stock Options

During 1999, Digital Angel Corporation adopted a non-qualified stock option plan (the Stock Option Plan). In connection with the merger with MAS, the Company assumed the options granted under the Stock Option Plan under its Amended and Restated Digital Angel Corporation Transition Stock Option Plan (DAC Stock Option Plan). As amended, the DAC Stock Option Plan provides 18,195,000 shares of common stock for which options may be granted. As of December 31, 2005, options to purchase 7,978,000 shares were outstanding, 154,000 restricted shares were outstanding and 2,539,000 shares are available for future grants of options. The options vest as determined by the Board of Directors and are exercisable for a period of no more than 10 years.

Under MAS s nonqualified stock option plan (the MAS Stock Option Plan), options may be granted at or below the fair market value of the stock and have five and 10 year lives. Options granted to certain individuals vest ratably over three years. As of December 31, 2005, options to purchase 477,000 shares were outstanding and 272,000 shares are available for future grants of options. In February 2006 the MAS Stock Option Plan was terminated. The termination has no effect on the options outstanding. Option shares authorized but unissued under options pursuant to the MAS Stock Option Plan are no longer available for future grant.

A summary of stock option activity for the aforementioned plans for 2005, 2004 and 2003 is as follows (in thousands, except exercise price data):

	2005		2004		2003	
	Shares	**Weighted Average Exercise Price**	**Shares**	**Weighted Average Exercise Price**	**Shares**	**Weighted Average Exercise Price**
Outstanding on January 1	5,028	$ 3.23	7,357	$ 2.98	7,816	$ 2.56
Granted	3,922	4.97	1,905	3.81	1,825	2.63
Exercised	(20)	2.73	(4,076)	2.94	(1,672)	0.67
Forfeited	(475)	4.46	(158)	3.90	(612)	3.44
Outstanding on December 31	8,455	3.97	5,028	3.23	7,357	2.98
Exercisable on December 31	8,255	3.98	3,255	2.94	5,333	3.07
Shares available for grant on December 31	2,811		4,412		1,157	

The following table summarizes information about the Company s stock options, for the aforementioned plans, at December 31, 2005 (in thousands, except exercise price data):

	Outstanding Stock Options			Exercisable Stock	
Range of Exercise Prices	**Shares**	**Weighted Average Remaining Contractual Life**	**Weighted Average Exercise Price**	**Shares**	**Weighted Average Exercise Price**
$ 0.01 to $2.00	1,227	6.51	$ 1.30	1,227	$ 1.30
$ 2.01 to $4.00	3,296	7.73	3.60	3,196	3.62
$ 4.01 to $6.00	3,814	9.02	4.96	3,714	4.98
$ 6.01 to $8.00					
$ 8.01 to $10.00	118	4.38	10.00	118	10.00
	8,455	8.09	3.97	8,255	3.98

On January 13, 2004, the Company granted its Chief Executive Officer (CEO) a ten-year option to purchase 1,000,000 shares of the Company s common stock at $3.92 per share. The option became exercisable on December 30, 2005.

On February 18, 2004, the Company granted its Chairman of the Board of Directors a ten-year option to purchase 500,000 shares of the Company s common stock at $3.43 per share. The option became exercisable on February 18, 2005.

In 2003, the Company granted stock options which were outside of its stock option plans. On September 5, 2003, the Company granted its former CEO a ten-year option to purchase 1,000,000 shares of the Company s common stock at $1.97 per share. The option was vested and exercisable on the grant date. At December 31, 2004, all of the options had been exercised.

On November 3, 2003, the Company granted its former CEO a ten-year option to purchase 1,000,000 shares of the Company s common stock at $2.40 per share. The option was exercisable one year from the date of grant, but only if the CEO was then an employee or director of the Company. In January 2004, this option was forfeited.

Applied Digital has four non-qualified option plans. On April 5, 2004, Applied Digital effected a one for ten reverse split of its common stock. All share prices and share amounts for Applied Digital common stock reflect the reverse stock split. Under the Applied Digital plans, options for 4.8 million common shares were authorized for issuance to certain officers and employees of Applied Digital, which include certain officers and employees of the Company. There were no options granted under the plans to the Company s officers and employees for services related to Digital Angel Corporation in 2005, 2004 or 2003. The options may not be exercised until one to three years after the grant date and are exercisable for periods ranging from five to ten years.

A summary of stock option activity in 2005, 2004 and 2003 for the Applied Digital plan as it relates to certain of the Company s officers and employees is as follows (in thousands, except exercise price data)

	2005			2004			2003		
	Shares		Weighted Average Exercise Price	Shares		Weighted Average Exercise Price	Shares		Weighted Average Exercise Price
Outstanding on January 1	161	$	17.54	212	$	16.33	242	$	15.51
Granted									
Exercised							(13)		1.50
Forfeited	(52)		18.43	(51)		12.57	(17)		14.02
Outstanding on December 31	109		18.28	161		17.54	212		16.33
Exercisable on December 31	109	$	18.28	151	$	17.51	197	$	16.09

The following table summarizes information about stock options under the Applied Digital plans as it relates to the Company s officers and employees at December 31, 2005 (in thousands, except exercise price data):

		Outstanding Stock Options			Exercisable Stock		
Range of Exercise Prices	Shares	Weighted Average Remaining Contractual Life		Weighted Average Exercise Price	Shares		Weighted Average Exercise Price
$ 0.01 to $20.00	77	2.68	$	13.49	77	$	13.49
$ 20.01 to $40.00	30	1.27		29.48	30		29.48
$ 40.01 to $60.00	2	0.39		42.50	2		42.50
	109	2.26	$	18.28	109	$	18.28

Qualified Employee Stock Purchase Plan

During 1999, Applied Digital adopted a non-compensatory, qualified Employee Stock Purchase Plan (the Stock Purchase Plan). Under the Stock Purchase Plan, options are granted at an exercise price of the lesser of 85% of the fair market value on the date of grant or 85% of the fair market value on the exercise date. Under the Stock Purchase Plan, options for 900,000 common shares of Applied Digital were authorized for issuance to substantially all full-time employees of Applied Digital, which includes employees of the Company. Approximately 22,906 options to purchase shares have been issued to employees of the Company and exercised through December 31, 2005. Each participant s options to purchase shares will be automatically exercised for the participant on the exercise dates determined by the board of directors of Applied Digital.

Restricted Stock

In March 2005, the Company granted its Chairman of the Board 100,000 shares of the Company s restricted stock. The restricted stock vests 50% on March 7, 2006 and 50% on March 7, 2007. The Company determined the value of the stock to be $506,000 based on the closing price of the Company s stock on the date of grant. The value of the restricted stock has been recorded as deferred compensation and is being amortized to compensation expense over the two year vesting period. In 2005, $211,000 was recognized as compensation expense in the Company s results of operations.

In February 2005, the Company granted an employee 54,230 shares of the Company s restricted stock. The restricted stock vests 30% on February 25, 2006, 30% on February 25, 2006 and 40% on February 25, 2007. The Company determined the value of the stock to be $250,000 based on the closing price of the Company s stock on the date of grant. The value of the restricted stock has been recorded as deferred compensation and is being amortized to compensation expense over the vesting period. In 2005, $64,000 was recognized as compensation expense in the Company s results of operations.

Stock Warrants

In May 2000, MAS issued fully vested warrants to purchase 75,000 shares of its common stock to an investment banking firm. The holder of the warrants may purchase 75,000 common shares at $10.50 per share, subject to adjustment as specified in the warrant agreement, for up to five years. These warrants expired unexercised in May 2005.

ADS had a term and revolving credit agreement (IBM Credit Agreement) with IBM Credit LLC (IBM Credit). In connection with an amendment to the IBM Credit Agreement, IBM Credit was granted warrants to acquire 1.16 million shares of Digital Angel s common stock exercisable at $1.07 and expiring on April 10, 2007. In October 2004, IBM Credit exercised its warrant to acquire shares of Digital Angel s common stock on a cashless basis pursuant to the warrant agreement, thus IBM received 809,688 shares of Digital Angel s common stock.

In April 2002, the Company issued a fully vested warrant to purchase 50,000 shares of its common stock to an investor relations firm as consideration for providing investor relations services. The holder of the warrant may purchase 50,000 common shares at $3.60 per share for up to five years. In November 2004, the warrant to purchase 50,000 shares of the Company s stock was exercised and the Company received proceeds of $180,000

On July 31, 2003, in connection with the $2,000,000 secured convertible note payable to Laurus Master Fund, we issued a warrant to purchase 125,000 shares of our common stock. The warrant issued to Laurus is exercisable through July 31, 2008 and permits Laurus Master Fund to purchase 75,000 shares of our common stock at $2.68 per share, 35,000 shares at $2.91 per share and 15,000 shares at $3.38 per share. The Company determined the estimated aggregate fair value of these warrants on the date of grant to be $143,000 based on the Black-Scholes valuation model using the following assumptions: expected volatility of 107.2 %, dividend yield of 0%, risk free interest of 3.3% and an expected life of 5 years. The value of the warrant was accounted for as debt discount and amortized to interest expense over the term of the secured convertible note. As of December 31, 2005, Laurus has not exercised their warrant.

On August 14, 2003, in connection with the Stock Purchase Agreement with ADS, pursuant to which Applied Digital Solutions agreed to purchase 3,000,000 shares of our common stock, the Company issued a warrant to purchase 1,000,000 shares of our common stock to ADS. The warrant issued to ADS is exercisable for five years, beginning February 1, 2004, and entitles ADS to purchase 1,000,000 shares of our common stock at a price per share of $3.74 payable in cash or shares of common stock of ADS. In December 2004, Applied Digital exercised its warrant for 1,000,000 shares of our common stock. Proceeds to the Company upon Applied Digital s exercise of the warrant were $3.74 million.

On August 14, 2003, the Company issued warrants to purchase 500,001 shares of our common stock to certain holders of Applied Digital Solutions Convertible Exchangeable Debentures. These warrants were issued to procure the consent of the holders of Convertible Exchangeable Debentures to the issuance of the Applied Digital common stock to Digital Angel Corporation pursuant to the Stock Purchase Agreement. At the time the Stock Purchase Agreement was executed, the terms of the Convertible Exchangeable Debentures prohibited Applied Digital from, among other things, issuing or selling shares of its common stock. Therefore, to avoid breaching the terms of its Convertible Exchangeable Debentures, Applied Digital was required to obtain the consent of the holders of Convertible Exchangeable Debentures to the issuance of Applied Digital common stock to Digital Angel Corporation pursuant to the Stock Purchase Agreement. The warrants issued to the holders of Convertible Exchangeable Debentures are exercisable for five years beginning February 1, 2004 and entitle the holder to purchase that number of shares of common stock of Digital Angel Corporation designated in the warrant at a price of $2.64 per share. The warrant was valued at $0.8 million using the Black-Scholes option pricing model and recorded as a charge to interest expense in Applied Digital s results of operations. Through December 31, 2005, 95,238 of the 500,001 warrants were exercised.

On August 28, 2003, in connection with the $3.5 million secured revolving convertible note and the $1.5 million secured minimum borrowing convertible note, the Company issued a warrant to purchase 115,000 shares of our common stock. The warrant is exercisable for five years and entitles Laurus to purchase 70,000 shares of our common stock at $2.55, 35,000 shares at $2.75 per share and 10,000 shares at $2.95 per share. The Company determined the estimated aggregate fair value of these warrants on the date of grant to be $133,000 based on the Black-Scholes valuation model using the following assumptions: expected volatility of 107.2%, dividend yield of 0%, risk free interest of 3.3% and an expected life of 5 years. The value of the warrant was accounted for as debt discount and was amortized to interest expense over the life of the secured convertible note. In March 2005, Laurus exercised their warrant for 115,000 shares, and the Company received proceeds of $304,000.

17. Non-Cash Compensation Expense

Non-cash compensation expense of $0.4 million, $0.03 million and $0.07 million has been included in selling, general and administrative expenses for 2005, 2004 and 2003, respectively. The 2005 expense primarily relates to 100,000 stock options issued to Applied Digital employees, 100,000 shares of restricted stock issued the Company s Chairman of the Board in March 2005 and 54,230 shares of restricted stock issued to an employee in February 2005. The 2004 expense resulted from 10,000 shares of common stock provided to an individual as compensation for recruiting services. The 2003 expense resulted primarily from re-pricing in September 2001 certain Applied Digital stock options. The options had original exercise prices ranging from $0.69 to $6.34 per share and were modified to change the exercise price to $0.15 per share. Due to the modification, these options were being accounted for as variable options under APB Opinion No. 25 and FASB Interpretation No. 44, and fluctuations in the common stock price resulted in increases and decreases of non-cash compensation expense until the options were exercised in April 2003.

18. Legal Proceedings

Digital Angel Corporation vs. Allflex USA, Inc and Pet Health Services (USA), Inc.

On October 20, 2004, the Company commenced an action in the United Stated District Court for the District of Minnesota against AllFlex USA, Inc. and Pet Health Services (USA), Inc. This suit claimed that Allflex was marketing and selling a syringe implantable identification transponder that infringed a 1993 patent granted to the Company for syringe implantable identification transponders previously found by the United States District Court for the District of Colorado to be enforceable. The suit also claimed that PetHealth was using, selling and/or distributing the same transponder in violation of the Company s patent. The suit sought, among other things, an adjudication of infringement and that the infringing parties be enjoined from further improper action. The suit sought actual damages, punitive damages and interest, costs and attorneys fees. Allflex asserted a counterclaim for breach of contract of an existing license agreement between the Company and Allflex and asserted a counterclaim seeking a declaration of the parties rights and obligations under the license agreement. Allflex also moved for a judgment on the pleadings, asserting that the license agreement should act as a bar to a case for infringement. The Company contested the motion on the ground that Allflex s actions exceed the scope of the license and constituted an impermissible infringement of the patent and asked the Court for leave to amend the complaint to assert a claim for infringement of a separate patent licensed exclusively to the Company by Bio Medic Data Systems. On June 23, 2005, the Court issued a ruling granting the Defendant s motion for judgment on the pleadings and denying the Company s motion for leave to amend.

On July 21, 2005, Allflex filed an action in the United Stated District Court for the Northern District of Texas seeking a declaratory judgment that it did not infringe the Bio Medic patent. The Company has not been served with this complaint and Allflex agreed to withdraw the complaint without prejudice.

On September 28, 2005, Allflex sought an award of attorneys fees and costs based on a fee-shifting clause in the license agreement and under 35 U.S.C. §285, which provides for an award of attorneys fees and costs in exceptional cases. The Company contested this motion, and on October 6, 2005, the Court denied the motion in its entirety. Final judgment in the action was entered on February 21, 2006, and the Company is considering whether to appeal the Court s ruling granting judgment on the pleadings.

Digital Angel Corporation vs. Datamars, Inc., Datamars, S.A., The Crystal Import Corporation and Medical Management International, Inc.

On October 20, 2004, the Company commenced an action in the United States District Court for the District of Minnesota against Datamars, Inc., Datamars, S.A., The Crystal Import Corporation, and Medical Management International, Inc. (Banfield). This suit claims that the defendants are marketing and selling syringe implantable identification transponders manufactured by Datamars that infringe the Company s 1993 patent for syringe implantable identification transponders previously found by the United States District Court for the District of Colorado to be enforceable. Certain of the locations in which the infringing transponders are or have been sold, include, but are not limited to, Banfield, The Pet Hospital of which certain locations are associated with PetSmart stores. The suit seeks, among other things, an adjudication of infringement and that the infringing parties be enjoined from further improper action. The suit also seeks actual damages, punitive damages and interest, costs and attorneys fees. The Company believes that the suit is well-grounded in law and fact. Discovery in the action has been commenced and is continuing. On February 28, 2006, the Court conducted a hearing (the Markman Hearing) in which each of the parties presented the Court with their views regarding the scope of the claims set forth in the subject patent. Following the hearing, the Court took the matter under advisement, and indicated that a ruling on the scope of the claims would be issued in the ordinary course. As of the date of this filing, no ruling has been received by the Company.

Crystal Import Corporation v. Digital Angel, et al.

On or about December 29, 2004, The Crystal Import Corporation filed an action against AVID Identification Systems, Inc. and the Company in the United States District Court for the Northern District of Alabama. Crystal s complaint primarily asserted federal and state antitrust and related claims against AVID, though it also asserted similar claims against the Company. The Company filed a motion to dismiss the action for failure to state a claim on which relief could be granted, or in the alternative, to have the action transferred to the United States District Court for the District of Minnesota. On October 12, 2005, the Alabama Court denied the Company s motion to dismiss the complaint, but granted the Company s motion to transfer the action to Minnesota. Following the docketing of the action in Minnesota, the Company and AVID filed a motion seeking to stay the case until the corresponding patent infringement actions have been resolved. This motion has been scheduled for hearing in May, 2006. Given the uncertainties associated with all litigation and given the early stage of this proceeding, the Company is unable to offer any assessment on the potential liability exposure, if any, to the Company from this lawsuit.

Digital Angel Corporation v. Corporativo SCM, S.A. de C.V.

On or about June 2, 2005, the Company filed a declaratory judgment action in the U.S. District Court for the District of Minnesota seeking to have the Court determine the rights and liabilities of the Company under a 2002 distribution agreement with Corporativo SCM, S.A. de C.V., a Mexican company which entered into a distribution agreement for a product that was then under development by the Company but the development of which was subsequently abandoned. Although the distribution agreement required that any actions arising out of or related to the agreement be filed within two years of the occurrence of the events giving rise to the claim, the Company received a letter in 2005 from the defendant threatening to assert a claim notwithstanding the two year limit set forth in the agreement. The defendant accordingly filed a motion to dismiss the declaratory judgment action, which the Court denied. On or about January 10, 2006, the defendant filed an answer and asserted a counterclaim against the Company for fraud seeking damages in an amount in excess of $75,000. The Company filed a response denying the allegations of the counterclaim, and has asked that the Court dismiss the claim both because the claim was not timely filed in accordance with the provisions of the agreement and because the counterclaim was not plead with the specificity required by the applicable rules of Civil Procedure. The defendant filed a responsive brief and, in addition, filed an amended complaint repleading its claims and adding a counterclaim for fraud in the inducement. The Company s motion to dismiss is scheduled for a hearing in March, 2006. Given the uncertainties associated with all litigation and given the early stage of this proceeding, the Company is unable to offer any assessment on the potential liability exposure, if any, to the Company from this lawsuit.

19. Supplemental Cash Flow Information

	2005	2004	2003
Income taxes paid	**$ 123**	$ 73	$
Interest paid	**382**	585	636
Non-cash investing and financing activities:			
Issuance of preferred stock for OuterLink acquisition		8,300	
Issuance of common stock for Applied Digital common stock	**3,500**	7,920	
Issuance of Applied Digital common stock for DSD acquisition	**3,500**		
Conversion of debt into common stock		2,930	
Warrants issued in connection with financing agreements			277
Assets acquired for long-term debt and capital leases	**586**		131

20. 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. The Company operates in two segments: (1) Animal Applications and (2) GPS and Radio Communications.

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.

	For the Year Ended December 31, 2005 (In Thousands)			
	Animal Applications	GPS and Radio Communications	Corporate / Unallocated	Consolidated
Product revenue	$ 34,663	$ 19,657	$	$ 54,320
Service revenue	1,309	1,197		2,506
Segment revenue	$ 35,972	$ 20,854	$	$ 56,826
Loss from operations	$ (988)	$ (8,399)	$	$ (9,387)
Depreciation and amortization	1,221	1,191		2,412
Interest income	336	11		347
Interest expense	337	29		366
Loss from continuing operations before income tax benefit and minority interest	(926)	(8,417)		(9,343)
Goodwill, net	47,343	1,148		48,491
Segment assets	81,105	9,102		90,207
Expenditures for property and equipment, net	820	562		1,382

	For the Year Ended December 31, 2004 (In Thousands)			
	Animal Applications	GPS and Radio Communications	Corporate / Unallocated	Consolidated
Product revenue	$ 24,950	$ 19,324	$	$ 44,274
Service revenue	921	1,107		2,028
Segment revenue	$ 25,871	$ 20,431	$	$ 46,302
Loss from operations	$ (796)	$ (405)	$	$ (1,201)
Depreciation and amortization	742	1,265		2,007
Interest income		41		41
Interest expense	1,168	175		1,343
Loss from continuing operations before provision for taxes, minority interest and equity in net loss of affiliate	(3,078)	(544)		(3,622)
Goodwill, net	43,971	5,026		48,997
Segment assets	76,127	16,546	6	92,673
Expenditures for property and equipment, net	264	320		584

	For the Year Ended December 31, 2003 (In Thousands)			
	Animal Applications	GPS and Radio Communications	Corporate / Unallocated	Consolidated
Product revenue	$ 22,389	$ 10,484	$	$ 32,873
Service revenue	1,559			1,559
Segment revenue	$ 23,948	$ 10,484	$	$ 34,432
Loss from operations	$ (343)	$ (5,331)	$	$ (5,674)
Depreciation and amortization	654	580		1,234
Interest income		(15)		(15)
Interest expense	712	60		772
Loss from continuing operations before provision for taxes, minority interest and equity in net loss of affiliate	(898)	(5,376)		(6,274)
Goodwill, net	43,971	1,148		45,119
Segment assets	58,852	6,124	1,251	66,227
Expenditures for property and equipment, net	555	602		1,157

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

Sales to one customer accounted for 10.0% of net sales in 2005. Sales to two customers accounted for 12.5% and 10.2% of net sales in 2004. Sales to one customer accounted for 11.8% of net sales in 2003. The Company s transponders are supplied by one supplier located in Spain.

21. Related Party Activity

In 2003, Applied Digital charged the Company for research expenses and directors and officers insurance aggregating $172,000.

The Company has an exclusive eleven-year Distribution and Licensing Agreement dated March 4, 2002, amended December 28, 2005, with VeriChip Corporation (VeriChip), a wholly-owned subsidiary of Applied Digital, covering the manufacturing, purchasing and distribution of the Company s implantable microchip and the maintenance of the VeriChip Registry by the Company. The amended agreement contains, among other things, minimum purchase requirements in order to maintain exclusivity, whereby VeriChip is required to purchase $875,000, $1,750,000 and $2,500,000 for each of 2007, 2008 and 2009, respectively, and $3,750,000 for 2010 and each year thereafter. The agreement continues until March 2013, and, as long as VeriChip continues to meet the minimum purchase requirements, will automatically renew annually under its terms. The agreement includes a license for the use of the Company s technology in VeriChip s identified markets. However, a predecessor to the Company entered into an exclusive licensing agreement with a third party for certain technologies which encompass human implantable microchips. Under the Distribution and Licensing Agreement the Company is the sole manufacturer and supplier to VeriChip. The existing terms with the Company s sole supplier of implantable microchips, Raytheon Microelectronics Espana, SA, expire on June 30, 2006. The Distribution and Licensing Agreement also includes indemnity and hold harmless provisions for VeriChip. Further, the agreement provides that the Company shall, at VeriChip s option, furnish and operate a computer database to provide data collection, storage and related services for VeriChip s customers for a fee.

Revenue recognized under the Distribution and Licensing Agreement was $0.7 million, $0.1 million and $0.5 million for 2005, 2004 and 2003, respectively.

See Note 11 for a description of the stock exchange transactions with Applied Digital.

Prior to January 1, 2005 and pursuant to a mutual agreement between the Company, Applied Digital and VeriChip Corporation, amounts due from VeriChip Corporation were offset against amounts the Company owed to Applied Digital for certain general and administrative services, research and development services, directors and officers insurance and expense reimbursement. Effective January 1, 2005, all amounts due from VeriChip Corporation are to be paid to the Company.

Following is a summary of amounts due from and amounts due to related parties as of December 31, 2005 and 2004. (In thousands)

	December 31, 2005	December 31, 2004
Due from VeriChip Corporation	**$ 232**	$
Due to Applied Digital		23

22. Summarized Quarterly Data (Unaudited)

(In thousands, except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year
2005					
Total revenue	**$ 13,403**	**$ 14,860**	**$ 13,758**	**$ 14,805**	**$ 56,826**
Gross profit	**5,995**	**6,640**	**5,936**	**6,924**	**25,495**
Net loss before discontinued operations	**(493)**	**(891)**	**(1,069)**	**(7,200)**	**(9,653)**
Income from discontinued operations			**85**	**92**	**177**
Net loss	**(493)**	**(891)**	**(984)**	**(7,108)**	**(9,476)**
Loss) per share-basic and diluted:					
Net loss from continuing operations	**(0.01)**	**(0.02)**	**(0.02)**	**(0.16)**	**(0.22)**
Net income from discontinued operations					
Net loss per common share	**(0.01)**	**(0.02)**	**(0.02)**	**(0.16)**	**(0.22)**
2004					
Total revenue	$ 10,771	$ 10,070	$ 11,180	$ 14,281	$ 46,302
Gross profit	4,529	4,156	5,016	6,373	20,074
Net income (loss) before discontinued operations	(3,367)	(1,239)	(782)	1,517	(3,871)
Income (loss) from discontinued operations	(378)	(750)	255	(213)	(1,086)
Net income (loss)	(3,745)	(1,989)	(527)	1,304	(4,957)

Income (loss) per share-basic:					
Net income (loss) from continuing operations	(0.11)	(0.04)	(0.02)	0.05	(0.12)
Net income (loss) from discontinued operations	(0.01)	(0.02)	0.01	(0.01)	(0.03)
Net income (loss) per common share-basic	(0.12)	(0.06)	(0.01)	0.04	(0.15)
Income (loss) per share-diluted:					
Net income (loss) from continuing operations	(0.11)	(0.04)	(0.02)	0.04	(0.12)
Net income (loss) from discontinued operations	(0.01)	(0.02)	0.01	(0.01)	(0.03)
Net income (loss) per common share-diluted	(0.12)	(0.06)	(0.01)	0.03	(0.15)

Digital Angel Corporation and Subsidiaries

Schedule II-Valuation and Qualifying Accounts

Allowance for Doubtful Accounts (in thousands):

	Years Ended December 31, 2005	2004	2003
Balance, at beginning of year	$ 241	$ 205	$ 191
Amount acquired through acquisition	10	65	
Additions charged to income	25	16	74
Write-offs	(64)	(45)	(60)
Balance, at end of year	$ 212	$ 241	$ 205

Allowance for Excess and Obsolete Inventory (in thousands):

	Years Ended December 31, 2005	2004	2003
Balance, at beginning of year	$ 1,915	$ 1,821	$ 1,382
Additions charged to income	419	150	597
Write-offs	(665)	(56)	(158)
Balance, at end of year	$ 1,669	$ 1,915	$ 1,821

Valuation Allowance on Deferred Tax Assets (in thousands):

	Years Ended December 31, 2005	2004	2003
Balance, at beginning of year	$ 27,666	$ 22,197	$ 19,481
Amount acquired through acquisition	15	9,192	
Additions charged to income	4,262		2,716
Write-offs	(155)	(3,723)	
Balance, at end of year	$ 31,788	$ 27,666	$ 22,197