

DIGITAL ANGEL CORP

Form 10-Q

August 14, 2002

**As filed with the Securities and Exchange Commission on August 14, 2002**

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

## FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2002

or

**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**

(IRS Employer  
Identification No.)

**490 Villaume Avenue  
South Saint Paul, Minnesota 55075**

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**(651) 455-1621**

(Address, including zip code, and telephone number,  
including area code, of registrant's principal executive offices)

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

Yes  No

The number of shares outstanding of each of the issuer's classes of common stock as of the close of business on July 29, 2002:

<b>Class</b>	<b>Number of Shares</b>
Common Stock; \$.005 Par Value	26,426,076

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**DIGITAL ANGEL CORPORATION**

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## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements.

## DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

## CONDENSED BALANCE SHEETS

(In thousands, except par value)

	Digital Angel Corporation and Subsidiaries (Consolidated) June 30, 2002 (Unaudited)	Advanced Wireless Group (Combined) December 31, 2001
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 584	\$ 596
Accounts receivable and unbilled receivables (net of allowance for doubtful accounts of \$318 in 2002 and \$296 in 2001)	4,494	5,402
Inventories	5,574	5,819
Other current assets	1,157	733
<b>Total Current Assets</b>	<b>11,809</b>	<b>12,550</b>
<b>Property And Equipment, net</b>	<b>14,951</b>	<b>14,476</b>
<b>Goodwill and Other Intangible Assets, net</b>	<b>106,258</b>	<b>72,876</b>
<b>Investment In Affiliates</b>	<b>256</b>	<b>6,779</b>
<b>Other Assets, net</b>	<b>547</b>	<b>698</b>
	\$ 133,821	\$ 107,379
<b>Liabilities and Stockholders Equity</b>		
<b>Current Liabilities</b>		
Notes payable and current maturities of long-term debt	\$ 387	\$ 82,643
Accounts payable	3,416	3,757
Accrued expenses and other current liabilities	4,341	2,044
Due to Applied Digital Solutions, Inc.	153	
<b>Total Current Liabilities</b>	<b>8,297</b>	<b>88,444</b>

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<b>Long-Term Debt And Notes Payable</b>	<b>2,410</b>	2,425
<b>Total Liabilities</b>	<b>10,707</b>	90,869
<b>Commitments And Contingencies</b>		
<b>Minority Interest</b>	<b>351</b>	394
<b>Stockholders Equity (See Note 1)</b>		
Preferred shares: Authorized 1,000 in 2002, of \$1.75 par value, no shares issued or outstanding		
Common shares: Authorized 95,000 shares in 2002, of \$.005 par value; 26,448 shares issued and 26,398 shares outstanding in 2002 and 18,750 shares issued and outstanding in 2001		
	<b>132</b>	94
Additional paid-in capital	<b>167,075</b>	37,929
Accumulated deficit	<b>(45,709)</b>	(21,700)
Common stock warrants	<b>1,638</b>	300
Treasury stock (carried at cost, 50 shares in 2002)	<b>(43)</b>	
Accumulated other comprehensive loss	<b>(330)</b>	(507)
<b>Total Stockholders Equity</b>	<b>122,763</b>	16,116
	<b>\$ 133,821</b>	\$ 107,379

See the accompanying notes to condensed financial statements.



## DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

## CONDENSED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(Unaudited)

	Digital Angel Corporation and Subsidiaries (Consolidated)	Advanced Wireless Group (Combined)	Digital Angel Corporation and Subsidiaries (Consolidated)	Advanced Wireless Group (Combined)
	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2002	2001	2002	2001
Product revenue	\$ 8,662	\$ 7,618	\$ 16,113	\$ 16,752
Service revenue	577	852	880	1,922
Total net revenue	9,239	8,470	16,993	18,674
Cost of products sold	4,835	4,600	9,135	9,961
Cost of services sold	247	479	498	1,028
Gross profit	4,157	3,391	7,360	7,685
Selling, general and administrative expenses	3,713	2,267	25,622	4,768
Management fees - Applied Digital Solutions, Inc.		178	193	371
Research and development expenses	782	1,326	1,545	2,410
Depreciation and amortization	1,095	3,024	1,830	5,383
Interest income		(8)		(11)
Interest expense - Applied Digital Solutions, Inc.			1,806	
Interest expense - others	67	92	125	151
Loss before taxes, minority interest and equity in net loss of affiliate	(1,500)	(3,488)	(23,761)	(5,387)
Provision (benefit) for income taxes		(8)		107
Loss before minority interest, and equity in net loss of affiliate	(1,500)	(3,480)	(23,761)	(5,494)
Minority interest	(2)	(5)	(43)	(27)
Equity in net loss of affiliate		49	291	67
Net loss	\$ (1,498)	\$ (3,524)	\$ (24,009)	\$ (5,534)

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Net loss per common share - basic and diluted	\$	(0.06)	\$	(0.19)	\$	(1.06)	\$	(0.30)
Weighted average number of common shares outstanding - basic and diluted		<b>26,169</b>		18,750		<b>22,616</b>		18,750

See the accompanying notes to condensed financial statements.

## DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

## CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY

For The Six Months Ended June 30, 2002

(In Thousands)

(Unaudited)

	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Common Stock Warrants	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders Equity
	Number	Amount						
<b>Balance - December 31, 2001</b>	18,750	\$ 94	\$ 37,929	\$ (21,700)	\$ 300	\$	\$ (507)	16,116
Net loss				(24,009)				(24,009)
Comprehensive loss -								
Foreign currency translation							177	177
Total comprehensive loss				(24,009)			177	(23,832)
Transfer of MAS common shares to ADS			(6,488)					(6,488)
Contribution by ADS			6,593					6,593
Exercise of stock options	2,392	12	589					601
Shares to be issued in settlement of liability	38		225					225
Merger consideration - Medical Advisory Systems, Inc.	5,268	26	28,163		272	(43)		28,418
Assumption of debt by ADS			81,383					81,383
Stock options remeasured in connection with merger			18,681					18,681
Warrants remeasured in connection with merger					1,066			1,066
<b>Balance - June 30, 2002</b>	<b>26,448</b>	<b>\$ 132</b>	<b>\$ 167,075</b>	<b>\$ (45,709)</b>	<b>\$ 1,638</b>	<b>\$ (43)</b>	<b>\$ (330)</b>	<b>122,763</b>

See the accompanying notes to condensed financial statements.

## DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

## CONDENSED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Digital Angel Corporation and Subsidiaries (Consolidated)	For the Six Months Ended June 30,	Advanced Wireless Group (Combined)
	2002		2001
<b>Cash Flows From Operating Activities</b>			
Net loss	\$	(24,009)	\$ (5,534)
Adjustments to reconcile net loss to net cash used in operating activities:			
Non-cash compensation expense		18,877	
Interest allocated by ADS and contributed to capital		1,806	
Deferred income taxes			34
Depreciation and amortization		1,830	5,383
Minority interest		(43)	(27)
Equity in net loss of affiliate		291	67
Loss on sale of equipment		7	7
Change in assets and liabilities:			
Decrease in accounts receivable		1,181	228
Decrease (increase) in inventories		312	(930)
Increase in other current assets		(545)	(514)
Increase in due to ADS		153	
(Decrease) increase in accounts payable and accrued expenses		(714)	530
<b>Net Cash Used In Operating Activities</b>		<b>(854)</b>	<b>(756)</b>
<b>Cash Flows From Investing Activities</b>			
Decrease in other assets		63	262
Payments for property and equipment		(673)	(1,091)
Proceeds from sale of property and equipment		23	
Cash acquired through acquisition, net of acquisition costs		40	
<b>Net Cash Used In Investing Activities</b>		<b>(547)</b>	<b>(829)</b>
<b>Cash Flows From Financing Activities</b>			
Net amounts borrowed on notes payable		136	(2)
Payments on long-term debt		(32)	(35)
Exercise of stock options		601	

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Net transactions with Applied Digital Solutions, Inc.	<b>684</b>	1,416
<b>Net Cash Provided By Financing Activities</b>	<b>1,389</b>	1,379
<b>Net Decrease In Cash And Cash Equivalents</b>	<b>(12)</b>	(206)
<b>Cash And Cash Equivalents - Beginning Of Period</b>	<b>596</b>	206
<b>Cash And Cash Equivalents - End Of Period</b>	<b>\$ 584</b>	<b>\$</b>

See the accompanying notes to condensed financial statements.

**DIGITAL ANGEL CORPORATION**

**NOTES TO CONDENSED FINANCIAL STATEMENTS**

**(Dollars in thousands)**

**(Unaudited)**

**1. Basis of Presentation**

On March 27, 2002, Digital Angel Acquisition Co. ( Acquisition ), then a wholly-owned subsidiary of Medical Advisory Systems, Inc. ( MAS ), merged with and into Digital Angel Corporation ( Digital Angel ), which was then a 93% owned subsidiary of Applied Digital Solutions, Inc. ( ADS ). In the merger, the corporate existence of Acquisition ceased, Digital Angel became a wholly-owned subsidiary of MAS, and MAS was renamed Digital Angel Corporation . In connection with the merger transaction, ADS contributed to MAS all of its stock in Timely Technology Corp., a wholly-owned subsidiary, and Signature Industries, Limited, an 85% owned subsidiary. These two subsidiaries along with Digital Angel comprised the Advanced Wireless Group ( AWG ). As a result of this contribution by ADS, Timely Technology Corp. became a wholly-owned subsidiary of the Company and Signature Industries, Limited became an 85% subsidiary. Prior to the merger with Digital Angel, ADS owned 850,000 shares of MAS stock representing approximately 16.6% of the outstanding stock of MAS. (The term Company means Digital Angel Corporation and its subsidiaries.) In the merger, the shares of Digital Angel owned by ADS were converted into a total of 18,750,000 shares of MAS common stock. As a result of the merger, ADS owned 19,600,000 shares or 77.15% of the Company's common stock. In connection with the merger, ADS transferred to Digital Angel Share Trust all shares of the Digital Angel Corporation common stock owned by ADS. The trust is the owner of and, through its Advisory Board, votes all shares of Digital Angel Corporation owned by ADS, including all shares issued to ADS in consideration of the Digital Angel Corporation merger, and has the ability to elect the Board of Directors of the Company. The Trust arose as a condition of the merger. In connection with certain obligations of ADS the shares owned by the Trust may be sold or otherwise disposed of to satisfy such obligations. Additionally, the Company has certain covenant obligations in connection with the ADS obligations (see Note 9).

The merger has been treated as a reverse acquisition for accounting purposes, with AWG treated as the accounting acquirer. The historical combined financial statements of AWG became those of the Registrant, and the assets and liabilities of MAS were accounted for as required under the purchase method of accounting. Although the equity accounts of AWG survive the merger, the capital structure of MAS survives the merger. Accordingly, the equity accounts of AWG have been restated based on the common shares received by the former shareholders of AWG in the merger.

On March 27, 2002, ADS amended and restated its debt agreement with IBM Credit Corporation, which, among other amendments, provided for a release of AWG from the responsibility to repay an existing obligation. Accordingly, ADS assumed this obligation, which resulted in an increase to additional paid-in capital of \$81.4 million net of deferred financing fees of approximately \$1.1 million on March 27, 2002.

Pursuant to the terms of the merger agreement, options to acquire shares of Digital Angel common stock were converted into options to acquire shares of MAS common stock effective March 27, 2002. The conversion resulted in a new measurement date for the options and, as a result, the Company recorded a charge of approximately \$18.7 million in non-cash compensation expense during the three months ended March 31, 2002. For current employees of the Company, these options are considered fixed awards under APB Opinion No. 25, and expense was recorded for the intrinsic value of the options converted. For all others, expense was recorded for the fair value of the options converted using the Black-Scholes option-pricing model.

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The accompanying unaudited condensed consolidated financial statements of Digital Angel

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Corporation and subsidiaries as of and for three and six month periods ended June 30, 2002 and the combined financial statements of AWG as of December 31, 2001 and for the three and six month periods ended June 30, 2001 (unaudited) have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X under the Securities Exchange Act of 1934.

Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of the Company's management, all adjustments (including normal recurring adjustments) considered necessary to present fairly the financial statements have been made.

The consolidated statements of operations for the three and six months ended June 30, 2002 are not necessarily indicative of the results that may be expected for the entire year. These statements should be read in conjunction with the AWG's combined financial statements and related notes thereto for the year ended December 31, 2001 included as an exhibit to our form 8-K/A filed with the Securities and Exchange Commission on July 19, 2002.

Certain items in the combined financial statements for the 2001 period have been reclassified for comparative purposes.

The accompanying condensed consolidated financial statements have been prepared assuming that the Company will continue as a going concern. The Company has suffered significant losses from operations and has not generated positive cash flows from operations. Additionally, the Company does not have an available line of credit. These factors raise substantial doubt about the Company's ability to continue as a going concern. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty. The Company has conducted discussions with several banks regarding a credit facility. Our capital requirements depend on a variety of factors, including, but not limited to, the rate of increase or decrease in our existing business base; the success, timing, and amount of investment required to bring new products on-line; revenue growth or decline; and potential acquisitions. Providing we are successful in obtaining the credit facility, of which there can be no assurance, management believes that we will have the financial resources to meet its future business requirements for at least the next twelve months.

The financial information in these financial statements includes an allocation of expenses incurred by ADS on behalf of the Company as discussed in Note 9. However, these financial statements may not necessarily be indicative of the results that may have occurred had AWG been a separate, independent entity during the periods presented or of future results of the Company.

### **Accounting Changes**

Effective January 1, 2002, the Company adopted Statement of Financial Accounting Standard No. 142, Goodwill and Other Intangible Assets (FAS 142). FAS 142 requires that goodwill and certain intangibles no longer be amortized but instead tested for impairment at least annually. There was no impairment of goodwill upon adoption of FAS 142. However, there can be no assurance that future goodwill impairment tests will not result in impairment charges.





The following table presents the impact of FAS 142 on net loss and net loss per share had the standard been in effect for the three months and six months ended June 30, 2001:

	<b>Three Months Ended June 30, 2001</b>		<b>Six Months Ended June 30, 2001</b>	
<b>Net loss:</b>				
Net loss as reported	\$	(3,524)	\$	(5,534)
Goodwill amortization		2,024		3,959
Equity method investment amortization		336		449
Adjusted net loss	\$	(1,164)	\$	(1,126)
<b>Basis and diluted loss per share:</b>				
Net loss per share, basis and diluted, as reported	\$	(0.19)	\$	(0.30)
Goodwill amortization		0.11		0.21
Equity method investment amortization		0.02		0.03
Adjusted net loss per share, basic and diluted	\$	(0.06)	\$	(0.06)

Amortization expense of other intangible assets totaled \$224 and \$20 for the six months ended June 30, 2002 and 2001, respectively.

## **2. Principles of Consolidation and Combination**

The June 30, 2002 condensed consolidated financial statements include the accounts of the Company and its wholly-owned and majority-owned subsidiaries from the date of acquisition. The combined financial statements at December 31, 2001 and for the three and six months ended June 30, 2001 include the accounts of AWG entities under common control. All significant intercompany accounts and transactions have been eliminated in consolidation and combination. AWG used the equity method of accounting for its investments which are less than majority owned, but over which it had significant influence.

## **3. Revenue Recognition**

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For software consulting and development services, the Company recognizes revenue based on the percent complete for fixed fee contracts, with the percent complete being calculated as either the number of direct labor hours in the project to date divided by the estimated total direct labor hours or based upon the completion of specific task orders. It is the Company's policy to record contract losses in their entirety in the period in which such losses are foreseeable. For non fixed fee jobs, revenue is recognized based on the actual direct labor hours in the job times the standard billing rate and adjusted to realizable value, if necessary. For product sales, the Company recognizes revenue at the time products





are 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 collectability is deemed probable. If uncertainties regarding customer acceptance exists, revenue is recognized when such uncertainties are resolved. There are no significant post-contract support obligations at the time of revenue recognition. The Company's accounting policy regarding vendor and post-contract support obligations is based on the terms of the customers' contract, billable upon the occurrence of the post-sale support. Costs of goods sold are recorded as the related revenue is recognized. The Company provides warranties on certain of its products. Estimated warranty costs are accrued in the same period in which the related revenue is recognized, based on anticipated parts and labor costs and utilizing historical experience. The Company does not offer a warranty policy for services to customers. Revenues from contracts that provide unlimited services are recognized ratably over the term of the contract. Fixed fee revenues from contracts for services are recorded when earned and excludes reimbursable costs. Reimbursable costs incurred in performing such services are presented on a net basis and include transportation, medical and communication costs. Other revenues are recognized at the time services or goods are provided.

**4. Inventory**

	<b>June 30, 2002</b>	<b>December 31, 2001</b>
Raw materials	\$ 1,641	\$ 1,474
Work in process	216	176
Finished goods	4,979	5,611
	6,836	7,261
Allowance for excess and obsolescence	(1,262)	(1,442)
Net inventory	\$ 5,574	\$ 5,819

## 5. Loss Per Share

The following is a reconciliation of the numerator and denominator of basic and diluted loss per share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
<b>Numerator:</b>				
Net loss	\$ (1,498)	\$ (3,524)	\$ (24,009)	\$ (5,534)
<b>Denominator:</b>				
Denominator for basic loss per share -				
Weighted-average shares	26,169	18,750	22,616	18,750
Denominator for diluted loss per share(1)	26,169	18,750	22,616	18,750
<b>Basic and diluted loss per share:</b>	<b>\$ (0.06)</b>	<b>\$ (0.19)</b>	<b>\$ (1.06)</b>	<b>\$ (0.30)</b>

(1) Potentially dilutive securities excluded from the computation of diluted loss per share because to do so would have been anti-dilutive.

	Three Months Ended June 30,	Six Months Ended June 30,
	2002	2002
Employee stock options	3,967	3,967
Warrants	1,239	1,239
	5,206	5,206



## 6. Segment Information

The Company is engaged in the business of developing and bringing to market proprietary technologies used to identify, locate and monitor people, animals and objects. Prior to March 27, 2002, the Company operated in four segments: Animal Tracking, Digital Angel Technology, Digital Angel Delivery System, and Radio Communications and Other. With the acquisition of Medical Advisory Systems, Inc. in March 2002, the Company re-organized into four segments: Animal Applications, Digital Angel Systems, GPS and Radio Communications, and Physician Call Center and Other. Animal Applications is the new name of our segment previously identified as Animal Tracking. We combined our Digital Angel Technology segment with our Digital Angel Delivery System segment to form the new Digital Angel Systems segment, which is now managed as a single business unit. GPS and Radio Communications is the new name of our segment previously identified as Radio Communications and Other and represents the activity of Signature Industries Limited, which is located in the United Kingdom. Physician Call Center and Other reflects the newly acquired Medical Advisory Systems, Inc. business. Prior period segment information has been restated to reflect our current segment structure.

The accounting policies of the operating segments are the same as those described in the summary of accounting policies in the Company's audited financial statements for the year ended December 31, 2001. It is on this basis that management utilizes the financial information to assist in making internal operating decisions. The Company evaluates performance based on stand-alone segment operating income.

Following is the selected segment data as of and for the three months ended June 30, 2002:

	Animal Applications	Digital Angel Systems	GPS and Radio Communications	Physician Call Center and Other	Corporate / Unallocated	Consolidated
Net revenue from external customers:						
Product	\$ 5,612	\$	\$ 2,480	\$ 570	\$	\$ 8,662
Service		577				577
Total revenue	\$ 5,612	\$ 577	\$ 2,480	\$ 570	\$	\$ 9,239
Income (loss) before provision (benefit) for income taxes, minority interest and equity in net loss of affiliate						
	\$ 122	\$ (1,357)	\$ (25)	\$ (240)	\$	\$ (1,500)
Total assets	\$ 79,037	\$ 16,978	\$ 5,513	\$ 32,293	\$	\$ 133,821

In the three month period ended June 30, 2002, 2 customers accounted for approximately 15.8% and 15.1% of our Animal Applications revenue and one customer accounted for 49.2% of our Digital Angel Systems revenue.

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Following is the selected segment data as of and for the six months ended June 30, 2002

	Animal Applications	Digital Angel Systems	GPS and Radio Communications	Physician Call Center and Other	Corporate / Unallocated	Consolidated
Net revenue from external customers:						
Product	\$ 10,427	\$	\$ 5,116	\$ 570	\$	\$ 16,113
Service		880				880
Total revenue	\$ 10,427	\$ 880	\$ 5,116	\$ 570	\$	\$ 16,993
Income (loss) before provision (benefit) for income taxes, minority interest and equity in net loss of affiliate	\$ 401	\$ (3,147)	\$ (288)	\$ (240)	(20,487)(1)	(23,761)
Total assets	\$ 79,037	\$ 16,978	\$ 5,513	\$ 32,293	\$	\$ 133,821

In the six month period ended June 30, 2002, 3 customers accounted for approximately 15.0%, 12.4% and 10.8% of our Animal Applications revenue. We buy most of our syringe-injectable microchips that are used in our electronic identification products from one supplier. In the six month period ended June 30, 2002, one customer accounted for approximately 57.1% of our Digital Angel Systems revenue.

(1) Consists of \$18,681 non-cash compensation expense associated with Digital Angel options converted into options to acquire Digital Angel Corporation stock and \$1,806 interest expense associated with ADS obligations to IBM Credit Corporation.

Following is the selected segment data as of and for the three months ended June 30, 2001:

	Animal Applications	Digital Angel Systems	GPS and Radio Communications	Physician Call Center and Other	Combined
Net revenue from external customers:					
Product	\$ 4,877	\$	\$ 2,741	\$	\$ 7,618
Service			852		852
Total revenue	\$ 4,877	\$ 852	\$ 2,741	\$	\$ 8,470
Income (loss) before provision (benefit) for income taxes, minority interest and equity in net loss of affiliate	\$ (2,090)	\$ (1,461)	\$ 63	\$	(3,488)
Total assets	\$ 91,799	\$ 14,459	\$ 6,750	\$	\$ 113,008

In the three month period ended June 30, 2001, 2 customers provided for approximately 22.7% and 22.6% of our Animal Applications revenue.



**Following is the selected segment data as of and for the six months ended June 30, 2001:**

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	Animal Applications	Digital Angel Systems	GPS and Radio Communications	Physician Call Center and Other	Combined
Net revenue from external customers:					
Product	\$ 11,260	\$	\$ 5,492	\$	\$ 16,752
Service		1,922			1,922
Total revenue	\$ 11,260	\$ 1,922	\$ 5,492	\$	\$ 18,674
Income (loss) before provision (benefit) for income taxes, minority interest and equity in net loss of affiliate	\$ (3,134)	\$ (2,028)	\$ (225)	\$	\$ (5,387)
Total assets	\$ 91,799	\$ 14,459	\$ 6,750	\$	\$ 113,008

**In the six month period ended June 30, 2001, 2 customers provided for approximately 17.8% and 17.0% of our Animal Applications revenue.**

## 7. Acquisitions

The following describes the acquisition by the Company during the six month period ended June 30, 2002:

Company Acquired	Date Acquired	Acquisition Price	Acquisition Costs	Value of Shares, Warrants & Options Issued or Issuable	Common Shares Issued	Goodwill and Other Intangibles Acquired	Business Description
Medical Advisory Systems, Inc.	03/27/02	\$ 31,723	\$ 3,305	\$ 28,418	5,218	\$ 29,901	Provider of medical assistance and technical products and services

On February 27, 2001, ADS acquired approximately 16.6% of the capital stock of MAS (AMEX:DOC), a provider of medical assistance and technical products and services, in a transaction valued at approximately \$8.3 million in consideration for 3.3 million shares of ADS's common stock. ADS controlled two of the seven seats on the Company's Board of Directors and became the largest single shareholder. This investment was accounted for under the equity method from February 27, 2001 through March 27, 2002. The excess of the purchase price over the estimated fair value of the shares acquired was approximately \$6.8 million (goodwill) and was being amortized on a straight-line basis over five years, through December 31, 2001.

On March 27, 2002, Digital Angel Corporation merged with a wholly-owned subsidiary of MAS. For accounting purposes, AWG is treated as the acquirer, and the assets and liabilities of MAS were recorded at fair value under the purchase method of accounting. The consolidated financial statements reflect the results of operations of MAS from the date of acquisition. The costs of acquisitions include all payments according to the acquisition agreements plus costs for investment banking services, legal and accounting services that were direct costs of acquiring these assets.

The cost of the March 27, 2002 acquisition consisted of 5.218 million shares of common stock valued at \$25.0 million, 1.2 million options and 75,000 warrants valued at \$3.4 million, and acquisition costs of \$3.3 million. The valuation of the stock is based on the value of the shares of MAS held by stockholders other than Applied Digital Solutions prior to the acquisition. Included in the acquisition costs are certain severance liabilities of \$2.5 million, related to employment agreements of two officers of MAS. The value of the options and warrants is based on the fair value of the options and warrants of MAS at the date of acquisition. The fair value was determined using the Black-Scholes option pricing model.

In considering the benefits of a merger of AWG and MAS, the management of AWG recognized the strategic advantage of combining the advanced wireless technologies being developed by AWG with the physician-staffed call center infrastructure of MAS. One of the principal benefits of such a combination is the ability of the Company to offer a complete end-to-end solution to the various vertical markets for Digital Angel™ products.

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Unaudited pro forma results of operations for the three and six months ended June 30, 2002 and 2001 are included below. Such pro forma information assumes that the above acquisition had occurred

as of January 1, 2002 and 2001, respectively, and revenue is presented in accordance with the Company's accounting policies. This summary is not necessarily indicative of what the result of operations of the Company would have been had it been a combined entity during such periods, nor does it purport to represent results of operations for any future periods.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Net operating revenue	\$ 9,239	\$ 9,387	\$ 17,543	\$ 20,665
Net loss	\$ (1,498)	\$ (3,863)	\$ (25,463)	\$ (6,209)
Net loss per common share - basic and diluted	\$ (0.06)	\$ (0.16)	\$ (0.88)	\$ (0.26)

## 8. Contingencies

### Silva, et al. v. Customized Services Administrators, Incorporated, dba CSA Travel Protection, Inc. et al., No. CV798528 (Santa Clara County Superior Court)

On May 29, 2001, Janet Silva, individually and as Guardian *ad Litem* for Jonathan Silva, a minor, and the Estate of Clarence William Silva, Jr. (collectively, Plaintiffs) filed suit against Customized Services Administrators, Incorporated (CSA), Pricesmart, Inc. (Pricesmart), Commercial Union Insurance Company (Commercial Union), CGU Insurance Group, and the Company (collectively the Defendants) in the Superior Court of the State of California in and for the County of Santa Clara. The allegations of the complaint arise from a vacation guarantee insurance policy (the Insurance Contract) allegedly purchased by Plaintiffs from Defendants on March 6, 2000. The complaint alleges, among other things, that Defendants breached the Insurance Contract, defrauded Plaintiffs, acted in bad faith, engaged in deceptive and unlawful business practices, resulting in the wrongful death of Clarence William Silva, Jr. (the Deceased) and the intentional infliction of emotional distress on Plaintiffs. The complaint seeks the cost of funeral and burial expenses of the Deceased and amounts constituting the loss of financial support of the Deceased, general damages, attorney's fees and costs, and exemplary damages.

CSA has filed a cross-claim against the Company alleging that the Company should be held liable for any liability that CSA may have to Plaintiffs. The Company has denied the allegations of the complaint and the CSA cross-claim and is vigorously contesting all aspects of this action.

The Company is party to various other legal proceedings. In the opinion of management, these proceedings are not likely to have a material adverse effect on the financial position, cash flows or overall trends in results of the Company. The estimate of potential impact on the Company's financial position, overall results of operations or cash flows for the above legal proceedings could change in the future.



## 9. Related Party Activity

ADS provided certain general and administrative services to the Company including finance, legal, benefits and other miscellaneous items. The costs of these services are included in the Company's Statements of Operations based on utilization, which management believes to be reasonable. Costs of these services were \$0.2 million for the three months ended June 30, 2001, and \$0.2 million and \$0.4 million for the six months ended June 30, 2002 and 2001, respectively. ADS also charged the Company \$1.8 million of interest expense in 2002, for which the liability was converted to a capital contribution. In addition, accrued expenses of \$0.3 million were relieved and contributed to capital by ADS. Other transactions resulted in a due to ADS of \$0.2 million at June 30, 2002.

ADS acquired Timely Technology Corp., a part AWG, in 2000 and the merger agreement included an earnout provision based on performance through June 30, 2002. ADS has agreed to pay the selling shareholder of Timely Technology Corp., \$3.6 million, payable in shares of ADS stock, as the final payment under the earnout provision. This obligation has been reflected in the accompanying financial statements as a capital contribution by ADS and an increase to goodwill and other intangibles.

In connection with certain obligations of ADS, the Company has the following covenants. Minimum Cumulative EBITDA, as defined, in the credit agreement, excludes non-cash compensation expense, one-time charges, impairment losses or any liability or claim that will be satisfied by issuance of the Company's common stock.

COVENANT	COVENANTS REQUIREMENT		
Current Assets to Current Liabilities	June 30, 2002		1.8:1
	September 30, 2002		1.8:1
	December 31, 2002		2.0:1
Minimum Cumulative Modified EBITDA	June 30, 2002	\$	577,000
	September 30, 2002	\$	1,547,000
	December 31, 2002	\$	3,329,000

At June 30, 2002, the Company and ADS are out of compliance with certain of the covenants. ADS has received a communication from its lender indicating that pending the expected execution of formal agreements the lender has agreed to waive such noncompliance of the Company and ADS.

## 10. Investment in Affiliates

The change in the Company's affiliates is as follows:

Balance December 31, 2001	\$	6,779
Equity in net loss of affiliate		(291)

<b>MAS common shares transferred to ADS</b>	<b>(6,488)</b>
<b>MAS affiliates obtained through merger (at cost)</b>	<b>256</b>
<b>Balance June 30, 2002</b>	<b>\$ 256</b>

## **11. Option Grant**

The Company adopted the Digital Angel Corporation Transition Stock Option Plan, which as amended, provides for 11.2 million shares of common stock for which options and other grants may be granted.

On June 27, 2002, the Company's Board of Directors granted 3,910,000 options to employees and directors of the Company. The options have an exercise price of \$3.39, the fair value of the Company's common stock on the date of grant, and expire in 10 years. 3,000,000 of the options vest one year from the date of grant and the remaining vest one-third annually on the first anniversary of the grant date. Pursuant to an amendment to the Company's Certificate of Incorporation, required by the terms of the Digital Angel Share Trust Agreement, the option grant requires the approval of two thirds of the Company's stockholders. Approval of the grant has not been obtained.

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

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

We consist of MAS and its three subsidiaries, which formerly were subsidiaries of Applied Digital Solutions, Inc. ( ADS ) Digital Angel Corporation ( DAC ), Timely Technology Corp. and Signature Industries, Limited. These three subsidiaries were known as the Advanced Wireless Group ( AWG ). DAC is engaged in the business of developing and bringing to market proprietary technologies used to identify, locate and monitor people, animals and objects. DAC is the result of the merger in September 2000 of Destron Fearing Corporation and Digital Angel.net Inc., which was then a wholly-owned subsidiary of ADS. Before March 27, 2002, the business of DAC was operated in four segments: Animal Tracking, Digital Angel Technology, Digital Angel Delivery System, and Radio Communications and Other. With the acquisition of MAS in March 2002, the Company re-organized into four segments: Animal Applications, Digital Angel Systems, GPS and Radio Communications, and Physician Call Center and Other. Animal Applications is the new name of our segment previously identified as Animal Tracking. We combined our Digital Angel Technology Segment with our Digital Angel Delivery System segment to form the new Digital Angel Systems segment, which is now managed as a single business unit. GPS and Radio Communications is the new name of our segment previously identified as Radio Communications and Other. Physician Call Center and Other reflects the newly acquired MAS business. Prior period segment information has been restated to reflect our current segment structure.

**RESULTS OF OPERATIONS**

The following table summarizes our results of operations as a percentage of net operating revenue for the three and six months ended June 30, 2002 and 2001 and is derived from the accompanying consolidated and combined statements of operations included in this report.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002 %	2001 %	2002 %	2001 %
Product revenue	93.8	89.9	94.8	89.7
Service revenue	6.2	10.1	5.2	10.3
Total net revenue	100.0	100.0	100.0	100.0
Cost of products sold	52.3	54.3	53.8	53.3
Cost of services sold	2.7	5.7	2.9	5.5
Total cost of products and services sold	55.0	60.0	56.7	58.8
Gross profit	45.0	40.0	43.3	41.2
Selling, general and administrative expenses	40.2	26.8	150.7	25.5
Management fees - Applied Digital Solutions, Inc.	0.0	2.1	1.1	2.0
Research and development expenses	8.4	15.6	9.1	12.9
Depreciation and amortization expenses	11.9	35.7	10.8	28.9
Interest income	0.0	(0.1)	0.0	(0.1)
Interest expense	0.7	1.1	11.4	0.8
Loss before provision (benefit) for income taxes, minority interest and equity in net loss of affiliate	(16.2)	(41.2)	(139.8)	(28.8)
Provision (benefit) for income taxes	0.0	(0.1)	0.0	0.6
Loss before minority interest and equity in net loss of affiliate minority interest	(16.2)	(41.1)	(139.8)	(29.4)
Minority interest	(0.0)	(0.1)	(0.2)	(0.1)
Equity in net loss of affiliate	0.0	0.6	1.7	0.3
Net loss	(16.2)	(41.6)	(141.3)	(29.6)

**Three Months Ended June 30, 2002 Compared to the Three Months Ended June 30, 2001****Revenue**

Revenue from operations for the three months ended June 30, 2002 was \$ 9.2 million, an increase of \$0.7 million, or 8.2%, from \$8.5 million in the three months ended June 30, 2001.



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Revenue for each of the operating segments was:

	Three Months Ended June 30, 2002		Three Months Ended June 30, 2001	
Animal Applications	\$	5,612	\$	4,877
Digital Angel Systems		577		852
GPS and Radio Communications		2,480		2,741
Physician Call Center and Other		570		
<b>Total</b>	<b>\$</b>	<b>9,239</b>	<b>\$</b>	<b>8,470</b>

The Animal Applications segment's revenue increased \$0.7 million, or 15.1%, in the three months ended June 30, 2002 compared to the three month period ended June 30, 2001. The increase is due primarily to sales of transponders to the fisheries industry customers.

The Digital Angel Systems segment's revenue decreased \$0.3 million, or 32.3%, in the three month period ended June 30, 2002 compared to the three month period ended June 30, 2001 primarily due to a shift in emphasis to the Digital Angel products which are in the initial stages of development.

The GPS and Radio Communications segment's revenue decreased \$0.3 million, or 9.5%, in the three month period ended June 30, 2002 compared to three month period ended June 30, 2001 primarily as a result of order fluctuations.

Physician Call Center and Other revenue was \$0.6 million in the three months period ended June 30, 2002. The segment became part of the Company on March 27, 2002.

### Gross Profit and Gross Profit Margin

Gross profit for the three month period ended June 30, 2002 was \$4.2 million, an increase of \$0.8 million, or 22.6%, compared to \$3.4 million in the three month period ended June 30, 2001. As a percentage of revenue, the gross profit margin was 45.0 % and 40.0% for the three months ended June 30, 2002 and 2001, respectively.

Gross profit from operations for each operating segment was:

	Three Months Ended June 30, 2002		Three Months Ended June 30, 2001	
Animal Applications	\$	2,266	\$	1,680
Digital Angel Systems		330		372

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GPS and Radio Communications		1,348	1,339
Physician Call Center and Other		213	
Total	\$	4,157	\$ 3,391

Gross profit margin from operations for each operating segment was:

	<b>Three Months Ended June 30, 2002 %</b>	<b>Three Months Ended June 30, 2001 %</b>
Animal Applications	40.4	34.4
Digital Angel Systems	57.2	43.7
GPS and Radio Communications	54.4	48.9
Physician Call Center and Other	37.4	
Total	45.0	40.0

The Animal Applications segment's gross profit increased \$0.6 million in the three month period ended June 30, 2002 compared to the three months ended June 30, 2001 due to the previously mentioned sales increase. The gross margin percentage increased to 40.4% in the three month period ended June 30, 2002 as compared to 34.4% in the three month period ended June 30, 2001 due to higher margin product mix.

The Digital Angel Systems segment's gross profit decreased \$42,000, or 11.3%, in the three month period ended June 30, 2002 as compared to the three month period ended June 30, 2001. Margins increased to 57.2 % in the three month period ended June 30, 2002 from 43.7% in the three month period ended June 30, 2001. The gross profit increase was primarily due to a shift to higher margin contracts.

The GPS and Radio Communications segment's gross profit remained constant at \$1.3 million for the three month period ended June 30, 2002. The gross margin percentage increased to 54.4 % in the three month period ended June 30, 2002 as compared to 48.9 % in the three month period ended June 30, 2001 due to a favorable shift in the product mix.

The Physician Call Center and Other segment's gross profit was \$0.2 million for the three month period ended June 30, 2002. The gross margin was 37.4% in the three month period ended June 30, 2002. This segment became part of the Company on March 27, 2002.

#### Selling, General and Administrative Expenses

Selling, general and administrative expenses from operations increased \$1.4 million, or 63.8%, in the three month period ended June 30, 2002 as compared to the three month period ended June 30, 2001. As a percentage of revenue, selling, general and administrative expenses were 40.2% and 26.8% for the three months ended June 30, 2002 and 2001, respectively.

Selling, general and administrative expenses for each of the operating segments were:

	Three Months Ended June 30, 2002		Three Months Ended June 30, 2001	
Animal Applications	\$	1,544	\$	888
Digital Angel Systems		843		190
GPS and Radio Communications		1,051		1,189
Physician Call Center and Other		275		
Total	\$	3,713	\$	2,267

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



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	<b>Three Months Ended June 30, 2002</b>	<b>Three Months Ended June 30, 2001</b>
	%	%
Animal Applications	27.5	18.2
Digital Angel Systems	146.1	22.3
GPS and Radio Communications	42.4	43.4
Physician Call Center and Other	48.2	
Total	40.2	26.8

The Animal Applications segment's selling, general and administrative expenses increased \$0.7 million in the three month period ended June 30, 2002 as compared to the three month period ended June 30, 2001 and as a percentage of revenue increased to 27.5% from 18.2% in the same respective periods.

The increase is primarily due to increased expenses in legal, accounting, and investor relations categories.

The Digital Angel Systems segment's selling, general and administrative expenses of \$0.8 million increased \$653,000 in the three month period ended June 30, 2002 as compared \$0.2 million in the three month period ended June 30, 2001. Selling, general and administrative expenses increased as a percentage of revenue to 146.1% in the three month period ended June 30, 2002 compared to 22.3% in the three month period ended June 30, 2001 primarily as a result of software amortization expenses.

The GPS and Radio Communications segment's selling, general and administrative expenses decreased \$0.1 million in the three month period ended June 30, 2002 as compared to the three month period ended June 30, 2001 primarily due to administrative cost reductions. As a percentage of revenue, selling, general and administrative expenses decreased to 42.4% in the three month period ended June 30, 2002 from 43.4% in the three month period ended June 30, 2001.

The Physician Call Center segment's selling, general and administrative expenses were \$0.3 million in the three month period ended June 30, 2002. As a percentage of revenue, selling, general and administrative expenses were 48.2% in the three month period ended June 30, 2002. This segment became part of the Company on March 27, 2002.

#### **Management Fees Applied Digital Solutions, Inc.**

Management fees charged by Applied Digital Solutions, Inc. amounted to \$0.2 million for the three months ended June 30, 2001. These fees were for general and administrative services performed for us. After March 31, 2002, we no longer pay a management fee to ADS.

#### **Research and Development Expense**

Research and development expense from operations was \$0.8 million in the three month period ended June 30, 2002, a decrease of \$0.5 million, or 41.0%, from \$1.3 million for the three month period ended June 30, 2001. As a percentage of revenue, research and development expense was 8.4% and 15.6% for the three months ended June 30, 2002 and 2001, respectively.

Research and development expense for each of the operating segments was:

**Three Months  
Ended June 30,  
2002**

**Three Months  
Ended June 30,  
2001**

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Animal Applications	\$	361	\$	253
Digital Angel Systems		296		1,073
GPS and Radio Communications		125		
Physician Call Center and Other				
Total	\$	782	\$	1,326

The significant decrease is due primarily to a reduction in basic research and development expenses associated with the Digital Angel™ product. Since the fundamental technology has now been developed, research expenses have declined and expenses are now focused on development for specific vertical markets.

**Depreciation and Amortization**

Depreciation and amortization expense from operations was \$1.1 million in the three month period ended June 30, 2002, a decrease of \$1.9 million, or 63.8%, from \$3.0 million in the three month period ended June 30, 2001. As a percentage of revenue, the depreciation and amortization expense was 11.9% and 35.7% for the three months ended June 30, 2002 and 2001, respectively.

The decrease was primarily due to the adoption of FAS 142, which took effect January 1, 2002. The adoption of FAS 142 requires the testing of goodwill for impairment at least annually, eliminating the need for monthly amortization of goodwill. Accordingly, goodwill amortization was not recorded during the three months ended June 30, 2002.

Depreciation and amortization expense for each of the operating segments was:

	<b>Three Months Ended June 30, 2002</b>		<b>Three Months Ended June 30, 2001</b>	
Animal Applications	\$	195	\$	2,360
Digital Angel Systems		547		577
GPS and Radio Communications		177		87
Physician Call Center and Other		176		
<b>Total</b>	<b>\$</b>	<b>1,095</b>	<b>\$</b>	<b>3,024</b>

### Interest Expense

Interest expense was \$0.1 million for the three month periods ended June 30, 2002 and 2001.

### Income Taxes

The Company and AWG had effective income tax rates of 0% and a (0.2)% for the three month period ended June 30 of 2002 and 2001, respectively. Differences in the effective income tax rates from the statutory federal income tax rate in 2002 arise primarily from valuation allowances recorded on deferred tax assets resulting from net operating losses and in 2001 arise primarily from valuation allowances recorded on deferred tax assets resulting from net operating losses, non-deductible goodwill amortization associated with acquisitions and state taxes net of federal benefits. The U.S. companies in AWG were included in ADS's consolidated federal income tax return through March 27, 2002. MAS and its subsidiaries file a separate consolidated federal income tax return. After March 27, 2002, AWG's U.S. subsidiaries will file a consolidated federal tax return with MAS.

### Six Months Ended June 30, 2002 Compared to the Six Months Ended June 30, 2001

#### Revenue

Revenue from operations for the six months ended June 30, 2002 was \$17.0 million, a decrease of \$1.7 million, or 9.0%, from \$18.7 million in the six months ended June 30, 2001.

Revenue for each of the operating segments was:

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	<b>Six Months Ended June 30, 2002</b>		<b>Six Months Ended June 30, 2001</b>	
Animal Applications	\$	10,427	\$	11,260
Digital Angel Systems		880		1,922
GPS and Radio Communications		5,116		5,492
Physician Call Center and Other		570		
Total	\$	16,993	\$	18,674

The Animal Applications segment's revenue decreased \$0.8 million, or 7.4%, in the six month period ended June 30, 2002 as compared to the six month period ended June 30, 2001. The decline is due primarily to the higher sales in the first quarter of 2001 to a large customer to prepare for the launch of the pet identification product in France.

The Digital Angel Systems segment's revenue decreased \$1.0 million, or 54.2%, in the six month period ended June 30, 2002 as compared to the six month period ended June 30, 2001 due to completed client assignments that were not replaced and a shift in emphasis to the Digital Angel products which are in the initial stages of development.

The GPS and Radio Communications segment's revenue decreased \$0.4 million, or 6.8%, in the six month period ended June 30, 2002 as compared to six month period ended June 30, 2001 primarily as a result of order fluctuations.

The Physician Call Center and Other revenue was \$0.6 million for the six months ended June 30, 2002. This segment became part of the Company on March 27, 2002.

#### Gross Profit and Gross Profit Margin

Gross profit for the six months ended June 30, 2002 was \$7.4 million, a decrease of \$0.3 million, or 4.2%, from \$7.7 million in the six months ended June 30, 2001. As a percentage of revenue, the gross profit margin was 43.3% and 41.2% for the six months ended June 30, 2002 and 2001, respectively.

Gross profit from operations for each operating segment was:

	Six Months Ended June 30, 2002		Six Months Ended June 30, 2001	
Animal Applications	\$	4,145	\$	4,171
Digital Angel Systems		382		894
GPS and Radio Communications		2,620		2,620
Physician Call Center and Other		213		
Total	\$	7,360	\$	7,685

Gross profit margin from operations for each operating segment was:

Six Months Ended June 30,	Six Months Ended June 30,
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	2002	2001
	%	%
Animal Applications	39.8	37.0
Digital Angel Systems	43.4	46.5
GPS and Radio Communications	51.2	47.7
Physician Call Center and Other	37.4	
Total	43.3	41.2

The Animal Applications segment's gross profit of \$4.1 million in the six months ended June 30, 2002 decreased \$26,000 compared to \$4.2 million in the six month period ended June 30, 2001. The gross profit margin increased to 39.8% in the six month period ended June 30, 2002 as compared to 37.0% in the six months ended June 30, 2001 due to a more favorable product mix.

The Digital Angel Systems segment's gross profit decreased \$0.5 million, or 57.3%, in the six months ended June 30, 2002 as compared to the six months ended June 30, 2001. Margins decreased to 43.4% in the six months ended June 30, 2002 from 46.5% in the six months ended June 30, 2001. The gross profit decrease was primarily due to the sales decline. The margin percentage declined due to the retention of personnel subsequent to the sales client contract completion as resources were shifted to support the Digital Angel™ products.

The GPS and Radio Communications segment's gross profit remained constant at \$2.6 million for the six months ended June 30, 2002. The gross margin percentage increased to 51.2% in the six months ended June 30, 2002 compared to 47.7% in the six months ended June 30, 2001 due to a favorable shift in the product mix.

The Physician Call Center and Other segment's profit was \$0.2 million for the six months ended June 30, 2002. The gross margin was 37.4% in the six months ended June 30, 2002. This segment became part of the Company on March 27, 2002.

### Selling, General and Administrative Expenses

Selling general and administrative expenses from operations increased \$20.9 million, or 437.4%, in the six months ended June 30, 2002 as compared to the six months ended June 30, 2001. This increase was caused primarily by an \$18.7 million charge arising from the remeasurement of options in connection with the merger. Pursuant to the terms of the merger agreement, options to acquire shares of Digital Angel common stock were converted into options to acquire shares of MAS common stock effective March 27, 2002. The conversion resulted in a new measurement date for the options and, as a result, the Company recorded a charge of approximately \$18.7 million in non-cash compensation expense during the three months ended March 31, 2002. For current employees of the Company, these options are considered fixed awards under APB Opinion No. 25, and expense was recorded for the intrinsic value of the options converted. For all others, expense was recorded for the fair value of the options converted using the Black-Scholes option-pricing model. As a percentage of revenue, selling, general and administrative expenses were 150.7% and 25.5% for the six months ended June 30, 2002 and 2001, respectively.

Selling, general and administrative expenses for each of the operating segments excluding the \$18.7 million charge were:

	Six Months Ended June 30, 2002	Six Months Ended June 30, 2001
Animal Applications	\$ 2,559	\$ 1,762
Digital Angel Systems	1,753	404
GPS and Radio Communications	2,354	2,602
Physician Call Center and Other	275	
Total	\$ 6,941	\$ 4,768

Selling, general and administrative expenses as a percentage of revenue for each of the operating segments excluding the \$18.7 million charge were:



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	Six Months Ended June 30, 2002 %	Six Months Ended June 30, 2001 %
Animal Applications	24.5	15.6
Digital Angel Systems	199.2	21.0
GPS and Radio Communications	46.0	47.4
Physician Call Center and Other	48.2	
Total	40.8	25.5

The Animal Applications segment's selling, general and administrative expenses increased \$0.8 million in the six months ended June 30, 2002 compared to the six months June 30, 2001 and as a percentage of revenue increased to 24.5 % from 15.6% in the same respective periods. The increase in the dollars was primarily due to increased legal, accounting, and investor relations expenses.

The Digital Angel Systems segment's selling, general and administrative expenses increased \$1.3 million in the six months ended June 30, 2002 as compared to the six months ended June 30, 2001. Selling, general and administrative expenses increased as a percentage of revenue to 199.2% in the six months ended June 30, 2002 compared to 21.0% in the six months ended June 30, 2001 as a result of the scale up of marketing personnel, advertising and media programs, and infrastructure to support the introduction of Digital Angel™ products.

The GPS and Radio Communications segment's selling, general and administrative expenses decreased \$0.2 million in the six months ended June 30, 2002 as compared to the six months ended June 30, 2001. As a percentage of revenue, selling, general and administrative expenses decreased to 46.0% in the first six months of 2002 from 47.4% in the first six months of 2001.

The Physician Call Center and Other segment's selling, general and administrative expenses were \$ 0.3 million in the six months ended June 30, 2002. This segment became part of the Company on March 27, 2002.

#### Management Fees Applied Digital Solutions, Inc.

Management fees charged by Applied Digital Solutions, Inc. amounted to \$0.2 million and \$0.4 million for the six months ended June 30, 2002 and 2001, respectively. These fees were for general and administrative services performed for us. After March 31, 2002, we no longer pay a management fee to Applied Digital Solutions, Inc.

#### Research and Development Expense

Research and development expense from operations was \$1.5 million in the six months ended June 30, 2002, a decrease of \$0.9 million, or 35.9%, from \$2.4 million for the six months ended June 30, 2001. As a percentage of revenue, research and development expense was 9.1% and 12.9% for the six months ended June 30, 2002 and 2001, respectively.

Research and development expense for each of the operating segments was:

	Six Months Ended June 30, 2002	Six Months Ended June 30, 2001
Animal Applications	\$ 605	\$ 555
Digital Angel Systems	701	1,855
GPS and Radio Communications	239	

Physician Call Center and  
Other

Total	\$	1,545	\$	2,410
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The decrease in expense is primarily due to the completion of some Digital Angel™ trademark technology development.

**Depreciation and Amortization**

Depreciation and amortization expense from operations was \$1.8 million in the six months ended June 30, 2002, a decrease of \$3.6 million, or 66.0%, from \$5.4 million in the six months ended June 30, 2001. As a percentage of revenue, the depreciation and amortization expense was 10.8% and 28.9% for the six months ended June 30, 2002 and 2001, respectively.

The decrease was primarily due to the adoption of FAS 142, which took effect January 1, 2002. The adoption of FAS 142 requires the testing of goodwill for impairment at least annually, eliminating the need for monthly amortization of goodwill. Accordingly, goodwill amortization was not recorded during the first six months of 2002.

Depreciation and amortization expense for each of the operating segments was:

	Six Month Ended June 30, 2002		Six Months Ended June 30, 2001	
Animal Applications	\$	290	\$	4,470
Digital Angel Systems		1,074		670
GPS and Radio Communications		290		243
Physician Call Center and Other		176		
Total	\$	1,830	\$	5,383

### Interest Expense

Interest expense was \$1.9 million and \$0.2 million for the first six months of 2002 and 2001, respectively. Interest expense in the first six months of 2002 includes interest expense of \$1.8 million on the debt owed to IBM Credit Corporation by Applied Digital Solutions, Inc. As discussed in Note 1 to the financial statements, this debt was recognized by AWG due to ADS's default on the loan agreement. On March 27, 2002, ADS restructured its loan agreement with IBM Credit Corporation. The provisions of this restructuring included AWG being released from responsibility to repay this debt. Accordingly, ADS assumed this liability on March 27, 2002.

### Income Taxes

The Company and AWG had effective income tax rates of 0.0% and 2.0% for the first six months of 2002 and 2001, respectively. Differences in the effective income tax rates from the statutory federal income tax rate in 2002 arise primarily from valuation allowances recorded on deferred tax assets resulting from net operating losses and in 2001 arise primarily from valuation allowances recorded on deferred tax assets resulting from net operating losses, non-deductible goodwill amortization associated with acquisitions and state taxes net of federal benefits. The U.S. companies in AWG were included in ADS's consolidated federal income tax return through March 27, 2002. MAS and its subsidiaries file a separate consolidated federal income tax return. After March 27, 2002, AWG's U.S. subsidiaries will file a consolidated federal tax return with MAS.

### LIQUIDITY AND CAPITAL RESOURCES FROM OPERATIONS

As of June 30, 2002, cash and cash equivalents totaled \$0.6 million, unchanged from December 31, 2001. Through March 27, 2002, AWG used a cash management system to apply excess cash on hand against advances due to ADS. Cash used in operating activities totaled \$0.9 million and \$0.8 million in the first six months of 2002 and 2001, respectively. In the first six months of 2002, the use of cash was due to the net loss, after adjusting for non-cash charges, increases in other current assets, and decreases in accounts payable and accrued expenses. Partially offsetting these uses of cash were increases in cash from decreases in accounts receivable. Accounts receivable, net of allowance for doubtful accounts, decreased by \$0.9 million, or 16.8%, to \$4.5 million at June 30, 2002 from \$5.4 million at December 31, 2001. This decrease is primarily due to a slower rate of sales in the six months ended June 30, 2002 as

compared to the rate of sales in 2001.

Inventory levels decreased by \$0.2 million to \$5.6 million at June 30, 2002 from \$5.8 million at December 31, 2001. Inventory acquired from our acquisition of MAS amounted to \$0.1 million.

Investment in affiliates decreased by \$6.5 million, or 96.2%, to \$0.3 million at June 30, 2002 compared to \$6.8 million at December 31, 2001. This decrease was due to transferring our shares representing our 16.5% ownership in MAS to ADS.

Accounts payable decreased by \$341,000 to \$3.4 million at June 30, 2002 from \$3.8 million at December 31, 2001. This was primarily due to the previously mentioned sales change and corresponding change in purchasing.

Accrued expenses and other current liabilities increased by \$2.3 million, or 112.4%, to \$4.3 million at June 30, 2002 from \$2.0 million at December 31, 2001. The increase was due to accrued acquisition costs, and accrued expenses acquired from the acquisition of MAS.

Investing activities used cash of \$0.5 million in the first six months of 2002 and \$0.8 million in the first six months of 2001. During the first six months of 2002 and 2001, \$0.9 million and \$1.1 million, respectively, were spent to acquire property and equipment.

Financing activities provided cash of \$1.4 million in the first six months of 2002 and 2001, respectively. Cash was provided primarily by stock option exercises in 2002 and additional investments by Applied Digital Solutions, Inc. in the six months end June 30, 2002 and 2001.

#### *Debt, Covenant Compliance and Liquidity*

ADS maintains a term and revolving credit agreement with IBM Credit (IBM Credit). Under the credit agreement in effect through March 27, 2002, IBM Credit maintained liens and security interests in the outstanding capital stock of the three AWG subsidiaries and on their assets to collateralize ADS's obligations to IBM Credit under the IBM credit agreement.

ADS generated a significant loss from operations in 2000. As a result, ADS was not in compliance with certain financial covenants of the IBM credit agreement as of December 31, 2000. The IBM credit agreement was amended and restated on October 17, 2000 and further amended on March 30, 2001. In connection with the amendment on March 30, 2001, Digital Angel granted IBM Credit Corporation warrants to acquire 1.2 million shares of Digital Angel's common stock valued at \$0.3 million. As of the March 30, 2001 amendment, ADS was in compliance with the revised covenants.

The IBM credit agreement contains certain quarterly financial covenants, which became more restrictive during 2001. ADS anticipated that it would continue to comply in 2001 with the quarterly financial covenants in the IBM credit agreement. However, ADS was not in compliance with its minimum EBITDA (as defined in the IBM credit agreement) or collateral shortfall covenants at June 30, 2001. ADS was also not in compliance with the minimum EBITDA, Tangible Net Worth and Current Assets to Current Liabilities covenant requirements at September 30, 2001 and it again had a collateral shortfall. As of December 31, 2001, ADS was not in compliance with various financial covenants, including minimum Tangible Net Worth, EBITDA, the ratio of Current Assets to Current Liabilities, and collateral. The IBM credit agreement was amended and restated on July 1, 2001, September 15, 2001, November 15, 2001, December 31, 2001, January 31, 2002 and February 27, 2002. These amendments extended the due dates of principal and interest payments under the credit agreement until April 2, 2002.

At December 31, 2001, ADS's outstanding borrowings under the IBM credit agreement totaled \$82.6 million. At that time, ADS did not have the funds to repay the borrowings under the IBM credit agreement. Accordingly, the \$82.6 million of outstanding borrowings was allocated to AWG effective as of September 30, 2001 and was reflected as a current obligation in the December 31, 2001 combined balance sheet. Interest associated with the borrowings was allocated to AWG for the period from September 30, 2001 to March 27, 2002. Under the terms of the agreement and plan of merger with MAS, the common stock and assets of the three AWG subsidiaries were released from all liens and security interests under the IBM credit agreement, and the shares of the Company's common stock beneficially owned by ADS upon completion of the merger were transferred to the Digital Angel Share Trust as



collateral for the debt. ADS assumed the debt which was treated as a capital contribution resulting in an increase in additional paid-in capital of approximately \$81.4 million.

On March 1, 2002, ADS and Digital Angel Share Trust, a newly created Delaware business trust, and IBM Credit entered into a Third Amended and Restated Term Credit Agreement. The new credit agreement became effective on March 27, 2002, the effective date of the merger between Digital Angel and MAS. Amounts outstanding under the new credit agreement bear interest at an annual rate of 17% and mature on February 28, 2003. No principal or interest payments are due until the maturity date. However, the maturity date will be extended for consecutive one-year periods if ADS repays at least 40% of the original principal amount outstanding plus accrued interest and expenses prior to February 28, 2003, and an additional 40% of the original principal amount outstanding plus accrued interest and expenses prior to February 28, 2004. In any event, all amounts outstanding will be required to be repaid by August 15, 2005. If all amounts are not repaid by February 28, 2003, the unpaid amount will accrue interest at an annual rate of 25%, and if they are not repaid by February 28, 2004, the interest rate increases to 35%.

ADS's new credit agreement contains debt covenants made by ADS relating to its financial position and performance, as well as the Company's financial position and performance. The Company's ability to meet its financial performance requirements and be in compliance throughout 2002 with covenants in the new credit agreement that apply to the Company cannot be assured. If business conditions are other than as anticipated or other unforeseen events or circumstances occur, these may impact the ability of ADS and the Company to remain in compliance with the covenants. In the absence of waiver or amendment to such financial covenants, such noncompliance would constitute an event of default under the new credit agreement, and IBM Credit would be entitled to accelerate the maturity of all amounts ADS owes it. At June 30, 2002 the Company and ADS are out of compliance with certain of the covenants. ADS has received a communication from its lender indicating that pending the expected execution of formal agreements the lender has agreed to waive such noncompliance of the Company and ADS.

On March 27, 2002, upon completion of the merger between Digital Angel and MAS, in satisfaction of a condition to the consent to the merger by IBM Credit, ADS transferred to a Delaware business trust controlled by an advisory board all of the shares of our common stock owned by it and, as a result, the trust has legal title to approximately 77.15% of our common stock. The trust has voting rights with respect to our common stock until ADS's obligations to IBM Credit are repaid in full. The trust may be obligated to liquidate the shares of our common stock owned by it for the benefit of IBM Credit if ADS fails to make payments, or otherwise defaults, under its new credit agreement with IBM Credit.

To date, financing from acquisitions, ADS's advances and revenue generated from operations have been our primary sources of funding. However, we do not anticipate receiving additional advances from ADS and the Company has not been able to generate positive cash flows from operations. We estimate that we will need to obtain approximately \$5 million to \$7 million in additional funding over the next twelve months in order to continue our efforts to implement our business plan. As a result, we will need to obtain additional capital in the near future. As of the date of these statements, we have held discussions with several banks and an asset-based lender regarding a credit facility. Our capital requirements depend on a variety of factors, including, but not limited to, the rate of increase or decrease in our existing business base; the success, timing, and amount of investment required to bring new products on-line; revenue growth or decline; and potential acquisitions. If we are successful in obtaining the credit facility and in raising additional equity capital, of which there can be no assurance, management believes that we will have the financial resources to meet its future business requirements for at least the next twelve months. See **RISK FACTORS** We Will Need Additional Financing.



**FORWARD LOOKING STATEMENTS AND ASSOCIATED RISKS**

**Forward Looking Statements and Associated Risk.**

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

our growth strategies including, without limitation, our ability to deploy new products and services;

anticipated trends in our business and demographics;

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

our future profitability and liquidity; and

regulatory, competitive or other economic influences.

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

**Risk Factors**

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

*As a Result of the Merger and the Transfer of Shares of Our Common Stock to the Digital Angel Share Trust, There is Uncertainty as to the Future Control of Our Company.*

After the merger, in satisfaction of a condition to the consent to the merger of IBM Credit Corporation, ADS transferred to the Digital Angel Share Trust (the Trust ) all shares of our common stock owned by ADS. As a result, the Trust is the beneficial owner of approximately 77% 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 and mergers, acquisitions and other significant corporate transactions. There can be no assurance as to how the Trust will exercise control over our Company.

Upon the request of IBM Credit Corporation, the Trust will be obligated to sell the shares of our common stock owned by ADS for the benefit of IBM Credit Corporation if ADS fails to make payments to IBM Credit Corporation beginning on February 28, 2003 or at such time ADS otherwise defaults under the agreement. Such sales may be in private transactions or in the public market. We can give no assurance as to when or how shares of our common stock will be sold, as to who will purchase such shares, or as to the number of shares that may be sold at any given time. As a result, duration of the Trust's control over us and the identity of any parties which may acquire control of us if and when such sales commence is uncertain.

***Sales of Our Common Stock by the Trust May Cause a Reduction in the Market Value of Our Common Stock.***

If amounts due to IBM Credit Corporation by ADS are not paid when due, including at least \$33 million on February 28, 2003, plus accrued interest and expenses, or if ADS or the Company is otherwise in default under its credit agreement and its obligations are accelerated, IBM Credit Corporation will have the right to require shares of our common stock held in the Trust to be sold to provide funds to satisfy the obligations of ADS. It is unlikely that ADS will have the funds required for payment of such obligations. The sale of a significant amount of shares of our common stock owned by the Trust in a single transaction or in a series of transactions over a short period of time could result in a significant decline in the market value of our common stock.

***We May Face Operational and Strategic Challenges That May Prevent Us From Successfully Integrating The MAS Business.***

The operation of our Company after the merger involves risks related to the integration and management of acquired properties and operations. We may encounter substantial difficulties, costs and delays in integrating the operations of our subsidiaries with our business, including:

perceived adverse changes in business focus;

potential conflicts in marketing or other important relationships;

loss of key employees or customers;

possible inconsistencies in standards, controls, procedures and policies among the companies and the need to implement and harmonize company-wide financial, accounting, information and other systems;

failure to maintain the quality of products and services that such companies have historically provided;

the need to coordinate geographically diverse organizations; and

the diversion of management's attention from the day-to-day operations.

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If we fail to integrate these businesses successfully and/or if we fail to realize the intended benefits of the merger, our financial condition and results of operations could be adversely affected and the market price of our common stock could decline from its current market price.

### ***We May Continue to Incur Losses.***

We incurred a net loss of \$24.0 million for the six month period ended June 30, 2002. We also recorded a net loss of \$17.4 million and \$3.9 million for the years ended December 31, 2001 and 2000, respectively. No assurance can be given as to whether or when we will be profitable. 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 business units. If we become profitable, of which there is no assurance, we may not be able to sustain or increase profitability. If we fail to achieve and maintain profitability within the time frame expected by investors, the market price of our common stock may be adversely affected.

***We Depend on the Protection of Our Proprietary Technology.***

Our success depends partly 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, including those relating to the Digital Angel Systems, will prevent its misappropriation or circumvention. In addition, there can be no assurance that any patent application, when filed, will result in an issued patent, or that our existing patents, or any patents that may be issued in the future, will provide us with significant protection against competitors. Moreover, there can be no assurance that any patents issued to or licensed by us will not be infringed upon or circumvented by others. Litigation to establish the validity of patents, to assert infringement claims against others, and to defend against patent infringement claims can be expensive and time-consuming, even if the outcome is in our favor. We also rely to a lesser extent on unpatented proprietary technology, and no assurance can be given that others will not independently develop substantially equivalent proprietary information, techniques or processes or that we can meaningfully protect our rights to such unpatented proprietary technology.

***Many Factors Can Negatively Affect the Animal Identification Market.***

The electronic animal identification market can be negatively affected by such factors as food safety concerns, consumer perceptions regarding cost and efficacy, international technology standards, national infrastructures, United States Food and Drug Administration (FDA) reviews, United States Federal Communications Commission (FCC) approvals, and slaughterhouse removal of microchips. In addition, certain foreign governmental standards that require specific codes may limit our ability to sell microchips from our current inventory in such countries. Many of the principal customers for fish electronic identification devices are government contractors that rely on funding from the United States government, and this market could be adversely affected by any decline in the availability of government funds. We may be adversely affected by these and other factors affecting the animal identification market, which could have an adverse effect on our financial condition and results of operations.

***We Depend on a Single Supplier For Our Electronic Identification Products.***

We rely largely on a production arrangement with Raytheon Corporation for the manufacture of our syringe-injectable microchips that are used in all of our electronic identification products. The termination, or any significant reduction, by Raytheon of its production of these microchips could have a material adverse effect on our financial condition and results of operations. In addition, Raytheon may not be able to produce sufficient quantities 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 potentially increased demand for our product could have a material adverse effect on our financial condition and results of operations. The Company also has its own microchip production operations located in another contract facility that we intend to use more intensively to meet additional product demand.

***We Depend on Principal Customers.***

For the six months ended June 30, 2002, we had three customers of our Animal Applications segment that accounted for a large portion of our gross revenue. Pacific States Marine, Schering-Plough Pharmaceutical and Biomark, Inc. accounted for approximately 15.0%, 12.4% and 10.8% of our gross Animal Applications revenues, respectively. In addition, 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.

***Significant Competition Exists in the Visual and Electronic Identification Markets.***

The market for visual and electronic identification for companion animals and livestock is highly competitive. We believe that our principal competitors in the visual identification market for livestock are AllFlex and Y-Text, and our principal competitor in the electronic identification market that has developed permanent electronic identification devices for the companion animal market is AllFlex. 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 we do. We cannot ensure that we will compete successfully or that our competitors will not succeed in developing or marketing technologies and products that are more widely accepted than those being developed by us or that would render our products obsolete or noncompetitive. We are not aware of competitors currently marketing products that would compete with the Digital Angel technology. However, we are aware of several potential competitors that have expressed an interest in similar technologies. If such competitors enter the market and compete with the Digital Angel technology, such competition could have a material adverse effect on our financial condition and results of operations.

***We Are Subject to Government Regulation.***

We are subject to federal, state and local regulation in the United States and other countries, and we cannot predict the extent to which we may be affected by future legislative and other regulatory developments concerning our products and markets. We are required to obtain regulatory approval before marketing most of our products. Our products are subject to FCC regulations governing electromagnetic emissions, and our insecticide products have been approved by the United States Environmental Protection Agency (EPA) and are produced in accordance with EPA regulations. Sales of insecticide products are incidental to our primary business and do not represent a material part of our operations. Our products also are subject to compliance with foreign government agency requirements. Our contracts with our distributors generally require the distributor to obtain all necessary regulatory approvals from the governments of the countries in which the distributor sells our products. However, any such approval may be subject to significant delays. Some regulators 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 actions by these regulators could have a material adverse effect on our business, financial condition and results of operations.

***The Digital Angel Systems Segment is a Development Stage Enterprise.***

The Digital Angel Systems segment is in the initial stage of operations and is a development stage enterprise. As a result, it has no operating history upon which to base an evaluation of its current business and future prospects. The first Digital Angel product was introduced in November 2001. Accordingly, this segment has generated no substantial revenues. Moreover, this segment does not currently have any contracts in place that will provide any significant revenue. In addition, because of this segment's lack of an operating history, management has limited insight into trends that may emerge and could materially adversely affect its business. This segment's prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in new and rapidly evolving markets. Stockholders should consider the risks and difficulties the Digital Angel Systems segment may encounter in its new and rapidly evolving market, especially given the segment's lack of operating history. These risks include the Digital Angel Technology segment's ability to:

develop and market the Digital Angel technology by integrating and miniaturizing new technologies

into marketable products and services;

build a customer base;

generate revenues;

compete favorably in a highly competitive market;

access sufficient capital to support growth;

recruit and retain qualified employees;

introduce new products and services; and

build technology and support systems.

***The Digital Angel™ Technology Is Not Proven And We May Not Be Able To Develop Products From This Unproven Technology.***

The Digital Angel™ Systems segment depends on the development, integration, miniaturization and successful marketing of several pieces of advanced technology that have not previously been integrated or used as anticipated by this segment. The Digital Angel™ Systems segment depends upon advanced technology, including: wireless communication, biosensors, motion determination and global positioning system capabilities. Many of these technologies are unproven or relatively new. In addition, these technologies have not been previously integrated or miniaturized into a commercial product. No assurances can be given as to when or if the Digital Angel™ technology will be successfully marketed. Our ability to develop and commercialize products based on our proprietary technology will depend on our ability to develop our products internally on a timely basis or to enter into arrangements with third parties to provide these functions. If we fail to develop and commercialize products successfully, it could have a material adverse effect on our business, financial condition and results of operations.

***The Digital Angel Systems Segment Expects to Incur Future Losses and May Not Achieve Profitability.***



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From the period from January 2000 until June 30, 2002, approximately \$7.3 million has been invested in research and development relating to the Digital Angel™ technology. Our management expects the Digital Angel Systems segment to incur additional development, sales and marketing, and other general expenses. As a result, the Digital Angel Systems segment may incur losses for the foreseeable future and will need to generate revenues to achieve profitability. Even if the segment achieves profitability, it may not be able to sustain it.

***We Depend on a Small Team of Senior Management and We May Have Difficulty Attracting and Retaining Additional Personnel.***

Our future success is highly dependent upon the continued services and performance of senior management and other key personnel. If we lose the services of any member of our senior management team, our overall operations could be 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.

***We Will Need Additional Financing***

Our company, especially the Digital Angel Systems segment, currently relies upon the revenue generated by our Animal Applications segment. We estimate that we will need to obtain approximately \$5.0 million to \$7.0 million in additional funding over the next twelve months in order to continue our efforts to implement our business plan. As of the date of these financial statements, we have held discussions with several banks and an asset-based lender regarding credit agreements.

Our actual capital needs will depend on operating losses, development expenses, working capital needs and other factors. Forecasts of such factors are inherently uncertain, and any variation in those factors from the levels used in current forecasts could result in us needing more capital, or capital earlier, than projected. Capital can be difficult and expensive to obtain, and there can be no assurance that we will be able to obtain additional financing. If this capital is not raised, we may not be able to execute our business plan, may not be able successfully to develop and market the Digital Angel™ technology, and our financial condition and results of operations may be materially adversely affected. To date, we have not been able to obtain this capital. No assurance can be given that we will be able to raise this additional necessary capital.

If funds are not available when required for working capital needs, our ability to carry out our business plan could be adversely affected and we may be required to scale back growth and operations to reflect the extent of available funding. Lending arrangements will probably include limitations on our ability to incur other indebtedness, pay dividends, create liens, sell or purchase shares of capital stock, sell assets or make acquisitions, or enter into other transactions. Such restrictions may adversely affect our ability to finance future operations or capital needs or to engage in other business activities. If additional funds are raised by issuing equity or convertible debt securities, the value of our stockholders investment may be diluted. These securities may have rights, preferences or privileges senior to those of our common stockholders.

Moreover, we may issue additional shares:

to employees;

in connection with acquisitions and corporate alliances; and

to raise capital.

Pursuant to a registration rights agreement, the Digital Angel Share Trust and any of its transferees of our common stock, subject to certain terms and conditions, have the right to require us to register shares of

our common stock beneficially owned by them upon demand and any other time we register stock for sale.

In addition, IBM Credit Corporation currently holds a warrant to acquire 1,163,906 shares of our common stock. The warrant is exercisable for five years beginning on April 5, 2002, or earlier under certain circumstances. Under the warrant, IBM Credit Corporation, subject to certain terms and conditions, has the right to require us to register shares of our common stock subject to the warrant.

#### **IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS**

In July 2001, the FASB issued FAS No. 141 *Business Combinations* and FAS No. 142 *Goodwill and Other Intangible Assets*. FAS 141 requires business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting and broadens the criteria for recording intangible assets separate from goodwill. Recorded goodwill and intangibles will be evaluated against these new criteria and may result in certain intangibles being included in goodwill, or alternatively, amounts initially recorded as goodwill may be separately identified and recognized apart from goodwill. FAS 142 requires the use of a non-amortization approach to account for purchased goodwill and certain intangibles. Under a non-amortization approach, goodwill and certain intangibles will not be amortized into results of operations, but instead would be reviewed for impairment and written down and charged to results of operations only in the periods in which the recorded value of goodwill and certain intangibles is more than its fair value. We adopted the provisions of each statement, which apply to goodwill and certain intangibles acquired prior to June 30, 2001, on January 1, 2002. The adoption of these standards will have the impact of eliminating our amortization of goodwill commencing January 1, 2002. There was no impairment of goodwill upon adoption of FAS 142. Future impairment reviews may result in periodic write-downs.

In August 2001, the FASB issued FAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. This standard supersedes FAS 121, *Accounting for the Impairment of Long-Lived Assets to Be Disposed Of*, and provides a single accounting model for long-lived assets to be disposed of. This standard significantly changes the criteria that would have to be met to classify an asset as held-for-sale. This distinction is important because assets to be disposed of are stated at the lower of their fair values or carrying amounts and depreciation is no longer recognized. The new rules will also supercede the provisions of APB Opinion 30, *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, with regard to reporting the effects of a disposal of a segment of a business and will require expected future operating losses from Discontinued Operations to be displayed in Discontinued Operations in the period in which the losses are incurred, rather than as of the measurement date as presently required by APB 30. This statement is effective for fiscal years beginning after December 15, 2001. We adopted this statement on January 1, 2002. The adoption of FAS 144 did not have a material impact on our operations or financial position.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

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

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

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

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings.**



**Silva, et al. v. Customized Services Administrators, Incorporated, dba CSA Travel Protection, Inc. et al., No. CV798528 (Santa Clara County Superior Court)**

On May 29, 2001, Janet Silva, individually and as Guardian *ad Litem* for Jonathan Silva, a minor, and the Estate of Clarence William Silva, Jr. (collectively, Plaintiffs ) filed suit against Customized Services Administrators, Incorporated ( CSA ), Pricesmart, Inc. ( Pricesmart ), Commercial Union Insurance Company ( Commercial Union ), CGU Insurance Group, and the Company (collectively the Defendants ) in the Superior Court of the State of California in and for the County of Santa Clara. The allegations of the complaint arise from a vacation guarantee insurance policy (the Insurance Contract ) allegedly purchased by Plaintiffs from Defendants on March 6, 2000. The complaint alleges, among other things, that Defendants breached the Insurance Contract, defrauded Plaintiffs, acted in bad faith, engaged in deceptive and unlawful business practices, resulting in the wrongful death of Clarence William Silva, Jr. (the Deceased ) and the intentional infliction of emotional distress on Plaintiffs. The complaint seeks the cost of funeral and burial expenses of the Deceased and amounts constituting the loss of financial support of the Deceased, general damages, attorney s fees and costs, and exemplary damages.

CSA has filed a cross-claim against the Company alleging that the Company should be held liable for any liability that CSA may have to Plaintiffs. The Company has denied the allegations of the complaint and the CSA cross-claim and is vigorously contesting all aspects of this action.

We and our subsidiaries are party to various other legal actions as either a plaintiff or a defendant. In our opinion, as of the date of this Form 10-Q, these proceedings will not have a material adverse effect on our financial position, our cash flows or our overall trends in results. The estimate of the potential impact on our financial position, our overall results of operations or our cash flows for these proceedings could change in the future.



**Item 2. Changes in Securities and Use of Proceeds.**



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### Recent Sales of Unregistered Securities

The following table lists all unregistered securities sold by the Company between January 1, 2002 and June 30, 2002. These shares were issued in acquisition transactions to the persons or entities indicated. These shares were issued without registration in reliance upon the exemption provided by Section 4(2) of the Securities Act of 1933, as amended, and Rule 506 of Regulation D promulgated thereunder.

Name/Entity/Nature	Number of Persons	Note	Issued For	Number of Common Shares
Applied Digital Solutions, Inc.	1	1	Acquisition	18,750,000
Richard J. Sullivan	1	2	Acquisition	937,500
Garrett A. Sullivan	1	2	Acquisition	468,750
Evan C. McKeown	1	2	Acquisition	30,468
<b>Total</b>				<b>20,186,718</b>

1. Represents shares issued in connection with the merger of Applied Digital Solutions, Inc.'s Advanced Wireless Group in exchange for shares of Digital Angel Corporation, which was a subsidiary of Applied Digital Solutions, Inc. No cash was involved in the transaction.

2. Represents shares issued to minority shareholders of Applied Digital Solutions, Inc.'s Advanced Wireless Group to effect the merger transaction. No cash was involved in the transaction.

### **Item 3. Defaults Upon Senior Securities.**

Not applicable.

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

At a special meeting of the stockholders of MAS held on March 18, 2002, the following matters were submitted to the stockholders for a vote:

The approval of an Agreement and Plan of Merger, dated as of November 1, 2002, pursuant to which Digital Angel Acquisition Co., a Delaware corporation and a wholly-owned subsidiary of MAS, would merge with and into Digital Angel Corporation, a Delaware corporation and a wholly-owned subsidiary of Applied Digital Systems, Inc. (3,396,247 shares voted for, 33,935 shares voted against, 14,120 shares abstained from voting, and no broker non-votes);

Amending MAS's Certificate of Incorporation to change its name to Digital Angel Corporation and to authorize 85,000,000 additional shares of common stock, par value \$0.005 per share (4,243,419 shares voted for, 40,514 shares voted against, 10,369 shares abstained from voting, and no broker non-votes); and

To transact such other business as may properly come before the meeting or any adjournment or postponement of the special meeting (4,246,403 shares voted for, 6,635 shares voted against, 20,864 shares abstained from voting, and no broker non-votes).

The meeting did not involve the election of directors.

**Item 5. Other Information.**

None

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

**(a) Exhibits**

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

- 2.1 Agreement and Plan of Merger by and between Applied Digital Solutions, Inc., Digital Angel Corporation, Medical Advisory Systems, Inc. and Acquisition Subsidiary, Inc. dated as of November 1, 2001 (incorporated herein by reference to Appendix A to final Proxy Statement filed by MAS with the Commission on February 14, 2002).
- 2.2 First Amendment to Agreement and Plan of Merger by and among Applied Digital Solutions, Inc., Digital Angel Corporation, Medical Advisory Systems, Inc. and Digital Angel Acquisition Co. dated as of March 26, 2002 (incorporated herein by reference to Exhibit 2.2 to Current Report on Form 8-K filed by MAS with the Commission on April 11, 2002).
- 3.1 Amended and Restated Certificate of Incorporation of MAS (incorporated herein by reference to MAS's Registration Statement on Form S-18 (No. 2-98314) filed by MAS with the Commission on June 7, 1985 and MAS's Annual Report on Form 10-KSB filed by MAS with the Commission on March 28, 1990).
- 3.2 Bylaws of MAS (incorporated herein by reference to MAS's Registration Statement on Form S-18 (No. 2-98314) filed by MAS with the Commission on June 7, 1985).
- The following exhibits are filed with this Quarterly Report on Form 10-Q:
- 3.3 Amendment to Certificate of Incorporation of MAS filed with the Delaware Secretary of State on March 27, 2002.
- 3.4 Amendment to Certificate of Incorporation of Digital Angel Corporation filed with the Delaware Secretary of State on May 14, 2002.
- 3.5 Amendment to Bylaws of MAS dated March 27, 2002.
- 10.1 Employment Agreement dated as of March 8, 2002 by and between Randolph K. Geissler and the Company

10.2 Employment Agreement dated as of April 1, 2002 by and between James P. Santelli and the Company

10.3 Amendment to Employment Agreement dated as of March 8, 2002 by and between Randolph K. Geissler and the Company

(b) **Reports on Form 8-K**





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The following are the Current Reports on Form 8-K filed by MAS or the Company during the quarter ended June 30, 2002 or during the period from June 30, 2002 to the date of this Quarterly Report on Form 10-Q/A:





- (i) On April 11, 2002, we filed a Current Report on Form 8-K which disclosed a change in control, an acquisition of assets, information regarding a potential change in certifying accountants, and a change in fiscal year.
  
- (ii) On April 18, 2002, we filed a Current Report on Form 8-K which disclosed changes in our Board of Directors and Officers.
  
- (iii) On April 25, 2002, we filed a Current Report on Form 8-K which disclosed a change in certifying accountants.
  
- (iv) On May 1, 2002, we filed a Current Report on Form 8-K/A which disclosed a change in certifying accountants, and a change in fiscal year.
  
- (v) On May 20, 2002, we filed a Current Report on Form 8-K which disclosed a change in certifying accountants.
  
- (vi) On May 20, 2002, we filed a Current Report on Form 8-K/A which disclosed required financial statements and pro forma financial information.
  
- (vii) On May 28, 2002, we filed a Current Report on Form 8-K which disclosed a change in certifying accountants.
  
- (viii) On June 6, 2002, we filed a Current Report on Form 8-K/A which disclosed a change in certifying accountants.
  
- (ix) On July 23, 2002, we filed a Current Report on Form 8-K/A which disclosed financial statements and pro forma financial information.

**SIGNATURE**

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

DIGITAL ANGEL CORPORATION  
(Registrant)

Dated: August 14, 2002

By: /S/ JAMES P. SANTELLI

James P. Santelli  
Vice President - Finance, Chief  
Financial Officer

**INDEX TO EXHIBITS**

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

3.3 Amendment to Certificate of Incorporation of MAS filed with the Delaware Secretary of State on March 27, 2002.\*

3.4 Amendment to Certificate of Incorporation of Digital Angel Corporation filed with the Delaware Secretary of State on May 14, 2002.\*

3.5 Amendment to Bylaws of MAS dated March 27, 2002.\*

10.1 Employment Agreement dated as of April 1, 2002 by and between Randolph K. Geissler and the Company.\*

10.2 Employment Agreement dated as of April 1, 2002 by and between James P. Santelli and the Company.\*

10.3 Amendment to Employment Agreement dated as of March 8, 2002 by and between Randolph K. Geissler and the Company.\*

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\* Filed previously.

**Certification Pursuant to 18 U.S.C. Section 1350,**

**as Adopted Pursuant to**

**Section 906 of the Sarbanes-Oxley Act of 2002**

In connection with the Quarterly Report on Form 10-Q of Digital Angel Corporation (the Company) for the period ended June 30, 2002, as filed with the Securities and Exchange Commission on August 1, 2002 (the Periodic Report), I, Randolph K. Geissler, Chief Executive Officer of the Company, hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Periodic Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)); and
2. The information contained in the Periodic Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: August 14, 2002

/s/ RANDOLPH K. GEISSLER  
Randolph K. Geissler  
Chief Executive Officer  
Digital Angel Corporation

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**Certification Pursuant to 18 U.S.C. Section 1350,**

**as Adopted Pursuant to**

**Section 906 of the Sarbanes-Oxley Act of 2002**

In connection with the Quarterly Report on Form 10-Q of Digital Angel Corporation (the Company) for the period ended June 30, 2002, as filed with the Securities and Exchange Commission on August 14, 2002 (the Periodic Report), I, James P. Santelli, Chief Financial Officer of the Company, hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Periodic Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)); and
2. The information contained in the Periodic Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: August 14, 2002

/s/ JAMES P. SANTELLI  
James P. Santelli  
Chief Financial Officer  
Digital Angel Corporation