DIGITAL ANGEL CORP
Form 10-Q
November 14, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2007

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to
Commission file number: 1-15177

DIGITAL ANGEL CORPORATION
(Exact Name of Registrant as Specified in Its Charter)

Delaware	**52-1233960**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification Number)*
490 Villaume Avenue, South St. Paul, MN	**55075**
(Address of Principal Executive Offices)	*(Zip Code)*

(651) 455-1621
Registrant s Telephone Number, Including Area Code

(Former Name, Former Address and Formal Fiscal Year, if Changed Since Last Report)

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 þ No 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 (check one).

Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer þ

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

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

Class	**Outstanding at November 5, 2007**
Common Stock, $.005 par value per share	45,894,933 shares

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PART I FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

DIGITAL ANGEL CORPORATION AND SUBSIDIARIES
Condensed Consolidated Balance Sheets
(in thousands, except par values)

	September 30, 2007 (unaudited)	December 31, 2006
Assets (Note 6)		
Current assets		
Cash	**$ 1,461**	$ 1,521
Restricted cash	**137**	81
Accounts receivable, net of allowance for doubtful accounts of $184 and $203 at September 30, 2007 and December 31, 2006, respectively	**12,531**	9,609
Accounts receivable from VeriChip Corporation		425
Inventories	**14,232**	9,897
Other current assets	**1,929**	2,016
Current assets from discontinued operations		2,335
Total current assets	**30,290**	25,884
Property and equipment, net	**11,615**	9,985
Goodwill	**53,335**	51,244
Other intangible assets, net	**1,568**	1,633
Other assets, net	**548**	619
Other assets from discontinued operations		531
Total Assets	**$ 97,356**	$ 89,896
Liabilities and Stockholders Equity		
Current liabilities		
Line of credit and current maturities of long-term debt	**$ 8,063**	$ 4,127
Note payable with Applied Digital Solutions, Inc.	**1,167**	
Accounts payable	**9,388**	6,024
Due to Applied Digital Solutions, Inc.	**137**	11
Accrued expenses and other current liabilities	**4,088**	2,793
Current liabilities from discontinued operations		2,448
Total current liabilities	**22,843**	15,403
Long-term debt	**3,837**	4,036
Note payable with Applied Digital Solutions, Inc.	**4,405**	
Other long-term liabilities		
Derivative warrant liability	**717**	
Other long-term liabilities	**363**	386
Other liabilities from discontinued operations		1,060

Total other long-term liabilities		**1,080**		1,446
Total Liabilities		**32,165**		20,885
Minority interest		**473**		465
Stockholders equity				
Preferred stock ($1.75 par value; shares authorized, 1,000; shares issued and outstanding, nil)				
Common stock ($0.005 par value; shares authorized, 95,000; shares issued, 46,248 and 44,894; shares outstanding, 45,870 and 44,516)		**231**		226
Additional paid-in capital		**218,153**		214,509
Accumulated deficit		**(152,564)**		(144,753)
Treasury stock (carried at cost, 378 common and preferred shares)		**(1,582)**		(1,580)
Accumulated other comprehensive income		**480**		144
Total Stockholders Equity		**64,718**		68,546
Total Liabilities and Stockholders Equity	**$**	**97,356**	$	89,896

See Notes to Condensed Consolidated Financial Statements.

DIGITAL ANGEL CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Operations (Unaudited)
(in thousands, except per share data)

	For the Three Months Ended September 30, 2007	For the Three Months Ended September 30, 2006	For the Nine Months Ended September 30, 2007	For the Nine Months Ended September 30, 2006
Revenue	**$ 20,335**	$ 12,400	**$ 55,166**	$ 40,147
Cost of sales	**12,096**	7,150	**33,605**	23,425
Gross profit	**8,239**	5,250	**21,561**	16,722
Selling, general and administrative expenses	**8,517**	5,633	**23,568**	17,264
Research and development expenses	**830**	765	**3,634**	2,287
Merger expenses	**560**		**786**	
Operating loss	**(1,668)**	(1,148)	**(6,427)**	(2,829)
Interest income	**8**	64	**53**	238
Interest expense	**(2,295)**	(117)	**(3,293)**	(323)
Change in derivative warrant liability	**241**		**537**	
Other income	**858**	27	**921**	72
Loss from continuing operations before income taxes and minority interest	**(2,856)**	(1,174)	**(8,209)**	(2,842)
Income tax (provision) benefit	**(359)**	(4)	**(397)**	68
Minority interest share of income	**(92)**	(2)	**(77)**	(59)
Net loss from continuing operations	**(3,307)**	(1,180)	**(8,683)**	(2,833)
Income (loss) from discontinued operations, including gain on sale of $1,705 on July 2, 2007	**1,705**	(255)	**872**	(1,312)
Net loss	**$ (1,602)**	$ (1,435)	**$ (7,811)**	$ (4,145)
Earnings per common share basic and diluted				
Loss from continuing operations	**$ (0.08)**	$ (0.02)	**$ (0.19)**	$ (0.06)
Income (loss) from discontinued operations	**0.04**	(0.01)	**0.02**	(0.03)
Net loss	**$ (0.04)**	$ (0.03)	**$ (0.17)**	$ (0.09)

Weighted average common shares outstanding basic and diluted	**45,023**	44,516	**44,701**	44,238

See Notes to Condensed Consolidated Financial Statements.

DIGITAL ANGEL CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statement of Changes in Stockholders Equity (Unaudited)
For the Nine Months Ended September 30, 2007
(in thousands)

	Preferred Stock Number	Preferred Stock Amount	Common Stock Number	Common Stock Amount	Additional Paid-In Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Income	Total Stockholders Equity
Balance, December 31, 2006		$	44,894	$ 226	$ 214,509	$ (144,753)	$ (1,580)	$ 144	$ 68,546
Net loss						(7,811)			(7,811)
Comprehensive loss:									
Foreign currency translation								336	336
Total comprehensive loss									(7,475)
Issuance of stock to Applied Digital Solutions, Inc.			921	4	1,424				1,428
Issuance of warrants					1,044				1,044
Compensation expense			433	1	1,176				1,177
Repurchase of preferred stock							(2)		(2)
Balance, September 30, 2007		$	46,248	$ 231	$ 218,153	$ (152,564)	$ (1,582)	$ 480	$ 64,718

See Notes to Condensed Consolidated Financial Statements.

DIGITAL ANGEL CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows (Unaudited)
(in thousands)

	For the Nine Months Ended September 30, 2007	2006
Cash Flows From Operating Activities		
Net loss	**$ (7,811)**	$ (4,145)
Adjustments to reconcile net loss to net cash used in operating activities:		
Equity-based compensation	**1,177**	566
Depreciation and amortization	**1,801**	1,436
Amortization of debt discount and financing costs	**2,048**	
Change in derivative warrant liability	**(537)**	
Minority interest	**77**	59
Loss on disposal of equipment	**6**	6
(Income) loss from discontinued operations	**(872)**	1,311
Change in assets and liabilities:		
(Increase) decrease in restricted cash	**(57)**	187
(Increase) decrease in accounts receivable	**(2,677)**	2,356
Decrease (increase) in accounts receivable from VeriChip Corporation	**425**	(31)
Increase in inventories	**(1,777)**	(1,811)
Increase (decrease) increase in other current assets	**97**	(714)
Decrease in deferred tax liability	**(18)**	(15)
Increase (decrease) in accounts payable and accrued expenses	**4,657**	(3,338)
Net cash (used in) provided by discontinued operations	**(258)**	240
Net Cash Used in Operating Activities	**(3,719)**	(3,894)
Cash Flows From Investing Activities		
Decrease in other assets	**10**	139
Payments for property and equipment	**(1,549)**	(1,767)
Net cash paid for acquisition	**(4,277)**	(1,000)
Net cash provided by (used in) discontinued operations	**258**	(264)
Net Cash Used in Investing Activities	**(5,558)**	(2,891)
Cash Flows From Financing Activities		
Borrowings on line of credit	**12,363**	3,512
Payments on line of credit	**(7,848)**	(2,678)
Borrowings on debt	**6,022**	
Payments on notes payable and long-term debt	**(7,036)**	(579)
Borrowings on note payable with Applied Digital Solutions, Inc.	**7,000**	
Exercise of stock options and warrants		559
Payments of dividends to minority shareholder in subsidiary	**(106)**	(140)
Payments for financing costs	**(1,205)**	
Purchase of treasury stock	**(2)**	

Net Cash Provided by Financing Activities		**9,188**		673
Effect of Exchange Rate Changes on Cash		**29**		25
Net Decrease In Cash		**(60)**		(6,087)
Cash Beginning of Period		**1,521**		9,949
Cash End of Period	**$**	**1,461**	$	3,862

See Notes to Condensed Consolidated Financial Statements.

DIGITAL ANGEL CORPORATION
Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Basis of Presentation

The accompanying condensed consolidated financial statements of Digital Angel Corporation and its subsidiaries (the Company) have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) and with the instructions to Form 10-Q and Article 10 of Regulation S-X under the Securities Exchange Act of 1934, as amended. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. The interim financial information in this report has not been audited. In the opinion of the Company s management, all adjustments (consisting of normal recurring adjustments) considered necessary for fair financial statement presentation have been made. Results of operations reported for interim periods may not be indicative of the results for the entire year. These condensed consolidated financial statements and notes should be read in conjunction with the consolidated financial statements and notes included in the 2006 Annual Report on Form 10-K, as amended, filed with the Securities and Exchange Commission (SEC).

The preparation of financial statements in conformity with GAAP requires management to make certain estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Although these estimates are based on the knowledge of current events and actions that we may undertake in the future, they may ultimately differ from actual results. Included in these estimates are assumptions about allowances for inventory obsolescence, bad debt reserves, lives of long-lived assets and intangible assets, assumptions used in Black-Scholes valuation models, estimates of the fair value of acquired assets and the determination of whether any impairment is to be recognized on long-lived and intangible assets, among others.

The condensed 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. 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 business segments: Animal Applications and GPS and Radio Communications, which are discussed further in Note 10.

As of September 30, 2007, Applied Digital Solutions, Inc. (Applied Digital) owned 25,495,190 shares or approximately 56% of the Company s common stock.

On April 5, 2007, the Company acquired certain assets and customer contracts of McMurdo Limited (McMurdo), a United Kingdom based subsidiary of Chemring Group Plc (Chemring), and manufacturer of emergency location beacons. Pursuant to the agreement, Signature Industries Limited (Signature), the Company s London based subsidiary operating in the GPS and Radio Communication business segment, acquired certain assets of McMurdo s marine electronics business, including fixed assets, inventory, customer lists, customer and supplier contracts and relations, trade and business names, and associated assets. For further discussion of the acquisition see Note 4.

On July 2, 2007, the Company completed the sale of its wholly-owned subsidiary, OuterLink Corporation (OuterLink) to Newcomb Communications, Inc. (Newcomb). OuterLink provides satellite-based mobile asset tracking and data messaging systems used to manage the deployment of aircraft and land vehicles. Pursuant to the agreement, the Company sold all of the issued and outstanding shares of stock of OuterLink. As a result, its operations are included as part of the Company s discontinued operations for all periods presented. For further discussion of the sale see Note 5.

2. Merger Agreement

On August 8, 2007, the Company, Applied Digital, and Digital Angel Acquisition Corp., a Delaware corporation and wholly-owned subsidiary of Applied Digital entered into an Agreement and Plan of Reorganization (the Merger Agreement), pursuant to which Digital Angel Acquisition Corp. will be merged with and into the Company, with the Company surviving and becoming a wholly-owned subsidiary of Applied Digital (the Merger). Each of the boards of directors of the Company and Applied Digital unanimously approved the Merger Agreement but the consummation of the Merger remains subject to customary conditions, including the approval of the issuance of shares in connection with the Merger by the stockholders of Applied Digital and approval of the Merger Agreement by a majority of the stockholders of the Company and by a majority of the minority stockholders of the Company. A special meeting of stockholders of Applied Digital and a special and annual meeting of the Company s stockholders are scheduled to be held on November 27, 2007 to approve the Merger. Upon consummation of the Merger, each outstanding share of the Company s common stock not currently owned by Applied Digital (or its affiliates) will be converted into 1.4 shares of common stock of Applied Digital. The shares of Applied Digital common stock to be issued to the Company s stockholders in connection with the Merger are expected to represent approximately 28.7% of the outstanding shares of Applied Digital s common stock immediately following the

DIGITAL ANGEL CORPORATION

Notes to Condensed Consolidated Financial Statements (Unaudited) (continued)

2. Merger Agreement (continued)

consummation of the Merger, based on the number of shares of Applied Digital and Digital Angel common stock outstanding on November 5, 2007. In addition, each of the Company s stock options and warrants existing on the effective date of the Merger will be assumed by Applied Digital. This amount represents a value for the Company s common stock of $.005 par value per share, representing a premium of approximately 21% over the average closing price of the Company s and Applied Digital s stock as of the previous twenty trading days ending on August 7, 2007.

3. Recent and Not Yet Adopted Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes a framework for measuring fair value in accordance with GAAP and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. Earlier application is encouraged provided that the reporting entity has not yet issued financial statements for that fiscal year including financial statements for an interim period within that fiscal year. The Company is currently assessing SFAS 157 and has not yet determined the impact that the adoption of SFAS 157 will have on the Company s results of operations or financial position.

In September 2006, FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R), (SFAS 158), which requires employers to: (a) recognize in its statement of financial position an asset for a plan s overfunded status or a liability for a plan s underfunded status; (b) measure a plan s assets and its obligations that determine its funded status as of the end of the employer s fiscal year; and (c) recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes will be reported in comprehensive income of a business entity. The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective as of the end of the fiscal year ending after December 15, 2006, for entities with publicly traded equity securities. The initial adoption did not have an impact on the Company s consolidated financial position, results of operations, cash flows or financial statement disclosures. The requirement to measure plan assets and benefit obligations as of the date of the employer s fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. The Company has not yet determined the impact that this requirement will have on the Company s consolidated financial position, results of operations, cash flows or financial statement disclosures.

In February 2007, FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement 115, (SFAS 159). This statement provides companies with an option to report selected financial assets and liabilities at fair value. This statement is effective for fiscal years beginning after November 15, 2007 with early adoption permitted. The Company is currently assessing SFAS 159 and has not yet determined the impact that the adoption of SFAS 159 will have on the Company s results of operations or financial position.

In June 2007, FASB issued Emerging Issues Task Force (EITF) issued Issue No. 07-3 Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities (EITF 07-3). EITF 07-3 requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and capitalized. This issue is effective for fiscal years beginning after December 15, 2007 and interim periods within those fiscal years. The Company is currently assessing EITF 07-3 and has not yet determined the impact that the adoption of EITF 07-3 will have on the Company s results of operations or financial position.

4. Acquisition

In April 2007, the Company, through its wholly-owned subsidiary Signature, acquired certain assets and customer contracts of McMurdo, a United Kingdom based subsidiary of Chemring and manufacturer of emergency location beacons. McMurdo develops and manufactures safety equipment technology. Its products, including the original Emergency Position Indicating Radio Beacon (EPIRB), the first Global Maritime Distress and Safety System (GMDSS) and the approved Search and Rescue Transponder, have become standard lifesaving equipment on many recreational, commercial and military marine vehicles. This acquisition was made to broaden the Company s emergency location beacon product offering to serve the military and commercial maritime sectors and provide stability to the Company s revenue base.

DIGITAL ANGEL CORPORATION
Notes to Condensed Consolidated Financial Statements (Unaudited) (continued)

4. Acquisition (continued)

Pursuant to the Asset Sale and Purchase Agreement (the Agreement) entered into in December 2006, Signature acquired certain assets and customer contracts of McMurdo s marine electronics business including fixed assets, inventory, customer lists, customer and supplier contracts and relations, trade and business names, and associated assets. The assets excluded certain accrued liabilities and obligations and real property, including the plant facility, which Signature has a license to occupy for a period of nine months from the Completion Date (as defined in the Agreement). Signature is currently in the process of formalizing a sublease with Chemring to extend the lease of the McMurdo facility until 2022 with an opt-out provision after two or three years. Under the terms of the Agreement, Signature retained McMurdo s employees related to the marine electronics business. In addition, pursuant to the terms of the Agreement, the Company guaranteed to McMurdo, Signature s obligations and liabilities to McMurdo under the Guaranteed Agreements (as defined in the Agreement) and Chemring guaranteed to Signature, McMurdo s obligations and liabilities under the Guaranteed Agreements. The Company paid consideration of approximately $4.7 million in cash, which included a payment of $0.5 million in the fourth quarter of 2006 and net of a purchase price adjustment of $0.9 million paid by Chemring in July 2007, and will make one additional purchase price payment of up to $3.0 million during the fourth quarter of 2007. The purchase price payment will be determined on a threshold basis with a minimum threshold, calculated on the basis of the invoiced value of specific products sold between November 1, 2006 and October 31, 2007 and payable when the parties finalize a statement of the sales. We expect to pay approximately $2.2 million in additional purchase price consideration as McMurdo s revenue is expected to exceed the threshold.

The estimated fair values of assets acquired are as follows:

	April 5, 2007 (in thousands)
Inventory	$ 592
Fixed assets	2,178
Goodwill and other intangibles	1,972
Total assets acquired	$ 4,742

The required purchase accounting adjustments, including the allocation of the purchase price based on the fair values of the assets acquired, have been made based upon preliminary valuations which are still in review and are subject to change. Based upon the Company s final valuation and review, it may determine that additional tangible assets exist or that their estimated useful lives require revision. The Company anticipates that it will finalize the purchase price allocation within the next several months. Any adjustments to the purchase price allocation will be recorded as an increase or decrease in goodwill. In addition, the purchase price payment of approximately $2.2 million that we anticipate paying in the fourth quarter of 2007 is expected to be recorded as additional goodwill or other intangible assets.

The acquisition was accounted for under the purchase method of accounting and, accordingly, the condensed consolidated financial statements reflect the results of operations of McMurdo from the date of acquisition. Unaudited pro forma results of operations for the nine months ended September 30, 2007 and the three and nine months ended September 30, 2006 are included below. Such pro forma information assumes that the above acquisition had occurred as of January 1, 2007 and 2006, respectively, and revenue is presented in accordance with the Company s accounting policies. These unaudited pro forma statements have been prepared for comparative purposes only and are not intended to be indicative of what the Company s results would have been had the acquisition occurred at the beginning of the periods presented or the results which may occur in the future.

	Pro Forma for the Three Months Ended September 30, 2006	Pro Forma for the Nine Months Ended September 30, 2007	Pro Forma for the Nine Months Ended September 30, 2006
		(unaudited, in thousands)	
Net operating revenue	$ 15,707	$ 59,344	$ 48,892
Net loss from continuing operations	(1,439)	(8,339)	(4,026)
Net loss from continuing operations per common share basic and diluted	(0.03)	(0.19)	(0.09)

DIGITAL ANGEL CORPORATION

Notes to Condensed Consolidated Financial Statements (Unaudited) (continued)

5. Discontinued Operations

In May 2007, the Company entered into a Stock Purchase Agreement with Newcomb to sell 100% of the issued and outstanding shares of stock of OuterLink. OuterLink, which operated in the Company s GPS and Radio Communications business segment, provides satellite-based mobile asset tracking and data messaging systems used to manage the deployment of aircraft and land
vehicles. On July 2, 2007, the Company completed the sale of OuterLink. Consideration, which is subject to certain adjustments based on OuterLink s closing balance sheet, initially consisted of a cash payment of $800,000 and a promissory note of $200,000 which matures on December 31, 2007. In connection with the closing, the Company also executed a one-year non-competition agreement with OuterLink. Mr. Paul F. Newcomb, President of Newcomb, was the founder and President of the predecessor company to OuterLink, which the Company acquired in January 2004.

In June 2007, in connection with the Company s planned sale of OuterLink, the Company entered into an amendment of the Securities Purchase Agreement and the Registration Rights Agreement between the Company and Imperium Master Fund, Ltd. (Imperium) and Gemini Master Fund, Ltd. (Gemini, and together with Imperium, the Investors) and received a waiver letter from the Investors waiving certain of their rights under the Subsidiary Guaranty executed by OuterLink in favor of the Investors and the Security Agreement executed by the Company and OuterLink in favor of the Investors (collectively, the amendments and the waiver letter, the OuterLink Amendments). Pursuant to the terms of the OuterLink Amendments, the Investors consented to the sale of OuterLink, waived all existing defaults, if any, released the outstanding shares of OuterLink owned by the Company from the pledge and security interest granted to the Investors, and released OuterLink from its obligations arising under the Subsidiary Guaranty. As consideration, the Company exchanged the 699,600 existing warrants for 841,000 newly issued seven-year warrants with an exercise price of $1.701. The warrants are more fully discussed in Note 6.

As a result of the sale of OuterLink, its operations are included as part of the Company s discontinued operations for all periods presented. The following discloses the operating income (losses) from discontinued operations for the three and nine months ended September 30, 2007 and 2006, attributable to OuterLink:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
	(unaudited, in thousands)		(unaudited, in thousands)	
Revenue	**$**	$ 791	**$ 1,417**	$ 1,822
Cost of sales		401	**853**	1,066
Gross profit		390	**564**	756
Selling, general and administrative expenses		313	**730**	916
Research and development expenses		332	**667**	1,152
Interest income				(2)
Gain on sale	**1,705**		**1,705**	
Income (loss) from discontinued operations	**$ 1,705**	$ (255)	**$ 872**	$ (1,312)
Earnings per common share basic and diluted:				
Income (loss) from discontinued operations	**$ 0.04**	$ (0.01)	**$ 0.02**	$ (0.03)

The results above do not include any allocated or common overhead expenses. Included in the results for the three months ended September 30, 2007 is a $1.7 million gain on the sale of OuterLink. Given the Company s current tax status, the gain did not result in a provision for income taxes due to Federal and State net operating losses and carryforwards.

DIGITAL ANGEL CORPORATION
Notes to Condensed Consolidated Financial Statements (Unaudited) (continued)

5. Discontinued Operations (continued)

The net assets of discontinued operations as of December 31, 2006 were comprised of the following:

	December 31, 2006 (in thousands)
Current assets	
Cash	$ 2
Accounts receivable	956
Inventory	503
Other current assets	874
Total current assets	2,335
Property and equipment, net	274
Other assets, net	257
Total long-term assets	531
Total assets	$ 2,866
Current liabilities	
Accounts payable	408
Accrued expenses and other current liabilities	270
Deferred revenue	1,770
Total current liabilities	2,448
Other long-term liabilities	1,060
Total liabilities	$ 3,508
Net liabilities from discontinued operations	$ 642

6. Financing Arrangements

On February 6, 2007, the Company entered into a Securities Purchase Agreement pursuant to which the Company sold a 10.25% senior secured debenture (debenture) in the original principal amount of $6.0 million and issued five-year warrants to purchase 699,600 shares of the Company s common stock at a per share exercise price of $2.973. Concurrently with the Securities Purchase Agreement, the Company executed a Registration Rights Agreement (the Registration Agreement), pursuant to which the Company is obligated to register for resale shares of the Company s common stock sufficient to cover the shares necessary to pay the principal and interest payments due on the debenture and the shares underlying the warrants. If the Company does not comply with the registration deadlines set forth in the Registration Agreement, the Company will be obligated to pay each Investor, pro rata, a default payment equal to 1% of the aggregate purchase price of the debenture for each month the registration default is not cured, capped at 9%, and the exercise price is subject to certain reset provisions. The Registration Agreement has been amended to extend the registration effective deadline to either: (1) a date no later than 60 days following the earlier of the closing of the Merger or December 31, 2007, or (2) a date no later than 120 days following the earlier of the closing of the Merger or

December 31, 2007 if the Registration Statement is subject to a full review by the SEC.

On June 28, 2007, the Company entered into an amendment of the Securities Purchase Agreement in connection with the planned sale of OuterLink and as consideration, the Company exchanged the 699,600 existing warrants for 841,000 newly issued seven-year warrants with an exercise price of $1.701.

The warrants contain certain anti-dilution provisions and, accordingly, the Company has accounted for the fair value of the warrants as a derivative liability subject to SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. At issuance, the fair value of the 699,600 warrants, as calculated using the Black-Scholes valuation model, was $1,254,000 using the following assumptions; volatility of 83.13%, risk free interest rate of 4.6%, dividend rate of 0.0% and expected life of 5 years. The fair value of the warrants was recorded as a discount to the debenture and amortized to interest expense over the life of the debenture, which was repaid on August 31, 2007 as more fully discussed below. Upon issuance of the 841,000 warrants, the Company recognized $127,000 of additional interest expense using the following Black-Scholes valuation assumptions; volatility 73.93%, risk free interest rate of 4.6%, dividend rate of 0.0% and expected life of 7.0 years. The warrants fair value is required to be revalued at each balance sheet date using the Black-Scholes valuation model with changes in value recorded in the condensed consolidated statement of operations as income or expense. At September 30, 2007, the warrants derivative fair value for the 841,000 warrants outstanding was $717,000

DIGITAL ANGEL CORPORATION
Notes to Condensed Consolidated Financial Statements (Unaudited) (continued)

6. Financing Arrangements (continued)

using the following assumptions; volatility of 73.27%, risk free interest rate of 4.4%, dividend rate of 0.0% and expected life of 6.75 years. Approximately $241,000 and $537,000 of income, net of the expense related to the exchange of the warrants, is included in the condensed consolidated statement of operations for the three and nine months ended September 30, 2007, respectively, as a result of the changes in the fair value and replacement of the warrants.

On August 24, 2007, the Company and Imperium agreed to an extension of the repayment date of the debenture by up to one month, or until September 27, 2007. The debenture was repaid on August 31, 2007.

Effective August 31, 2007, the Company and certain of its subsidiaries, Digital Angel Technology Corporation, Fearing Manufacturing Co., Inc. and Digital Angel International (collectively Eligible Subsidiaries) entered into a $6.0 million revolving asset-based financing transaction with Kallina Corporation (Kallina or the Lender), a wholly-owned subsidiary of Laurus Master Fund, Ltd., pursuant to the terms of a Security Agreement. Under the terms of the Security Agreement, the Company may borrow, from time to time, an amount equal to the lesser of the amount of availability under the borrowing base and $6.0 million, subject to certain reserves that the Lender is authorized to take in its reasonable commercial judgment (the Revolving Facility). The borrowing base is calculated as a percentage of the total amount of eligible accounts and inventory owned by the Company and its Eligible Subsidiaries. The Company had $0.7 million of available funds under the Revolving Facility at September 30, 2007. Amounts outstanding under the Revolving Facility accrue interest at a rate per annum equal to the prime rate plus 2.0%, but not less than 10.0% at any time. The Revolving Facility matures on August 31, 2010. At September 30, 2007, the interest rate for amounts borrowed on the Revolving Facility was 10.0%. The Company and its Eligible Subsidiaries have pledged all of their respective assets, excluding the stock of all foreign subsidiaries other than stock held by the Company in Signature, in support of the obligations under the Revolving Facility. The Company used a portion of the proceeds from the Revolving Facility to terminate and pay-off all obligations under the Greater Bay facility. See Note 7 for further discussion.

In connection with the Revolving Facility, the Company issued warrants to purchase 967,742 shares of the Company s common stock at a per share exercise price of $1.69. The warrants can be exercised at any time prior to August 31, 2014. The warrants are valued at approximately $1.0 million using the following assumptions; volatility of 73.08%, risk free interest rate of 4.4%, dividend rate of 0.0% and expected life of seven years. The amount was recorded as a discount to the Revolving Facility and is being amortized to interest expense over the life of the Revolving Facility. The Company also entered into a Registration Rights Agreement with the Lender pursuant to which the Company has agreed to file a registration statement no later than December 31, 2007 covering the resale by the Lender of those shares received upon exercise of the warrants.

Effective August 31, 2007, the Company entered into a $7.0 million secured term note (intercompany term loan) with Applied Digital. The intercompany term loan accrues interest at a rate per annum equal to the prime rate plus 3.0%, but no less than 11.0%, and matures on August 31, 2009. At September 30, 2007, the interest rate was 11.0%. The Company is obligated to make monthly interest payments beginning October 2007 and monthly principal payments of approximately $167,000 beginning March 2008 as well as a final payment of $4.0 million at maturity. As consideration for the intercompany term loan, the Company issued to Applied Digital 921,402 shares of the Company s common stock. The Company determined the value of the stock to be approximately $1.4 million, based on the closing price of the Company s stock on the issuance date, which was recorded as a debt discount. The debt discount is being amortized to interest expense over the life of the intercompany term loan. In addition, the Company incurred a total of approximately $0.6 million of financing fees in connection with the Revolving Facility and intercompany term loan. These fees were recorded as debt issuance costs and are being amortized to interest expense over the lives of the Revolving Facility and intercompany term loan. The Company used the proceeds to repay all amounts due under the debenture.

Based on the Company s election to prepay the debenture, the Company wrote off approximately $1.5 million of deferred financing costs and debt discount associated with the debenture and the Greater Bay facility in the third quarter of 2007.

Concurrently with the closing of the Revolving Facility, Applied Digital entered into a $7.0 million non-convertible debt financing transaction with the Lender pursuant to the terms of a Securities Purchase Agreement between Applied Digital and the Lender (the Applied Digital Financing Transaction). The Company and its Eligible Subsidiaries have guaranteed the obligations of Applied Digital under the Applied Digital Financing Transaction and Applied Digital has guaranteed the obligations of the Company and its Eligible Subsidiaries under the Revolving Facility.

DIGITAL ANGEL CORPORATION
Notes to Condensed Consolidated Financial Statements (Unaudited) (continued)

7. Accounts Receivable

	September 30, 2007	December 31, 2006
	(in thousands)	
Receivables assigned to factor	**$ 2,249**	$ 1,094
Advances from factor	**(1,799)**	(875)
Amounts due from factor	**450**	219
Unfactored accounts receivable	**12,265**	9,593
Allowance for doubtful accounts	**(184)**	(203)
	$ 12,531	$ 9,609

On March 23, 2007, the Company entered into a revolving invoice funding facility (Greater Bay facility) with Greater Bay Business Funding (Greater Bay), a division of Greater Bay Bank N.A. The Greater Bay facility provided that the Company sell and assign to Greater Bay, all rights, title, and interest in the accounts receivable of Digital Angel Technology Corporation. Under the Greater Bay facility, Greater Bay advanced 80% of the eligible receivables, as defined, not to exceed a maximum of $5,000,000 at any given time. Greater Bay paid the remainder of the receivable upon collection and interest was payable on the daily outstanding balance of funds drawn and was equal to the Greater Bay Bank N.A. prime rate plus 3.00%. On August 31, 2007, the Company used a portion of the proceeds from the Revolving Facility to terminate and repurchase the factored receivables under the Greater Bay facility.

Signature has entered into an Invoice Discounting Agreement, (as amended, the RBS Invoice Discounting Agreement) with The Royal Bank of Scotland Commercial Services Limited (RBS). The RBS Invoice Discounting Agreement provides for Signature to sell with full title guarantee most of its receivables, as defined in the RBS Invoice Discounting Agreement. Under the RBS Invoice Discounting Agreement, RBS prepays 80% of the receivables sold in the United Kingdom and 80% of the receivables sold in the rest of the world, not to exceed an outstanding balance of £2.0 million (approximately $4.1 million at September 30, 2007) 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. The discounting charge accrues at an annual rate of 1.5% above the base rate as defined in the RBS Invoice Discounting Agreement (5.3% at September 30, 2007). Signature pays a commission charge to RBS of 0.16% of each receivable balance sold. The RBS Invoice Discounting Agreement requires a minimum commission charge of £833 (approximately $1,700) per month. Discounting charges of $28,000 and $78,000 are included in interest expense for the three and nine months ended September 30, 2007, respectively. As of September 30, 2007, $1.8 million of receivables were financed under the RBS Invoice Discounting Agreement.

8. Inventory

Inventory consists of the following:

	September 30, 2007	December 31, 2006
	(in thousands)	

Raw materials	**$ 6,306**	$ 3,291
Work in process	**1,380**	402
Finished goods	**7,918**	7,215
	15,604	10,908
Allowance for excess and obsolescence	**(1,372)**	(1,011)
Net inventory	**$ 14,232**	$ 9,897

At September 30, 2007, the Company had approximately $8.4 million of inventory located in Europe and approximately $1.0 million located in China.

9. Other Income

Included in Other Income is $825,000 related to the settlement of a legal matter.

DIGITAL ANGEL CORPORATION

Notes to Condensed Consolidated Financial Statements (Unaudited) (continued)

10. Stock Options and Restricted Stock

Stock Option Plans

As of September 30, 2007, the Company maintained the Amended and Restated Digital Angel Corporation Transition Stock Option Plan (DAC Stock Option Plan), which is described below, and has outstanding stock options which were issued pursuant to another plan that was terminated on February 23, 2006. On January 1, 2006, the Company adopted SFAS 123R, Share-Based Payment (SFAS 123R), using the modified prospective transition method. Accordingly, during the nine month period ended September 30, 2006, the Company recorded stock-based compensation expense for awards granted in 2006 and awards granted prior to, but not yet vested as of January 1, 2006, as if the fair value method required for pro forma disclosure under SFAS 123 were in effect for expense recognition purposes. Upon adoption of SFAS 123R, the Company elected to continue using the Black-Scholes valuation model and has recognized compensation expense using a straight-line amortization method. During the three and nine month periods ended September 30, 2007, the Company recorded $658,000 and $1.2 million, respectively, in stock-based employee compensation expense (including compensation for options granted to non-employees and for restricted stock grants). During the three and nine month periods ending September 30, 2006, the Company recorded $279,000 and $566,000, respectively, of stock-based compensation expense.

On January 13, 2004, the Company granted its former Chief Executive Officer a ten-year option to purchase 1,000,000 shares of the Company s common stock at $3.92 per share. This option was granted outside the Company s stock plans and approved by the Company s stockholders on May 6, 2004. The option became exercisable on December 30, 2005 and remains outstanding as of September 30, 2007. The option will be forfeited in December 2007 unless exercised.

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. This option was granted outside the Company s stock plans and approved by the Company s stockholders on May 6, 2004. The option became exercisable on February 18, 2005. As of September 30, 2007, the option remains outstanding.

Prior to the adoption of SFAS 123R, the Company presented all tax benefits related to stock-based compensation as an operating cash inflow. SFAS 123R requires the cash flows resulting from tax deductions in excess of compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. The Company did not record any excess income tax benefits relating to SFAS 123R during the nine months ended September 30, 2007 and 2006.

As of September 30, 2007, the DAC Stock Option Plan, which is stockholder-approved, has 18,195,312 shares of common stock reserved for issuance, of which 16,845,142 shares have been issued and 1,350,170 remain available for issuance. As of September 30, 2007, awards consisting of options to purchase 8,638,197 shares were outstanding under the DAC Stock Option Plan and awards consisting of options to purchase 472,820 shares were outstanding under the Company s terminated stock option plan. Additionally, restricted stock awards for 545,669 shares of common stock have been granted under the DAC Stock Option Plan. Option awards are generally granted with exercise prices between market price and 110% of the market price of the Company s stock at the date of grant; option awards generally vest over 3 to 9 years and have 10-year contractual terms. Certain option and share awards provide for accelerated vesting if there is a change in control (as defined in the DAC Stock Option Plan).

Stock Option Activity

The fair value of each option award is estimated on the date of grant using the Black-Scholes valuation model. The following assumptions were used for options granted during the nine month period ended September 30:

	2007	2006
Risk-free interest rate	**4.5 5.2%**	5.0%
Expected life (in years)	**5.0**	8.4
Dividend yield	**0.0%**	0.0%

Expected volatility	**80.9**	**131.2%**	106.1	113.3%
Weighted-average volatility		**95.9%**		108.8%

DIGITAL ANGEL CORPORATION
Notes to Condensed Consolidated Financial Statements (Unaudited) (continued)

10. Stock Options and Restricted Stock (continued)

The Company s computation of expected volatility is determined based on historical volatility. The computation of expected life is determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant.

A summary of the Company s stock option activity as of September 30, 2007, and changes during the nine months then ended is presented below (in thousands, except per share amounts):

	Stock Options	Weighted Average Exercise Price	Weighted Average Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2007	11,705	$ 3.84		
Granted	520	2.11		
Exercised				
Forfeited or expired	(1,614)	3.87		
Outstanding at September 30, 2007	10,611	$ 3.75	6.85	$ 470*
Vested or expected to vest at September 30, 2007	10,108	$ 3.78	6.75	$ 470*
Exercisable at September 30, 2007	8,569	$ 3.93	6.59	$ 470*

* The intrinsic value of a stock option is the amount by which the market value of the underlying stock exceeds the exercise price of the option. The market value of the Company s common stock was $1.29 per share at September 30, 2007.

The weighted average grant-date fair value of options granted during the nine month periods ended September 30, 2007 and 2006 was $1.39 and $2.69, respectively. The total intrinsic value of options exercised during the nine month periods ended September 30, 2007 and 2006 was nil and $644,000, respectively.

A summary of the status of the Company s nonvested stock options as of September 30, 2007 and changes during the nine month period ended September 30, 2007, is presented below (in thousands, except per share amounts):

	Stock Options	Weighted Average Grant-Date Fair Value
Nonvested at January 1, 2007	2,458	$ 2.64
Granted	520	1.39
Vested	(303)	2.19
Forfeited or expired	(633)	2.11
Nonvested at September 30, 2007	2,042	$ 1.94

As of September 30, 2007, there was $3.6 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the DAC Stock Option Plan. That cost is expected to be recognized over a weighted-average period of 5.9 years. As defined in the DAC Stock Option Plan, a change in control (which would occur upon the consummation of the Merger between the Company and Applied Digital, see Note 2), would trigger the accelerated vesting of the 2,041,665 unvested stock options and all unrecognized compensation cost would be immediately recognized.

Cash received from option exercises under all share-based payment arrangements for the nine month periods ended September 30, 2007 and 2006, was nil and $563,000, respectively.

Restricted Stock

In August 2007, the Company granted its former CEO 307,143 shares of the Company s restricted stock. The restricted stock vests 100% on September 7, 2008. The Company determined the value of the stock to be $430,000 based on the closing price of the Company s stock on August 8, 2007 and was recorded as compensation expense in the Company s results of operations for the nine months ended September 30, 2007.

DIGITAL ANGEL CORPORATION
Notes to Condensed Consolidated Financial Statements (Unaudited) (continued)

10. Stock Options and Restricted Stock (continued)

In August 2007, the Company granted its Chairman of the board of directors 25,000 shares of the Company s restricted stock. The restricted stock vested 100% on October 15, 2007. The Company determined the value of the stock to be $39,000 based on the closing price of the Company s stock on the date of the grant. The value of the restricted stock was recorded as compensation expense. In the nine months ended September 30, 2007, $29,000 was recognized as compensation expense in the Company s results of operations related to the restricted stock.

In March 2005, the Company granted its Chairman of the board of directors 100,000 shares of the Company s restricted stock. The restricted stock vested 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 was recorded as deferred compensation and was amortized to compensation expense over the two-year vesting period. In the nine month periods ended September 30, 2007 and 2006, $42,000 and $190,000, respectively, was recognized as compensation expense in the Company s results of operations related to the restricted stock.

In February 2005, the Company granted an employee 54,230 shares of the Company s restricted stock. The restricted stock vested 30% on February 25, 2006, 30% on February 25, 2007 and will vest 40% on February 25, 2008. 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 the nine month periods ended September 30, 2007 and 2006, $69,000 and $56,000, respectively, was recognized as compensation expense in the Company s results of operations related to the restricted stock.

11. Segment Information

The Company develops and deploys sensor and communication technologies that enable rapid and accurate identification, location tracking and condition monitoring of high-value assets. The Company s two operating segments are Animal Applications and GPS and Radio Communications. Previously, the Company combined its Corporate functions with its Animal Applications segment. Beginning April 1, 2007, Corporate has been reclassified and presented separately. Prior period results have also been reclassified for consistency.

Animal Applications Develops, manufactures, and markets visual and electronic identification tags and radio frequency identification microchips, primarily for identification, tracking and location of companion pets, horses, livestock, fish and wildlife worldwide, and more recently, for animal bio-sensing applications, such as temperature reading for companion pet, horse and livestock applications. The Animal Applications segment consists of operations located in Minnesota, DSD Holding A/S and its wholly and majority-owned subsidiaries located in Denmark and Poland, and Digital Angel International, Inc. and its subsidiaries located in Argentina, Brazil, Chile, Paraguay and Uruguay.

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 companion pet identification system involves the insertion of a microchip with identifying information into 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. The Company has distribution agreements with a variety of other companies outside the United States to market its 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, once implanted, can be identified without being captured or sacrificed.

DIGITAL ANGEL CORPORATION
Notes to Condensed Consolidated Financial Statements (Unaudited) (continued)

11. Segment Information (continued)

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 the Company has marketed since the 1940s. Currently, sales of visual products represent a substantial percentage of the Company s sales to livestock producers.

The Company s implantable radio frequency microchip was cleared by the U.S. Food and Drug Administration 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 (VeriChip), an affiliated, majority-owned subsidiary of Applied Digital, covering the manufacturing, purchasing and distribution of the human implantable microchip, which is more fully described in Note 13.

GPS and Radio Communications Designs, manufactures and markets global positioning systems (GPS) enabled equipment used for location tracking and message monitoring of vehicles, aircraft and people in remote locations. This segment s principal products are GPS-enabled search and rescue equipment and intelligent communications products and services for telemetry, mobile data and radio communications applications, including Digital Angel s SARBE brand, which serve commercial and military markets, as well as alarm sounders for industrial use and other electronic components. The GPS and Radio Communications segment consists of the operations of the Company s subsidiary, Signature (90.9% owned), and includes the operations of the McMurdo business acquired in April 2007, both of which are located in the United Kingdom.

The GPS and Radio Communications segment s personal locator beacons (PLBs), which are sold under the SARBE brand name, are used by military air crew in the event of an ejection or other event requiring emergency evacuation of an aircraft in a remote, possibly hostile location. Even if aircrew are unconscious or injured, the SARBE transmission will be initiated immediately as no human intervention is required, reducing the time it takes to initiate a search.

The Company is also a distributor of two-way communications equipment in the United Kingdom. Its products range from conventional radio systems for the majority of radio users, construction and manufacturing industries, intrinsically safe radio equipment for use in hazardous environments, trunked radio systems for large scale users and marine radios, ariband radios and inmarsat communication equipment for use on a global basis.

The GPS and Radio Communications segment also manufactures electronic alarm sounders under the Clifford & Snell name. These products are used to provide audible and/or visual signals, which alert personnel in hazardous areas, including the oil and petrochemical industry and in the fire and security market.

The Corporate category includes general and administrative expenses, interest expense and income and other expenses associated with corporate activities and functions. Included in Corporate for the three and nine months ended September 30, 2007 is approximately $0.6 million and $0.8 million, respectively, for costs associated with the Merger between the Company and Applied Digital.

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

DIGITAL ANGEL CORPORATION
Notes to Condensed Consolidated Financial Statements (Unaudited) (continued)

11. Segment Information (continued)

The following is the selected segment data as of and for the periods ended:

As of and For the Three Months Ended September 30,	Animal Applications	GPS and Radio Communications	Corporate	Total From Continuing Operations
	(in thousands)			
2007				
Revenue	**$ 10,346**	**$ 9,989**	**$**	**$ 20,335**
Operating (loss) income	**(338)**	**986**	**(2,316)**	**(1,668)**
Operating (loss) income from continuing operations before income taxes and minority interest	**(382)**	**945**	**(3,419)**	**(2,856)**
Segment assets from continuing operations	**$ 77,723**	**$ 19,513**	**$ 120**	**$ 97,356**
2006				
Revenue	$ 8,254	$ 4,146	$	$ 12,400
Operating loss	(155)	(311)	(682)	(1,148)
Operating loss from continuing operations before income taxes and minority interest	(181)	(326)	(667)	(1,174)
Segment assets from continuing operations	$ 78,041	$ 8,303	$	$ 86,344

As of and For the Nine Months Ended September 30,	Animal Applications	GPS and Radio Communications	Corporate	Total From Continuing Operations
	(in thousands)			
2007				
Revenue	**$ 31,635**	**$ 23,531**	**$**	**$ 55,166**
Operating loss	**(2,183)**	**(97)**	**(4,147)**	**(6,427)**
Operating loss from continuing operations before income taxes and minority interest	**(2,310)**	**(215)**	**(5,684)**	**(8,209)**
Segment assets from continuing operations	**$ 77,723**	**$ 19,513**	**$ 120**	**$ 97,356**
2006				
Revenue	$ 28,131	$ 12,016	$	$ 40,147
Operating income (loss)	8	(666)	(2,171)	(2,829)
Operating loss from continuing operations before income taxes and minority interest	(62)	(702)	(2,078)	(2,842)
Segment assets from continuing operations	$ 78,041	$ 8,303	$	$ 86,344

12. Supplemental Cash Flow Information

	Nine Months Ended September 30,	
	2007	**2006**
	(in thousands)	
Interest paid	**$ 1,241**	$ 316
Taxes paid	**70**	80
Non-cash activity:		
Issuance of common stock to former shareholders of DSD Holding A/S		1,000
Reclass of other assets to acquisition cost	**494**	
Liability recorded for warrants issued in connection with the debenture	**1,253**	
Issuance of warrants to Kallina	**1,044**	
Issuance of common stock to Applied Digital as a debt discount	**1,428**	
Financing of equipment through capital lease	**871**	440

DIGITAL ANGEL CORPORATION
Notes to Condensed Consolidated Financial Statements (Unaudited) (continued)

13. Income Taxes

Effective January 1, 2007, the Company adopted FASB Interpretation No. 48, Accounting for Uncertainties in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The impact of adoption was immaterial to the Company s condensed consolidated results of operations and financial position and therefore, no FIN 48 liability was recorded. In addition, the Company did not record any liability for income tax-related interest and penalties. Any future expense for income tax-related interest and penalties will be classified as a component of income taxes.

The Company files income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions in which the Company operates. In general, the Company is no longer subject to U.S. federal, state or local income tax examinations for years ended before December 31, 2002. DSD Holding is no longer subject to non-U.S. income tax examinations for years ended before December 31, 2002 and Signature is no longer subject to non-U.S. income tax examinations for years ended before December 31, 2004. We do not currently have any examinations ongoing.

14. Related Party Activity

On August 31, 2007, the Company entered into a $7.0 million intercompany loan with Applied Digital and issued to Applied Digital 921,402 shares of the Company s common stock as consideration. See Note 6 for further discussion.

The Company has a Distribution and Licensing Agreement dated March 4, 2002, amended December 28, 2005 and May 9, 2007, with VeriChip, a majority owned subsidiary of Applied Digital at September 30, 2007, covering the manufacturing, purchasing and distribution of the Company s implantable microchip and the maintenance of the VeriChip Registry by us (the Distribution and Licensing Agreement). The Distribution and Licensing Agreement contains, among other things, minimum purchase requirements in order to maintain exclusivity, whereby VeriChip is required to purchase $0, $875,000, $1,750,000 and $2,500,000 for each of 2007, 2008, 2009 and 2010, respectively, and $3,750,000 for 2011 and each year thereafter. As of September 30, 2007, VeriChip has purchased approximately $0.4 million of the minimum purchase requirement for 2008. The Distribution and Licensing Agreement continues until March 2014 and, as long as VeriChip continues to meet the minimum purchase requirements, will automatically renew annually under its terms. The Distribution and Licensing agreement includes a license for the use of the Company s technology in VeriChip s identified markets. 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 España, SA, expire on June 30, 2010.

Revenue recognized under the Distribution and Licensing Agreement was nil and $21,000 for the three months ended September 30, 2007 and 2006, respectively, and $39,000 and $194,000 for the nine months ended September 30, 2007 and 2006, respectively. Amounts due from VeriChip as of September 30, 2007 and December 31, 2006 were nil and $425,000, respectively.

Laurus Capital Management, LLC or its affiliates beneficially owned approximately 10% of the Company s common stock at August 31, 2007. The Company has entered into financing arrangements with Kallina, an affiliate of Laurus, in the ordinary course of business.

The Company s subsidiary, DSD Holding A/S (DSD), leases a 13,600 square foot building located in Hvidovre, Denmark. The building is occupied by DSD s administrative and production operations. The lease agreement has no expiration, but includes a three-month termination notice requirement that can be utilized by the owner or DSD. DSD leases the building from LANO Holding ApS, which is 100%-owned by Lasse Nordfjeld, president of the Company s Animal Applications Group. For nine months ended September 30, 2007, DSD paid to LANO Holding ApS the aggregate amount of DKK 544,000 (approximately $98,000 at September 30, 2007) for lease payments.

DIGITAL ANGEL CORPORATION

Notes to Condensed Consolidated Financial Statements (Unaudited) (continued)

15. Legal Proceedings

Digital Angel Corporation v. 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, (Crystal), and Medical Management International, Inc. The suit claimed that the defendants were marketing and selling syringe implantable identification transponders manufactured by Datamars that infringed 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. The suit sought, among other things, an adjudication of infringement, injunctive relief, and actual and punitive damages. 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. On May 22, 2006, the Court issued its order on the Markman Hearing, largely adopting the Company s views on the scope of the claims in the subject patent.

The Crystal Import Corporation v. Digital Angel, et al.

On or about December 29, 2004, Crystal 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. On October 12, 2005, the Alabama Court transferred the action to Minnesota. Following the docketing of the actio