China Natural Gas, Inc.
Form 10-Q/A
October 01, 2010

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

FORM 10-Q/A
(Amendment No. 2)

(Mark One)

x QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2010

¨ TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from to

000-31539
(Commission file number)

CHINA NATURAL GAS, INC.
(Exact name of registrant as specified in its charter)

Delaware	98-0231607
(State or other jurisdiction of incorporation or organization)	(IRS Employer of Identification No.)

19th Floor, Building B, Van Metropolis
Tang Yan Road, Hi-Tech Zone
Xi'an, 710065, Shaanxi Province, China
(Address of principal executive offices)

(zip code)

86-29-8832-7391
(registrant 's telephone number, including area code)

N/A
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 x No ¨

In dicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨	Smaller reporting company ¨
(Do not check if a smaller reporting company)	

Number of shares of Common Stock outstanding as of May 6, 2010: 21,183,904

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

EXLANATORY NOTE

This Amendment No. 2 on Form 10-Q/A (the “Amended Filing”) amends Amendment No. 1 to the Quarterly Report of China Natural Gas, Inc. (the “Company”) (as amended, the "Amended 10-Q"), which in turn had amended the Quarterly Report on Form 10-Q for the quarter ended March 31, 2010, originally filed on May 7, 2010 (the “Original Filing”).

As previously disclosed in the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2010, in February 2010, the Company obtained a bank loan in the amount of $17.7 million (the "Loan") and, in connection with the Loan, Xi'an Xilan Natural Gas Co. Ltd., the Company's variable interest entity, pledged its equipment and vehicles located within China to secure the Loan (the "Pledge") and guaranteed the repayment of the Loan (the "Guarantee").

By August 8, 2010, the Company’s former outside counsel determined that the Pledge was prohibited by the indenture (the "Indenture") for the Company's 5% guaranteed senior note issued to Abax Lotus Ltd. ("Abax") dated January 29, 2008 (the "Senior Notes"). As a result, the Company believed that Abax had the right to declare a default under the Indenture and could thereafter accelerate the Senior Notes, which would cause a simultaneous default under the warrant agreement governing the Company's warrants issued in connection with the Senior Notes, thereby entitling the warrant holders to require the Company to redeem their warrants. In view of the potential default under the Indenture and warrant agreement, the Board, in consultation with management and the Audit Committee, determined that the Company was required to restate its annual financial statements for the year ended December 31, 2009 and the quarter ended March 31, 2010 to reclassify from long term liabilities to short term liabilities the Senior Notes and the fair value of the redeemable warrants (the “Reclassification”).

Therefore, the Company filed a Current Report on Form 8-K on August 19, 2010 to disclose that its financial statements contained in its Annual Report on Form 10-K for the year ended December 31, 2009 (the "Annual Report") and the Original Filing should not be relied upon, and, on August 20, 2010, the Company filed:

- Amendment No. 1 to the Annual Report (as amended, the “Amended 10-K”) to (i) restate the financial statements contained therein to make the Reclassification and disclose as subsequent events the Loan, the Pledge and the Guarantee as well as the initial determination that the Pledge was not permitted under the Indenture, (ii) make other amendments to the Annual Report to give effect to the foregoing and (iii) amend Part II, Item 9A, Controls and Procedures of the Annual Report; and

- the Amended 10-Q to (i) amend Part II, Item 4, Other Information, of the Original Filing to disclose the Loan, the Pledge and the Guarantee as well as the initial determination that the Pledge was not permitted under the Indenture, (ii) restate the financial statements contained therein to make the Reclassification, record the Loan as a long term liability and record an increase in restricted cash as a result of obtaining the proceeds of the Loan; (iii) make other amendments to the Original Filing to give effect to the foregoing; (iv) amend Part I, Item 4, Controls and Procedures, of the Original Filing; and (v) file the Loan, the Pledge and the Guarantee as exhibits to the Amended 10-Q.

Also, in its Quarterly Report on Form 10-Q for the quarter ended June 30, 2010, the Company (i) recorded the Senior Notes and warrants, which were described as redeemable, as current liabilities in the financial statements contained therein; (ii) made other disclosures in such quarterly report to give effect to the foregoing; and (iii) disclosed in Part II, Item 4, Other Information, of such quarterly report the Loan, the Pledge and the Guarantee as well as the initial determination that the Pledge was not permitted under the Indenture.

Subsequent to restating its financial statements and filing the Amended 10-K and Amended 10-Q, management of the Company internally revisited the analysis of whether the Pledge was indeed prohibited by the Indenture and determined that it was not. In late August 2010, the Company engaged the law firm DLA Piper, which had not previously advised the Company or management on these matters, to review the Company's analysis, and DLA Piper subsequently confirmed the Company's analysis. At the request of the Company's independent auditors, the Company engaged another law firm with no prior relationship to the Company to review the Company's analysis, and that law firm subsequently confirmed the Company's analysis. The Company engaged DLA Piper as its regular outside counsel for SEC reporting and other public company matters in early September 2010. The Board of Directors of the Company, in consultation with management and the Audit Committee, determined on September 15, 2010, that none the Loan, the Pledge or the Guarantee, individually or together, were prohibited by the Indenture.

The purpose of this Amended Filing is to reverse all disclosure in the Amended 10-Q related to the Reclassification and to further amend Part I, Item 4, Controls and Procedures. With respect to the former, the amendments herein include: (i) reversal of the reclassification of the Company’s Senior Notes payable and the fair value of the redeemable warrants from current liabilities back to long term liabilities, (ii) removal of the statements indicating that the Pledge was not permitted under the Indenture, and (iii) other amendments to the Amended 10-Q to give effect to the foregoing. The Company is not restating the Amended 10-Q’s restatement of long term liabilities and restricted cash on the Company’s consolidated balance sheet as of March 31, 2010 or the restatement of financing activities in consolidated statements of cash flow for the three months ended March 31, 2010, which restatements were made to record the Loan as a long term liability and record an increase in restricted cash as a result of obtaining the proceeds of the Loan, and are described in the Amended 10-Q.

In accordance with Rule 12b-15 under the Exchange Act, each item of the Original Filing, as amended by the Amended 10-Q, that is amended by this Amended Filing is also restated in its entirety, and this Amended Filing is accompanied by currently dated certifications on Exhibits 31.1, 31.2, 32.1 and 32.2 by the Company’s Chief Executive Officer and Chief Financial Officer. Except as described above, this Amended Filing does not amend, update, or change any items, financial statements, or other disclosures in the Original Filing, as amended by the Amended 10-Q, and does not reflect events occurring after the filing of the Original Filing, including as to any exhibits to the Original Filing, as amended by the Amended 10-Q, affected by subsequent events. Information not affected by the changes described above is unchanged and reflects the disclosures made at the time of the Original Filing, as amended by the Amended 10-Q. Accordingly, this Amended Filing should be read in conjunction with the Original Filing and our other SEC filings subsequent to the filing of the Original Filing, including the Amended 10-Q and any other amendments to those filings. Capitalized terms not defined in the Amended Filing are as defined by the Original Filing.

China Natural Gas, Inc.
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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

CHINA NATURAL GAS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
AS OF MARCH 31, 2010 AND DECEMBER 31, 2009

	March 31, 2010 (Unaudited) (As Restated – See Note 2)	December, 31 2009
ASSETS		
CURRENT ASSETS:		
Cash & cash equivalents	$ 30,172,391	$ 48,177,794
Restricted cash	13,203,000	-
Accounts receivable, net of allowance for doubtful accounts of $196,138 and $163,280 as of March 31, 2010 and December 31, 2009, respectively.	1,514,070	1,289,116
Other receivables	491,020	709,741
Other receivable - employee advances	190,045	338,689
Inventories	874,678	841,837
Advances to suppliers	1,302,568	596,868
Prepaid expense and other current assets	1,546,556	1,076,915
Loans receivable	14,259,240	293,400
Total current assets	63,553,568	53,324,360
INVESTMENT IN UNCONSOLIDATED JOINT VENTURES	1,467,000	1,467,000
PROPERTY AND EQUIPMENT, NET	75,603,216	72,713,012
CONSTRUCTION IN PROGRESS	57,102,317	52,918,236
DEFERRED FINANCING COSTS	1,234,540	1,336,998
OTHER ASSETS	16,937,089	15,854,910
TOTAL ASSETS	$ 215,897,730	$ 197,614,516
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued liabilities	$ 1,970,228	$ 2,081,261
Other payables	85,082	80,788
Unearned revenue	2,199,805	1,813,641
Accrued interest	200,509	786,052
Taxes payable	2,888,511	1,901,577
Total current liabilities	7,344,135	6,663,319
LONG TERM LIABILITIES:		
Notes payable, net of discount $11,946,508 and $12,707,713 as of March 31, 2010 and December 31, 2009, respectively	28,053,492	27,292,287

Derivative liabilities - warrants	19,152,570	19,545,638
Long term debt	13,203,000	
Total long term liabilities	60,409,062	46,837,925
COMMITMENTS AND CONTINGENCIES		

7,618

7,918

16,385

15,021

Cost of services sold

276

302

555

607

Gross profit

5,062

6,640

11,838

12,635

Selling, general and administrative expenses

6,003

6,118

12,235

11,446

Research and development expenses

1,151

1,119

2,341

2,205

Operating loss

(2,092

)

(597

)

(2,738

)

(1,016

)

Interest income

82

83

175

159

Interest expense

(111

)

(79

)

(206

)

(180

)

Other income

28

7

45

33

Loss before taxes and minority interest

(2,093

)

(586

)

(2,724

)

(1,004

)

Income tax (provision) benefit

(12

)

(86

)

72

(86

)

Minority interest share of income

(19

)

(219

)

(58

)

(294

)

Net loss

$

(2,124

)

$

(891

)

(2,710

)

$

(1,384

)

Net loss per common share-basic and diluted

$

(0.05

)

$

(0.02

)

$

(0.06

)

$

(0.03

)

Weighted average number of common shares outstanding - basic and diluted

44,286

43,917

44,097

43,792

See the accompanying notes to condensed consolidated financial statements.

DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
For The Six Months Ended June 30, 2006
(In Thousands)
(Unaudited)

	Preferred Stock Number	Preferred Stock Amount	Common Stock Number	Common Stock Amount	Additional Paid-In Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive (Loss) Income	Total Stockholders Equity
Balance-December 31, 2005		$	44,225	$ 223	$ 212,083	$ (137,950)	$ (1,580)	$ (330)	$ 72,446
Net loss						(2,710)			(2,710)
Comprehensive (loss) income-foreign currency translation								205	205
Total comprehensive loss						(2,710)		205	(2,505)
Issuance of common stock as consideration for DSD acquisition			282	1	999				1,000
Exercise of stock options			320	1	562				563
Restricted stock issued			67						
Amortization of deferred compensation					$ 162				162
Stock compensation expense					126				126
Balance-June 30, 2006		$	44,894	$ 225	$ 213,932	$ (140,660)	$ (1,580)	$ (125)	$ 71,792

See the accompanying notes to condensed consolidated financial statements.

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DIGITAL ANGEL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	For the Six Months Ended June 30, 2006	2005
Cash Flows From Operating Activities		
Net loss	**$ (2,710)**	$ (1,384)
Adjustments to reconcile net loss to net cash used in operating activities:		
Equity-based compensation	**288**	145
Depreciation and amortization	**956**	1,179
Minority interest	**58**	294
Loss on disposal of equipment	**4**	5
Change in assets and liabilities:		
Decrease in restricted cash	**195**	327
Decrease in accounts receivable	**3,399**	1,035
Increase in due from VeriChip Corporation	**(45)**	(63)
Increase in inventories	**(1,731)**	(1,035)
Increase in other current assets	**(578)**	(167)
Increase in due to ADS		46
Decrease in accounts payable, accrued expenses and deferred revenue	**(1,663)**	(1,837)
Net cash (used in) provided by discontinued operations	**(16)**	77
Net Cash Used In Operating Activities	**(1,843)**	(1,378)
Cash Flows From Investing Activities		
Increase (decrease) in other assets	**87**	(204)
Payments for property and equipment	**(720)**	(675)
Payments for acquisition costs	**(1,000)**	(893)
Net Cash Used in Investing Activities	**(1,633)**	(1,772)
Cash Flows From Financing Activities		
Amounts borrowed on line of credit	**2,427**	1,969
Amounts paid on line of credit	**(2,004)**	(2,157)
Payments on notes payable and long-term debt	**(355)**	(367)
Exercise of stock options and warrants	**563**	358
Payment of dividend to minority shareholder	**(140)**	
Purchase of treasury stock		(1,537)
Net Cash Provided by (Used in) Financing Activities	**491**	(1,734)
Effect of Exchange Rate Changes on Cash	**27**	54
Net Decrease In Cash	**(2,958)**	(4,830)
Cash - Beginning Of Period	**10,049**	17,492
Cash - End Of Period	**$ 7,091**	$ 12,662

See the accompanying notes to condensed consolidated financial statements.

DIGITAL ANGEL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands)
(Unaudited)

1. The Company and Basis of Presentation

Digital Angel Corporation and its subsidiaries (the Company) develop and deploy sensor and communications technologies that enable rapid and accurate identification, location tracking, and condition monitoring of high-value assets. The Company operates in two segments: (1) Animal Applications and (2) GPS and Radio Communications.

Animal Applications develops, manufactures, and markets a broad line of electronic and visual identification devices for the companion animal, livestock, fish and wildlife markets worldwide. The Animal Applications segment consists of our operations located in Minnesota, DSD Holdings A/S and its wholly-owned subsidiaries, located in Denmark and Poland, and Digital Angel International, Inc. and its subsidiaries located in Argentina and Brazil. The positive identification and tracking of cattle and hogs are crucial for asset management and for disease control and food safety. In addition to the visual ear tags which have been sold by the Company since the late 1940 s, Animal Applications utilizes radio frequency transmission (RFID) technologies in its electronic ear tags and implantable microchips.

GPS and Radio Communications consists of the design, manufacture and support of global positioning system (GPS) enabled equipment. The GPS and Radio Communications segment consists of the Company s subsidiaries Signature Industries Limited (90.9% owned), located in the United Kingdom and OuterLink Corporation, located in Massachusetts. Applications for the segment s products include location tracking and message monitoring of vehicles, aircraft and people in remote locations through systems that integrate geosynchronous satellite communications and GPS enabled equipment and intelligent communications products and services for telemetry, mobile data and radio communications applications serving commercial and military markets. Technology development in this segment includes the integration and miniaturization into marketable products of two technologies: wireless communications and position location technology (including GPS and other systems).

On February 28, 2005, the Company acquired Denmark-based DSD Holdings A/S and its wholly-owned subsidiaries Daploma International A/S and Digitag A/S, including Daploma International A/S s 70%-owned subsidiary, Daploma Polska. DSD Holdings A/S became a wholly-owned subsidiary of Digital Angel Corporation. DSD Holdings A/S produces visual and RFID tags. DSD Holdings A/S s operations are included from the date of acquisition.

As of June 30, 2006, Applied Digital Solutions, Inc. (Applied Digital or ADS) owned 24,573,788 shares or approximately 55.2% of the Company s common stock.

The accompanying unaudited condensed consolidated financial statements of the Company as of June 30, 2006 and for the three and six month periods ended June 30, 2006 and 2005 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, 2006 and 2005 are not necessarily indicative of the results that may be expected for the entire year. These statements should be read in conjunction with the Digital Angel Corporation s audited consolidated financial statements and related notes thereto for the year ended December 31, 2005 which are included in the Company s Annual Report on Form 10-K.

Certain items in the condensed consolidated financial statements for the 2005 periods have been reclassified for comparative purposes.

2. Principles of Consolidation

The June 30, 2006 and 2005 condensed consolidated financial statements include the accounts of the Company and its wholly-owned and majority-owned subsidiaries (DSD Holdings A/S operations are included from the date of acquisition, February 28, 2005). All significant intercompany accounts and transactions have been eliminated in consolidation.

3. Revenue Recognition

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

The Company s subsidiary, OuterLink Corporation, earns revenue from messaging services and from the sale of related products to customers (communication terminals and software). OuterLink Corporation s messaging service is only available through use of its products and such products have no alternative use. Accordingly, service revenue is recognized as the services are performed. OuterLink Corporation s product revenue, for which title and risk of loss transfers to the customer on shipment, is deferred upon shipment and is recognized ratably over the estimated customer service period of 42 months in the six month period ended June 30, 2006 and 30 months in the six month period ended June 30, 2005.

The Company records a liability for product warranties at the time it is probable that a warranty liability has been incurred and the amount of loss can be reasonably estimated. The Company s warranty liability was $34,000 as of June 30, 2006. Following is a reconciliation of the Company s product warranties (in thousands):

	Amount of Liability
Balance as of December 31, 2005	$ 34
Accruals for warranties issued during the period	
Accruals related to pre-existing warranties (including changes in estimates)	
Settlements made (in cash or in kind) during the period	
Balance as of June 30, 2006	$ 34

4. Stock-Based Compensation

On January 1, 2006 we adopted SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R). SFAS 123R replaced SFAS No. 123 and supercedes APB Opinion No. 25. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS 123 are no longer an alternative to financial statement recognition. We adopted SFAS 123R using the modified prospective method which requires the application of the accounting standard as of January 1, 2006. Our consolidated financial statements as of and for the three and six month periods ended June 30, 2006 reflect the impact of adopting SFAS 123R. In accordance with the modified prospective method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123R. See Note 8, Stock Options and Restricted Stock for further details.

5. Inventory (in thousands)

	June 30, 2006	December 31, 2005
Raw materials	**$ 3,463**	$ 3,198
Work in process	**262**	122
Finished goods	**7,755**	7,006
	11,480	10,326
Allowance for excess and obsolescence	**(878)**	(1,669)
Net inventory	**$ 10,602**	$ 8,657

6. Stock Exchange with Applied Digital Solutions, Inc.

On February 25, 2005, the Company entered into a Stock Purchase Agreement with Applied Digital. The purpose of the stock exchange was to use the shares as partial consideration for the acquisition of DSD Holdings A/S and its wholly-owned subsidiaries, Daploma International A/S and Digitag A/S, including Daploma International A/S s 70%-owned subsidiary, Daploma Polska, as described more fully in Note 10. The Company and Applied Digital entered into the share exchange because of the selling shareholders desire, at the time the transaction was negotiated, to receive their consideration in Applied Digital common stock as opposed to the Company s common stock. In addition, the stock purchase represented a strategic investment by Applied Digital whereby Applied Digital could increase its ownership interest in the Company. Pursuant to the agreement, the Company issued 644,140 shares of its common stock to Applied Digital. The Company received 684,543 shares of Applied Digital common stock as consideration. The exchange ratio of shares was based upon the average of the volume-weighted-average price of the Company s common stock and Applied Digital s common stock for the ten trading days immediately preceding, and not including, the transaction closing date which was $5.434 for the Company s common stock and $5.113 for Applied Digital s common stock. The value of the stock exchanged was $3.5 million.

7. Discontinued Operations

In April 2004, our Board of Directors approved a plan to sell our Medical Systems segment. The Medical Systems segment represented the business operations of Medical Advisory Systems, Inc, which we acquired on March 27, 2002. The Medical Systems segment was one of our reporting units in accordance with SFAS 131, Disclosures about Segments of an Enterprise and Related Information . Accordingly, the financial condition, results of operations and cash flows of our Medical Systems segment have been reported as discontinued operations for all periods presented. For the six months ended June 30, 2006 and 2005, there were no losses attributable to the Medical Systems segment. The Company does not anticipate the Medical Systems division incurring additional losses in the future. However, in accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets , any additional operating losses or changes in the values of assets or liabilities will be reflected in the financial condition and results of operations as incurred.

The net liabilities of discontinued operations as of June 30, 2006 and December 31, 2005, were comprised of accrued expenses aggregating $68,000 and $84,000, respectively.

8. Stock Options and Restricted Stock

Stock Option Plans

As of June 30, 2006 the Company maintains the Amended and Restated Digital Angel Corporation Transition Stock Option Plan (DAC Stock Option Plan), which is described below, and has outstanding stock options which were issued pursuant to another plan which was terminated on February 23, 2006. On January 1, 2006 we adopted SFAS 123R, using the modified prospective transition method. Accordingly, during the six month period ended June 30, 2006 we recorded stock-based compensation expense for awards granted in 2006 and awards granted prior to, but not yet vested as of January 1, 2006, as if the fair value method required for pro forma disclosure under SFAS 123 were in effect for expense recognition purposes. Upon adoption of SFAS 123R we elected to continue using the Black-Scholes option pricing and we have recognized compensation expense using a straight-line amortization method. During the three and six months ended June 30, 2006 we recorded $0.1 million and $0.3 million, respectively, (this amount includes compensation for options granted to non-employees and for restricted stock grants) in stock-based employee compensation expense.

As of June 30, 2006, the DAC Stock Option Plan, which is stockholder-approved, has 18,195,312 shares of common stock reserved for issuance, of which 17,701,516 shares have been issued and 493,796 remain available for issuance. As of June 30, 2006 awards consisting of options to purchase 9,703,196 shares were outstanding under the DAC Stock Option Plan and awards consisting of options to purchase 476,820 shares were outstanding under the Company s terminated stock option plan. Additionally, restricted stock awards for 154,230 shares of common stock have been granted under the DAC Stock Option Plan. Option awards are generally granted with exercise prices between market price and 110% of the market price of the Company s stock at the date of grant; option awards generally vest over 3 to 9 years and have 10-year contractual terms. Certain option and share awards provide for accelerated vesting if there is a change in control (as defined in the DAC Stock Option Plan).

Stock Option Activity

The fair value of each option award is estimated on the date of grant using a Black-Scholes valuation model. The following assumptions were used for options granted in the six month periods ended June 30, 2006 and 2005.

	For the Six Months Ended June 30, 2006		2005	
Risk-free interest rate	4.89	%	3.81	%
Expected life (in years)	4-10		5	
Dividend yield	0.0	%	0.0	%
Expected volatility	87.19	%	106.09-111.95	%
Weighted-average volatility	87.19	%	108.71	%

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

A summary of the Company s stock option activity as of June 30, 2006, and changes during the six months then ended is presented below (in thousands, except per share amounts):

	Stock Options	Weighted Average Exercise Price	Weighted Average Contractual Term	Aggregate Intrinsic Value	
Outstanding at January 1, 2006	9,955	$ 3.94			
Granted	2,100	3.26			
Exercised	320	1.75			
Forfeited or Expired	55	4.49			
Outstanding at June 30, 2006	11,680	$ 3.87	8.07	$ 2,069	*
Exercisable at June 30, 2006	9,413	$ 4.02	7.62	$ 2,049	*

* The intrinsic value of a stock option is the amount by which the market value of the underlying stock exceeds the exercise price of the option. The market value of our stock was $3.11 at June 30, 2006.

The weighted-average grant-date fair value of options granted during the six-month periods ended June 30, 2006 and 2005 were $2.73 and $5.02 respectively. The total intrinsic value of options exercised during the six-month periods ended June 30, 2006 and 2005 was $644,000 and $72,000, respectively.

A summary of the status of the Company s nonvested stock options as of June 30, 2006, and changes during the six month period ended June 30, 2006, is presented below (in thousands, except per share amounts):

	Stock Options	Weighted Average Grant-Date Fair Value
Nonvested at January 1, 2006	217	$ 2.42
Granted	2,100	2.73
Vested	(50)	2.36
Nonvested at June 30, 2006	2,267	$ 2.70

As of June 30, 2006, there was $4.9 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the DAC Stock Option Plan. That cost is expected to be recognized over a weighted-average period of 6.6 years. The total fair value of shares vested during the six months ended June 30, 2006, was $118,000.

Cash received from option exercise under all share-based payment arrangements for the six-month periods ended June 30, 2006 and 2005, was $0.6 million and $55,000, respectively.

On January 13, 2004, the Company granted its Chief Executive Officer (CEO) a ten-year option to purchase 1,000,000 shares of the Company s common stock at $3.92 per share. This option was granted outside the Company s stock plans and approved by the Company s shareholders on May 6, 2004. The option became exercisable on December 30, 2005. As of June 30, 2006 the option remains outstanding.

On February 18, 2004, the Company granted its Chairman of the Board of Directors a ten-year option to purchase 500,000 shares of the Company s common stock at $3.43 per share. This option was granted outside the Company s stock plans and approved by the Company s shareholders on May 6, 2004. The option became exercisable on February 18, 2005. As of June 30, 2006 the option remains outstanding.

Restricted Stock

In March 2005, the Company granted its Chairman of the Board 100,000 shares of the Company s restricted stock. The restricted stock vested 50% on March 7, 2006 and will vest 50% on March 7, 2007. The Company determined the value of the stock to be $506,000 based on the closing price of the Company s stock on the date of grant. The value of the restricted stock has been recorded as deferred compensation and is being amortized to compensation expense over the two year vesting period. In the six month period June 30, 2006, $125,000 was recognized as compensation expense in the Company s results of operations.

In February 2005, the Company granted an employee 54,230 shares of the Company s restricted stock. The restricted stock vested 30% on February 25, 2006, will vest 30% on February 25, 2007 and 40% on February 25, 2008. The Company determined the value of the stock to be $250,000 based on the closing price of the Company s stock on the date of grant. The value of the restricted stock has been recorded as deferred compensation and is being amortized to compensation expense over the vesting period. In the six month period June 30, 2006 $37,000 was recognized as compensation expense in the Company s results of operations.

Pro Forma Information for Periods Prior to the Adoption of SFAS 123R

Prior to the adoption of SFAS 123R, we provided the disclosures required under SFAS 123 as amended by SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosures. Employee stock-based compensation expenses recognized under SFAS 123 was not reflected in our results of operations for the three and six month periods ended June 30, 2005 for employee stock option awards as all stock options were granted with an exercise price greater than or equal to the market value of the underlying common stock on the date of grant. Previously reported results have not been restated.

The pro forma information for the three and six months ended June 30, 2005 was as follows (in thousands, except per share amounts):

	For the Three Months Ended June 30, 2005	**For the Six Months Ended June 30, 2005**
Reported net loss	$ (891)	$ (1,384)
Stock-based compensation expense in reported net loss	145	145
Stock-based compensation expense determined under the fair value based method	(1,526)	(2,760)
Pro forma net loss	$ (2,272)	$ (3,999)
Loss per share (basic and diluted)		
As reported	$ (0.02)	$ (0.03)
Pro forma	$ (0.05)	$ (0.09)

9. Segment Information

The Company is an advanced technology company in the field of rapid and accurate identification, location tracking, and condition monitoring of high-value assets. The Company s operating segments are: (1) Animal Applications and (2) GPS and Radio Communications.

It is on the basis of segment reporting 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, 2006 (in thousands):

	Animal Applications	**GPS and Radio Communications**	**Corporate / Unallocated**	**Consolidated**
Net revenue from external customers:				
Product	$ 8,203	$ 4,300	$	$ 12,503
Service	172	281		453
Total revenue	$ 8,375	$ 4,581	$	$ 12,956
Operating loss	$ (1,413)	$ (679)	$	$ (2,092)
Loss before income taxes and minority interest share of income	$ (1,404)	$ (689)	$	$ (2,093)
Total assets	$ 79,190	$ 9,425	$	$ 88,615

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Following is the selected segment data as of and for the three months ended June 30, 2005 (in thousands):

	Animal Applications	GPS and Radio Communications	Corporate / Unallocated	Consolidated
Net revenue from external customers:				
Product	$ 8,036	$ 6,211	$	$ 14,247
Service	300	313		613
Total revenue	$ 8,336	$ 6,524	$	$ 14,860
Operating income (loss)	$ (1,078)	$ 481	$	$ (597)
Income (loss) before taxes and minority interest share of income	$ (1,081)	$ 495	$	$ (586)
Total assets	$ 81,024	$ 15,628	$	$ 96,652

Following is the selected segment data as of and for the six months ended June 30, 2006 (in thousands):

	Animal Applications	GPS and Radio Communications	Corporate / Unallocated	Consolidated
Net revenue from external customers:				
Product	$ 19,288	$ 8,357	$	$ 27,645
Service	589	544		1,133
Total revenue	$ 19,877	$ 8,901	$	$ 28,778
Operating loss	$ (1,509)	$ (1,229)	$	$ (2,738)
Loss before income taxes and minority interest share of income	$ (1,475)	$ (1,249)	$	$ (2,724)
Total assets	$ 79,190	$ 9,425	$	$ 88,615

Following is the selected segment data as of and for the six months ended June 30, 2005 (in thousands):

	Animal Applications	GPS and Radio Communications	Corporate / Unallocated	Consolidated
Net revenue from external customers:				
Product	$ 15,917	$ 11,027	$	$ 26,944
Service	716	603		1,319
Total revenue	$ 16,633	$ 11,630	$	$ 28,263
Operating income (loss)	$ (1,122)	$ 106	$	$ (1,016)
Income (loss) before taxes and minority interest share of income	$ (1,102)	$ 98	$	$ (1,004)
Total assets	$ 81,024	$ 15,628	$	$ 96,652

10. Acquisitions

The following describes the acquisitions by the Company (in thousands) in the six months ended June 30, 2006 and the year ended December 31, 2005:

Company Acquired	Date Acquired	Acquisition Price	Goodwill and Other Intangibles Acquired	Other Net Assets and Liabilities	Business Description
DSD Holdings A/S	2/28/05	$ 5,902	$ 8,008	$ (2,106)	Manufactures and markets visual and electronic RFID tags for livestock.

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On February 28, 2005, the Company acquired DSD Holdings A/S and its wholly-owned subsidiaries Daploma International A/S and Digitag A/S, including Daploma International A/S s 70%-owned subsidiary. DSD Holdings A/S became a wholly-owned subsidiary of Digital Angel Corporation. Denmark-based DSD Holdings A/S through its subsidiaries manufactures and markets visual and electronic RFID tags for livestock. The acquisition was accounted for under the purchase method of accounting. The excess of purchase price over the fair value of the assets and liabilities of DSD Holdings A/S has been recorded as goodwill of $4.0 million and intangible assets of $2.0 million. The intangible assets are customer relationships, tradename, patents and a non-compete agreement. The customer relationships, patents and a non-compete agreement are being amortized over periods ranging from 3 to 15 years. Amortization recorded in the six months ended June 30, 2006 and 2005 was $90,000 and $100,000, respectively.

Under the terms of the DSD Holdings A/S acquisition, the Company purchased all of the outstanding capital stock of DSD Holdings A/S in consideration for a purchase price of seven times DSD Holdings A/S s average annual EBITDA over the next three years less outstanding indebtedness at the end of the time period. An initial payment of $3.5 million was made at closing through the delivery of Applied Digital common stock valued at $3.5 million which the Company acquired from Applied Digital in exchange for $3.5 million of Digital Angel Corporation common stock. To account for pre-closing pricing fluctuations the Company paid additional consideration of $195,000 to the shareholders of DSD Holdings A/S on June 7, 2005.

Pursuant to the terms of the stock purchase agreement, at any time between the closing date of the acquisition and December 31, 2006 the Company had the right to buyout the remaining purchase price. On April 13, 2006, Digital Angel exercised its right to buyout the remaining purchase price by electing to pay the set amount of $2.0 million. The $2.0 million buyout price was satisfied by a cash payment of $1.0 million made on April 13, 2006 and the issuance on June 8, 2006 of $1.0 million worth of Digital Angel s unregistered common stock, or 282,115 shares. The number of shares of Digital Angel s common stock that were exchanged was determined based upon the average of the volume-weighted-average price of Digital Angel s common stock for the 10 trading days prior to the closing date of the share exchange agreement, or $3.545 per share. LANO Holdings Aps, wholly owned by Lasse Nordfjeld, and Torsten Nordfjeld received 174,403 shares and 28,268 shares, respectively, of the 282,115 shares issued to the former shareholders of DSD. The $2.0 million buyout price was recorded as additional goodwill.

Applied Digital and the former shareholders of DSD agreed to exchange, per the terms of a share exchange agreement dated April 12, 2006, registered shares of Applied Digital s common stock for the unregistered shares of the Company s common stock paid by the Company to the former shareholders of DSD pursuant to the buyout agreement. Pursuant to the share exchange agreement, Applied Digital issued to the former shareholders of DSD 454,545 shares of Applied Digital s common stock, valued at $972,249 and $27,751 in cash in exchange for the 282,115 shares of Digital Angel common stock that the former shareholders of DSD received from the Company in partial payment of the buyout, as more fully discussed above. The number of shares of Applied Digital common stock that were exchanged was determined based upon the average of the volume-weighted-average price of our common stock for the two trading days immediately preceding, and not including, the transaction closing date of June 8, 2006, which was $2.14 per share.

In addition, on February 28, 2005 Digital Angel entered into employment agreements with the Chief Executive Officer of DSD Holdings A/S and its subsidiaries, Lasse Nordfjeld and his son, the President of Daploma, Torsten Nordfjeld.

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

The results of DSD Holdings A/S have been included in the consolidated financial statements since its date of acquisition. Unaudited pro forma results of operations for the six months ended June 30, 2005 are included below. Such pro forma information assumes that the above acquisition had occurred as of January 1, 2005, and revenue is presented in accordance with the Company s accounting policies. This summary is not necessarily indicative of what the results of operations of the Company would have been had it been a combined entity during such periods, nor does it purport to represent results of operations for any future periods.

(In thousands)	**For the Six Months Ended June 30, 2005**		
Net revenue	$	29,146	
Net loss	$	(1,415	)
Net loss per common share - basic and diluted	$	(0.03	)

11. Litigation

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

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

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

On September 28, 2005, Allflex sought an award of attorneys fees and costs based on a fee-shifting clause in the license agreement and under 35 U.S.C. §285, which provides for an award of attorneys fees and costs in exceptional cases. The Company contested this motion, and on October 6, 2005, the Court denied the motion in its entirety.

Final judgment in the action was entered on February 21, 2006. On March 20, 2006, the Company filed a notice of appeal of the final judgment with the Federal Circuit Court of Appeals in Washington, D.C. The appeal is presently pending.

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

On October 20, 2004, the Company commenced an action in the United States District Court for the District of Minnesota against Datamars, Inc., Datamars, S.A., The Crystal Import Corporation, and Medical Management International, Inc. (Banfield). This suit claims that the defendants are marketing and selling syringe implantable identification transponders manufactured by Datamars that infringe the Company s 1993 patent for syringe implantable identification transponders previously found by the United States District Court for the District of Colorado to be enforceable. Certain of the locations in which the infringing transponders are or have been sold, include, but are not limited to, Banfield, The Pet Hospital of which certain locations are associated with PetSmart stores. The suit seeks, among other things, an adjudication of infringement and that the infringing parties be enjoined from further improper action. The suit also seeks actual damages, punitive damages and interest, costs and attorneys fees. The Company believes that the suit is well-grounded in law and fact. Discovery in the action has been commenced and is continuing. On February 28, 2006, the Court conducted a hearing (the Markman Hearing) in which each of the parties presented the Court with their views regarding the scope of the claims set forth in the subject patent. On May 22, 2006, the Court issued its order on the Markman Hearing, largely adopting Digital Angel s views on the scope of the claims in the subject patent. The parties are continuing discovery in light of that order.

Crystal Import Corporation v. Digital Angel, et al.

On or about December 29, 2004, The Crystal Import Corporation filed an action against AVID Identification Systems, Inc. and the Company in the United States District Court for the Northern District of Alabama. Crystal s complaint primarily asserted federal and state antitrust and related claims against AVID, though it also asserted similar claims against the Company. The Company filed a motion to dismiss the action for failure to state a claim on which relief could be granted, or in the alternative, to have the action transferred to the United States District Court for the District of Minnesota. On October 12, 2005, the Alabama Court denied the Company s motion to dismiss the complaint, but granted the Company s motion to transfer the action to Minnesota. Following the docketing of the action in Minnesota, the Company and AVID filed a motion seeking to stay the case until the corresponding patent infringement actions have been resolved. Prior to the hearing on the motion, an agreement was reached pursuant to which the Court entered an order on July 12, 2006 staying the action for 90 days with permission to seek an additional stay thereafter. Given the uncertainties associated with all litigation and given the early stage of this proceeding, the Company is unable to offer any assessment on the potential liability exposure, if any, to the Company from this lawsuit.

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

On or about June 2, 2005, the Company filed a declaratory judgment action in the U.S. District Court for the District of Minnesota seeking to have the Court determine the rights and liabilities of the Company under a 2002 distribution agreement with Corporativo SCM, S.A. de C.V., a Mexican company which entered into a distribution agreement for a product that was then under development by the Company but the development of which was subsequently abandoned. Although the distribution agreement required that any actions arising out of or related to the agreement be filed within two years of the occurrence of the events giving rise to the claim, the Company received a letter in 2005 from the defendant threatening to assert a claim notwithstanding the two year limit set forth in the agreement. The defendant accordingly filed a motion to dismiss the declaratory judgment action, which the Court denied. On or about January 10, 2006, the defendant filed an answer and asserted a counterclaim against the Company for fraud seeking damages in an amount in excess of $75,000. The Company filed a response denying the allegations of the counterclaim, and moved to dismiss the counterclaim because it was not timely and failed to plead fraud with particularlity. The Court denied the Company s motion to dismiss on May 8, 2006 and the Company filed an Answer to the Amended Counterclaim that, among other things, denies the allegations of the Amended Counterclaim and asserts affirmative defenses. The case is in the initial discovery stages. Given the uncertainties associated with all litigation and given the early stage of this proceeding, the Company is unable to offer any assessment on the potential liability exposure, if any, to the Company from this lawsuit.

12. Supplemental Cash Flow Information (in thousands)

	Six Months Ended June 30, 2006	2005
Interest paid	**$ 199**	$ 201
Taxes paid	**59**	85
Non-cash activity:		
Issuance of common stock for ADS common stock		3,500
Issuance of common stock to former shareholders of DSD Holdings A/S	**1,000**	
Financing of equipment through capital lease	**352**	

13. Related Party Activity

The Company has an exclusive eleven-year Distribution and Licensing Agreement dated March 4, 2002, amended December 28, 2005, with VeriChip Corporation (VeriChip), a wholly-owned subsidiary of Applied Digital, covering the manufacturing, purchasing and distribution of the Company s implantable microchip and the maintenance of the VeriChip Registry by the Company. The amended agreement contains, among other things, minimum purchase requirements in order to maintain exclusivity, whereby VeriChip is required to purchase $875,000, $1,750,000 and $2,500,000 for each of 2007, 2008 and 2009, respectively, and $3,750,000 for 2010 and each year thereafter. The agreement continues until March 2013, and, as long as VeriChip continues to meet the minimum purchase requirements, will automatically renew annually under its terms. The Distribution and Licensing agreement includes a license for the use of the Company s technology in VeriChip s identified markets. Under the Distribution and Licensing Agreement the Company is the sole manufacturer and supplier to VeriChip. The existing terms with the Company s sole supplier of implantable microchips, Raytheon Microelectronics Espana, SA, expire on June 30, 2010.

Revenue recognized under the Distribution and Licensing Agreement was $0.2 million and $0.5 million for the six months ended June 30, 2006 and 2005, respectively.

See Note 6 for a description of the stock exchange transactions with Applied Digital.

Amounts due from VeriChip as of June 30, 2006 and December 31, 2005 were $277,000 and $232,000, respectively.

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

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

We consist of Digital Angel Corporation and our subsidiaries - Digital Angel Technology Corporation (DATC), Fearing Manufacturing, Inc., Timely Technology Corp., Signature Industries Limited (90.9% owned subsidiary), OuterLink Corporation, DSD Holdings A/S and its subsidiaries Daploma International A/S (including its 70%-owned subsidiary, Daploma Polska) and Digitag A/S, Digital Angel Holdings, LLC and Digital Angel International, Inc. and its subsidiaries Digital Angel S.A. and Digital Angel do Brasil Produtos de Informatica LTDA.

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, 2006 and 2005 and is derived from the accompanying consolidated statements of operations included in this report.

	Three Months Ended June 30, 2006 %	2005 %	Six Months Ended June 30, 2006 %	2005 %
Product revenue	96.5	95.9	96.1	95.3
Service revenue	3.5	4.1	3.9	4.7
Total net revenue	100.0	100.0	100.0	100.0
Cost of products sold	58.8	53.3	56.9	53.1
Cost of services sold	2.1	2.0	2.0	2.2
Total cost of products and services sold	60.9	55.3	58.9	55.3
Gross profit	39.1	44.7	41.1	44.7
Selling, general and administrative expenses	46.3	41.2	42.5	40.5
Research and development expenses	8.9	7.5	8.1	7.8
Operating loss	(16.1)	(4.0)	(9.5)	(3.6)
Interest income	0.6	0.6	0.6	0.6
Interest expense	(0.9)	(0.5)	(0.7)	(0.6)
Other income	0.2	0.0	0.2	0.0
Loss before tax, minority interest and discontinued operations	(16.2)	(3.9)	(9.4)	(3.6)
Income tax expense	(0.1)	(0.6)	0.2	(0.3)
Minority interest share of income	(0.1)	(1.5)	(0.2)	(1.0)
Net loss	(16.4)	(6.0)	(9.4)	(4.9)

Three Months Ended June 30, 2006 Compared to the Three Months Ended June 30, 2005

Revenue

Total revenue for the three months ended June 30, 2006 decreased $1.9 million, or 12.8%, to $13.0 million when compared to $14.9 million in revenue for the three months ended June 30, 2005.

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

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
Animal Applications	$ 8,375	$ 8,336
GPS and Radio Communications	4,581	6,524
Total	$ 12,956	$ 14,860

The Animal Applications segment s revenue increased approximately $39,000 in the three months ended June 30, 2006 compared to the three month period ended June 30, 2005. Revenue for the three month period ended June 30, 2006 consisted primarily of electronic and visual product sales to livestock customers of approximately $4.5 million, sales to companion animal customers of approximately $3.0 million and sales to fish and wildlife customers of $0.9 million.

The GPS and Radio Communications segment s revenue decreased approximately $1.9 million, or 29.8% to approximately $4.6 million in the three months ended June 30, 2006 from approximately $6.5 million in the three months ended June 30, 2005. The decrease in revenue was due to an approximately $2.1 million decrease in sales of Signature s Sarbe products, offset by an increase in sales at Signature s Radio Hire division of approximately $0.2 million. We attribute $1.2 million of the Sarbe product sales decrease to the completion of the Indian government contract in May 2005 and $0.9 million of the Sarbe product sales decrease to other Sarbe product customers, including the UK Ministry of Defence.

Gross Profit and Gross Profit Margin

Gross profit for the three month period ended June 30, 2006 was approximately $5.1 million, a decrease of approximately $1.6 million, or 23.8%, compared to approximately $6.6 million in the three month period ended June 30, 2005. As a percentage of revenue, the gross profit margin decreased to 39.1% for the three months ended June 30, 2006 from 44.7% for the three months ended June 30, 2005.

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

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
Animal Applications	$ 2,806	$ 3,175
GPS and Radio Communications	2,256	3,465
Total	$ 5,062	$ 6,640

Gross profit margin from operations for each operating segment was:

	Three Months Ended June 30, 2006 %	Three Months Ended June 30, 2005 %
Animal Applications	33.5	38.1
GPS and Radio Communications	49.2	53.1

The Animal Applications segment s gross profit decreased approximately $0.4 million, or 11.6%, in the three month period ended June 30, 2006 compared to the three months ended June 30, 2005. The gross margin percentage was 33.5% for the three month period ended June 30, 2006 compared to 38.1% for the three month period ended June 30, 2005. We attribute the decrease in gross margin and gross margin percentage to additional freight and importation duties associated with providing inventory to South America from Denmark and the United States. The Company has initiated manufacturing of livestock tags in Argentina and anticipates that gross margins on South American sales will improve in the second half of 2006. Gross profit margin for the three months ended June 30, 2006 excluding the impact of the South American initiative would have been 35.1%.

The GPS and Radio Communications segment s gross profit decreased approximately $1.2 million, or 34.9%, in the three month period ended June 30, 2006 as compared to the three month period ended June 30, 2005. The decrease in gross profit relates to the decrease in sales and decreased gross margin percentage. The gross margin percentage decreased to 49.2% in the three month period ended June 30, 2006 as compared to 53.1% in the three month period ended June 30, 2005. The decrease in gross margin percentage relates primarily to higher margins on G2R Sarbe locator beacons shipped under the contract with the government of India in the three months ended June 30, 2005. Signature completed shipments under the contract with the government of India in May 2005.

Selling, General and Administrative Expenses

Selling, general and administrative expenses decreased approximately $0.1 million, or 1.9%, in the three month period ended June 30, 2006 as compared to the three month period ended June 30, 2005. As a percentage of revenue, selling, general and administrative expenses were 46.3% and 41.2% for the three months ended June 30, 2006 and 2005, respectively.

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

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
Animal Applications	$ 3,494	$ 3,558
GPS and Radio Communications	2,509	2,560
Total	$ 6,003	$ 6,118

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

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005

	%	%
Animal Applications	41.7	42.7
GPS and Radio Communications	54.8	39.2

The Animal Applications segment s selling, general and administrative expenses decreased approximately $0.1 million in the three month period ended June 30, 2006 as compared to the three month period ended June 30, 2005 and selling, general and administrative expense as a percentage of revenue decreased to 41.7% from 42.7% in the same respective periods.

The GPS and Radio Communications segment s selling, general and administrative expenses decreased approximately $51,000 to approximately $2.5 million in the three month period ended June 30, 2006 from approximately $2.6 million in the three month period ended June 30, 2005. In the three months ended June 30, 2006 decreased amortization expense at our subsidiary, OuterLink Corporation, was partially offset by increased salary expense at our subsidiary, Signature Industries Limited. As a percentage of revenue, selling, general and administrative expenses increased to 54.8% in the three month period ended June 30, 2006 from 39.2% in the three month period ended June 30, 2005. The increase in selling, general and administrative expense as a percentage of sales resulted primarily from the decrease in sales in the current period.

All of the Company s out-of-the money, unvested stock options issued to current employees, officers and directors prior to November 15, 2005 were vested on December 30, 2005, therefore equity based compensation expense related to stock options granted prior to the adoption of SFAS 123R was immaterial. On June 14, 2006 the Company granted 2.1 million stock options to employees and directors of Digital Angel Corporation. Compensation expense related to the 2.1 million stock options is expected to be approximately $4.5 million and will be recognized over the weighted average period of 7.2 years.

Research and Development Expense

Research and development expense was approximately $1.2 million in the three month period ended June 30, 2006 compared to approximately $1.1 million for the three month period ended June 30, 2005. As a percentage of revenue, research and development expense was 8.9% and 7.5% for the three months ended June 30, 2006 and 2005, respectively.

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

	Three Months Ended June 30, 2006	**Three Months Ended June 30, 2005**
Animal Applications	$ 726	$ 695
GPS and Radio Communications	425	424
Total	$ 1,151	$ 1,119

The Animal Applications segment s research and development expense was approximately $0.7 million in the three month periods ended June 30, 2006 and 2005. Research and development in the three month period ended June 30, 2006 relates to continued product development.

The GPS and Radio Communications segment s research and development expense was approximately $0.4 million in the three month periods ended June 30, 2006 and 2005. Research and development in the three month period ended June 30, 2006 relates to the continued development of OuterLink Corporation s next generation of communication system hardware.

Interest Expense

Interest expense was approximately $0.1 million for the three month periods ended June 30, 2006 and 2005.

Income Taxes

The Company recorded an income tax provision of $12,000 in the three month period ended June 30, 2006 compared to a tax provision of $86,000 for the three month period ended June 30, 2005. The income tax provision for the three month period ended June 30, 2006 relates to a subsidiary of Daploma International A/S. The Company accounts for income taxes under the asset and liability approach. Deferred tax assets and liabilities are recognized for the expected future tax consequences attributed to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse. A valuation allowance is provided against net deferred tax assets when it is more likely than not that a tax benefit will not be realized.

Six Months Ended June 30, 2006 Compared to the Six Months Ended June 30, 2005

Revenue

Revenue for the six months ended June 30, 2006 increased $0.5 million, or 1.8%, to $28.8 million when compared to $28.3 million in revenue for the six months ended June 30, 2005.

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

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Animal Applications	$ 19,877	$ 16,633
GPS and Radio Communications	8,901	11,630
Total	$ 28,778	$ 28,263

The Animal Applications segment s revenue increased approximately $3.2 million, or 19.5%, in the six months ended June

30, 2006 compared to the six month period ended June 30, 2005. The increase in revenue was principally due to an increase in electronic and visual product sales to livestock customers of approximately $2.0 million, an increase in sales to companion animal customers of approximately $2.0 million, and $0.5 million to the inclusion of DSD Holdings A/S for an additional two months of operations in the six months ended June 30, 2006. DSD Holdings A/S was acquired on February 25, 2005. The increases in the Animal Application segment are offset by a decrease in sales to fish and wildlife customers of $0.9 million and a decrease in sales to VeriChip Corporation of $0.3 million.

The GPS and Radio Communications segment s revenue decreased approximately $2.7 million, or 23.5% to approximately $8.9 million in the six months ended June 30, 2006 from approximately $11.6 million in the six months ended June 30, 2005. The decrease in revenue was due to an approximately $3.2 million decrease in sales of Signature s Sarbe products, offset by an increase in sales at Signature s Radio Hire division of approximately $0.5 million. We attribute $2.2 million of the Sarbe product sales decrease to the completion of the Indian government contract in May 2005 and $1.0 million of the Sarbe product sales decrease to other Sarbe product customers, including the UK Ministry of Defence.

Gross Profit and Gross Profit Margin

Gross profit for the six month period ended June 30, 2006 was approximately $11.8 million, a decrease of approximately $0.8 million, or 6.3%, compared to approximately $12.6 million in the six month period ended June 30, 2005. As a percentage of revenue, the gross profit margin decreased to 41.1% for the six months ended June 30, 2006 from 44.7% for the six months ended June 30, 2005.

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

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Animal Applications	$ 7,457	$ 6,589
GPS and Radio Communications	4,381	6,046
Total	$ 11,838	$ 12,635

Gross profit margin from operations for each operating segment was:

	Six Months Ended June 30, 2006 %	Six Months Ended June 30, 2005 %
Animal Applications	37.5	39.6
GPS and Radio Communications	49.2	52.0

The Animal Applications segment s gross profit increased approximately $0.9 million, or 13.2%, in the six month period ended June 30, 2006 compared to the six months ended June 30, 2005. We attribute approximately $0.5 million of the increase to the previously mentioned sales increases and $0.4 million to the inclusion of DSD Holdings A/S for an additional two months of operations in the six month period ended June 30, 2006. DSD Holdings A/S was acquired on February 28, 2005. The gross margin percentage was 37.5% for the six month period ended June 30, 2006 compared to 39.6% for the six month period ended June 30, 2005. We attribute the decrease in gross margin percentage to additional freight and importation duties associated with providing inventory to South America from Denmark and the United States. The Company has initiated manufacturing of livestock tags in Argentina and anticipates that gross margins on South American sales will improve in the second half of 2006. Gross profit margin for the six months ended June 30, 2006 excluding the impact of the South American initiative would have been 38.9%.

The GPS and Radio Communications segment s gross profit decreased approximately $1.7 million, or 27.5%, in the six month period ended June 30, 2006 as compared to the six month period ended June 30, 2005. The decrease in gross profit relates to the decrease in sales and decreased gross margin percentage. The gross margin percentage decreased to 49.2% in the six month period ended June 30, 2006 as compared to 52.0% in the six month period ended June 30, 2005. The decrease in gross margin percentage relates primarily to higher margins on G2R Sarbe locator beacons shipped under the contract with the government of India in the first six months of 2005. Signature completed shipments under the contract with the government of India in May 2005.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased approximately $0.8 million, or 6.9%, in the six month period ended June 30, 2006 as compared to the six month period ended June 30, 2005. As a percentage of revenue, selling, general and administrative expenses were 42.5% and 40.5% for the six months ended June 30, 2006 and 2005, respectively.

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

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Animal Applications	$ 7,446	$ 6,341
GPS and Radio Communications	4,789	5,105
Total	$ 12,235	$ 11,446

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

	Six Months Ended June 30, 2006 %	Six Months Ended June 30, 2005 %
Animal Applications	37.5	38.1
GPS and Radio Communications	53.8	43.9

The Animal Applications segment s selling, general and administrative expenses increased approximately $1.1 million in the six month period ended June 30, 2006 as compared to the six month period ended June 30, 2005 and selling, general and administrative expense as a percentage of revenue decreased to 37.5% from 38.1% in the same respective periods. The increase in selling, general and administrative expense relates primarily to a charge of approximately $0.2 million in acquisition expenses, approximately $0.6 million in additional compensation expense, approximately $0.3 million of additional expense related to DSD Holding A/S and increased selling, general and administrative expenses in our South American subsidiaries of $0.2 million. Such increases are offset by decreased insurance expense of $0.3 million. The six month period ended June 30, 2005 includes 4 months of results for DSD Holdings A/S compared to six months of results in the six month period ended June 30, 2006. DSD Holdings A/S was acquired on February 28, 2005.

The GPS and Radio Communications segment s selling, general and administrative expenses decreased approximately $0.3 million to approximately $4.8 million in the six month period ended June 30, 2006 from approximately $5.1 million in the six month period ended June 30, 2005. The decrease in selling, general and administrative expense relates primarily to reduced intangible amortization expense at our subsidiary, OuterLink Corporation. As a percentage of revenue, selling, general and administrative expenses increased to 53.8% in the six month period ended June 30, 2006 from 43.9% in the six month period ended June 30, 2005. The increase in selling, general and administrative expense as a percentage of sales resulted primarily from the decrease in sales in the current period.

All of the Company s out-of-the money, unvested stock options issued to current employees, officers and directors prior to November 15, 2005 were vested on December 30, 2005, therefore equity based compensation expense related to stock options granted prior to the adoption of SFAS 123R was immaterial. On June 14, 2006 the Company granted 2.1 million stock options to employees and directors of Digital Angel Corporation. Compensation expense related to the 2.1 million stock options is expected to be approximately $4.5 million and will be recognized over the weighted average period of 7.2 years.

Research and Development Expense

Research and development expense was approximately $2.3 million in the six month period ended June 30, 2006, an increase of approximately $0.1 million, or 6.2%, from approximately $2.2 million for the six month period ended June 30, 2005. As a percentage of revenue, research and development expense was 8.1% and 7.8% for the six months ended June 30, 2006 and 2005, respectively.

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

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Animal Applications	$ 1,521	$ 1,370
GPS and Radio Communications	820	835
Total	$ 2,341	$ 2,205

The Animal Applications segment s research and development expense was approximately $1.5 million in the six month period ended June 30, 2006, an increase of approximately $151,000, or 11.0%, from approximately $1.4 million for the six month period ended June 30, 2005. The increase is primarily related to new product development.

The GPS and Radio Communications segment s research and development expense was approximately $0.8 million in the six month periods ended June 30, 2006 and 2005. Research and development in the six month period ended June 30, 2006 relates to the continued development of OuterLink Corporation s next generation of communication system hardware.

Interest Expense

Interest expense was approximately $0.2 million for the six month periods ended June 30, 2006 and 2005.

Income Taxes

The Company recorded an income tax benefit of approximately $72,000 in the six month period ended June 30, 2006 and an income tax provision of approximately $86,000 for the six month period ended June 30, 2005. The income tax benefit for the six month period ended June 30, 2006 relates to a subsidiary of Daploma International A/S. The Company accounts for income taxes under the asset and liability approach. Deferred tax assets and liabilities are recognized for the expected future tax consequences attributed to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse. A valuation allowance is provided against net deferred tax assets when it is more likely than not that a tax benefit will not be realized.

LIQUIDITY AND CAPITAL RESOURCES

As of June 30, 2006, the Company had cash of $7.1 million. Cash used in operating activities totaled approximately $1.8 million and approximately $1.4 million in the first six months of 2006 and 2005, respectively.

In the first six months of 2006, the use of cash was due primarily to an increase in inventory of approximately $1.7 million, and a decrease in accounts payable, accrued expenses and deferred revenue of approximately $1.7 million. Offsetting these uses of cash was depreciation and amortization of approximately $1.0 million and non-cash equity based compensation of approximately $0.3 million.

Investing activities used cash of approximately $1.6 million and approximately $1.8 million in the first six months of 2006 and 2005, respectively. The Company purchased approximately $0.7 million of property and equipment in the first six months of 2006 and 2005. On April 13, 2006 the Company exercised its right to buyout the remaining purchase price for the acquisition of DSD Holdings. The $2 million buyout price was satisfied by a cash payment of $1 million paid in April 2006 and $1 million worth of the Company s unregistered common stock issued in June 2006.

Financing activities provided cash of approximately $0.5 million in the first six months of 2006 and used cash of approximately $1.7 million in the first six months of 2005. In the first six months of 2006, proceeds to the Company related to stock option exercises were approximately $0.6 million. In the first six months of 2005, approximately $1.5 million of cash was used for the purchase of 328,100 shares of treasury stock.

The Company expects that current available funds will adequately fund the Company s operations for the next twelve months.

Debt, Covenant Compliance and Liquidity

Invoice Discounting Agreement On April 9, 2003, Signature Industries Limited entered into a two-year Invoice Discounting Agreement with The Royal Bank of Scotland Commercial Services Limited (RBS). The Invoice Discounting Agreement, as amended October 28, 2003 and June 21, 2005, provides for Signature to sell with full title guarantee most of its receivables, as defined in the Invoice Discounting Agreement, as amended. RBS prepays 80% of the receivables sold in the United Kingdom and 75% of the receivables sold in the rest of the world, not to exceed an outstanding balance of £750,000 ($1.3 million at June 30, 2006) at any given time. RBS pays Signature the remainder of the receivable upon collection of the receivable. Receivables which remain outstanding 90 days from the end of the invoice month become ineligible and RBS may require Signature to repurchase the receivable back. The discounting charge accrues daily at an annual rate of 1.85% above the base rate, as defined in the amended Invoice Discounting Agreement (6.35% at June 30, 2006). Signature pays a commission charge to RBS of 0.16% of each receivable balance sold. The Invoice Discounting Agreement, as amended, requires a minimum commission charge of £833 per month. Discounting charges of $21,000 and $11,000 are included in interest expense for the six months ended June 30, 2006 and 2005, respectively. As of June 30, 2006, $0.4 million of receivables were financed under the Invoice Discounting Agreement.

Equipment Loans-DSD Holdings DSD Holdings is party to equipment loans which are collateralized by production equipment. Principal and interest payments totaling approximately DKK 0.5 million ($84,000 USD at June 30, 2006) are payable quarterly. Payments are due through January 2010. The interest rates on the loans are variable and range from 4.555% to 7.06% as of June 30, 2006. As of June 30, 2006, the amount outstanding under the equipment loans was $1.0 million

Line of Credit-DSD Holdings DSD Holdings and its wholly-owned subsidiary, Daploma International A/S, are party to a credit agreement with Danske Bank. On June 1, 2006, DSD Holdings and Daploma International A/S amended the borrowing availability from DKK 12 million ($2.0 million USD at June 30, 2006) to DKK 18 million ($3.0 million USD at June 30, 2006). In connection with the amendment, Digital Angel Corporation executed a Letter of Support which confirms that Digital Angel Corporation shall maintain its holding of 100% of the share capital of Daploma, and that Digital Angel shall neither sell, nor pledge, nor in any other way dispose of any part of Daploma or otherwise reduce its influence on Daploma without the prior consent of Danske Bank A/S. As of June 30, 2006 the amount outstanding under the credit agreement was $2.3 million. The interest is determined quarterly and is based on the international rates Danske Bank can establish on a loan in the same currency on the international market plus 2.0%. At June 30, 2006, the annual interest rate on the facility was 5.05%. Borrowing availability under the credit facility considers guarantees outstanding. At June 30, 2006 the borrowing availability on the credit agreement was DKK 3.7 million ($0.6 million at June 30, 2006). The credit agreement shall remain effective until further notice. DSD Holdings can terminate the credit agreement and pay the outstanding balance or Danske Bank may demand the credit line be settled immediately at any given time, without prior notice.

Note Payable-DSD Holdings As of June 30, 2006, DSD Holdings is party to a note payable with Danske Bank. Principal payments of DKK 0.3 million ($50,400 USD at June 30, 2006) plus interest are payable quarterly through December 15, 2008. The interest rate on the note is calculated based on the international rates Danske Bank can establish on a loan in DKK in the international market plus 2.0%. The interest rate on the note payable was 4.85% at June 30, 2006. As of June 30, 2006, the amount outstanding under the note payable was $0.5 million.

Mortgage Notes Payable The Company is party to a mortgage notes payable collateralized by land and building. Principal and interest payments totaling approximately $30,000 are payable monthly through October 2010. The final payment of $2.0 million is due in November of 2010. The interest rate on the note is fixed at 8.18%. As of June 30, 2006, the amount outstanding under the mortgage note payable was $2.3 million.

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

Stock Repurchase On March 29, 2005, the Company s Board of Directors approved the repurchase of up to 1.5 million shares of its common stock over a ninety day period commencing on March 30, 2005. The Company purchased 328,000 shares for a total of $1.5 million.

The following table summarizes the Company s fixed cash obligations as of June 30, 2006 over various future years (in thousands):

		Payments Due by Period			
Contractual cash obligations	**Total**	**Less than 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 Years**
Notes Payable and Long-Term Debt	$ 6,702	$ 3,125	$ 1,228	$ 2,349	$
Operating Leases	18,151	745	1,270	977	15,159
Employment Contracts	1,624	1,214	410		
	$ 26,477	$ 5,084	$ 2,908	$ 3,326	$ 15,159

IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

In December 2004, SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R) was issued. SFAS 123R replaced SFAS No. 123 and supercedes APB Opinion No. 25. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS 123 are longer an alternative to financial statement recognition.

On January 1, 2006 we adopted the provisions of SFAS 123R, using the modified prospective transition method. Accordingly, during the six months ended June 30, 2006 we recorded stock-based compensation expense for awards granted in 2006 and awards granted prior to, but not vested as of January 1, 2006, as if the fair value method required for pro forma disclosure under SFAS 123 were in effect for expense recognition purposes. In accordance with modified prospective transition method prior periods have not been restated. However, the pro forma effects of recognizing the estimated fair value of stock based compensation for the first quarter of 2005 are disclosed in Note 8 of the Notes to our Condensed Consolidated Financial Statements. Upon adoption of SFAS 123R we elected to continue using the Black-Scholes option pricing model and have recognized compensation expense using a straight-line amortization method.

All of the Company s out-of-the-money, unvested stock options issued to current employees, officers and directors prior to November 15, 2005 were vested on December 30, 2005, and, therefore, the initial adoption of SFAS 123R did not have a material impact on our consolidated results of operations and earnings (loss) per share. The purpose of the accelerated vesting was to enable the Company to avoid recognizing in our statements of operations non-cash compensation expense associated with the options in future periods. As a result of the acceleration, we avoided recognition of approximately $8.6 million of compensation expense in our statement of operations over the course of the original vesting periods. Such expense was included in our pro forma stock-based compensation footnote disclosure for the quarter ended December 31, 2005. The majority of the accelerated options, absent the acceleration, would have been vested in 2006, with a smaller percentage vesting over the next 30 months. As of June 30, 2006, there was $4.9 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the DAC Stock Option Plan. That cost is expected to be recognized over a weighted-average period of 6.6 years.

Although the initial adoption of SFAS 123R did not have a material impact on our consolidated results of operations and earnings (loss) per share, as we grant more options or other share based compensation to employees, we expect that the impact may be material.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FAS No. 109 (FIN 48), which clarifies the accounting for uncertainty in income taxes. Currently, the accounting for uncertainty in income taxes is subject to significant and varied interpretations that have resulted in diverse and inconsistent accounting practices and measurements. Addressing such diversity, FIN 48 prescribes a consistent recognition threshold and measurement attribute, as well as clear criteria for subsequently recognizing, derecognizing and measuring changes in such tax positions for financial statement purposes. FIN 48 also requires expanded disclosure with respect to the uncertainty in income taxes. FIN 48 is effective for fiscal years beginning after December 15, 2006. We have not yet determined the impact of FIN 48 on our consolidated financial position, results of operations, cash flows or financial statement disclosures.

Forward-Looking Statements and Associated Risks

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

- our growth strategies including, without limitation, our ability to deploy new products and services;
- anticipated trends in our business and demographics;
- our ability to successfully integrate the business operations of recently acquired companies;
- our future profitability and liquidity; and
- regulatory, competitive or other economic influences.

Words such as anticipates, expects, intends, plans, believes, seeks, estimates and similar expressions also identify forward-looking st 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. See Item 1A. Risk Factors included in our 2005 Annual Report on Form 10-K/A.

Our actual results might differ materially from historical performance or current expectation. We do not undertake any obligation to update or revise publicly any forward-looking statement, whether as a result of new information, future event or otherwise.

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 do not believe that any changes in currency fluctuations, inflation, and changes in political and economic conditions would have a material affect on our business or our results of operations.

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.

Item 4. Controls and Procedures

As of the end of the period covered by this Form 10-Q, we carried out an evaluation, under the supervision and with the participation of our management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective.

During the period covered by the Form 10-Q, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

For information with respect to certain legal proceedings, see the information included under the caption entitled, Litigation (Note 11) of the Notes to Condensed Consolidated Financial Statements which is incorporated herein by reference.

Item 1A. Risk Factors

Information regarding risk factors appears in Management s Discussion and Analysis of Financial Condition and Results of Operations-Forward Looking Statements and Associated Risks in Part I, Item 2 of this Form 10-Q. There have been no material changes in our risk factors from those disclosed in our 2005 Annual Report on Form 10-K/A.

Item 4. Submission of Matters to a Vote of Securityholders

At the Annual Meeting of Stockholders held on May 4, 2006, the following proposals were adopted by the margins indicated:

PROPOSAL 1- ELECTION OF DIRECTORS

The following persons were elected as directors of the Company:

Kevin N. McGrath

Scott R. Silverman

John R. Block

Barry Edelstein

Howard S. Weintraub, Ph.D.

Michael S. Zarriello

No fewer than 40,766,057 were voted in favor of, no more than 938,461 shares were withheld.

PROPOSAL 2-RATIFICATION OF THE APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The following is the result of the stockholders vote on the ratification of the appointment of Eisner LLP as independent registered public accounting firm:

For	41,475,644
Against	70,058
Abstain	128,815

Item 5. Other Information

Item 6. Exhibits

(a) Exhibits

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

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

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

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

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 3, 2006	By:	/s/ James P. Santelli James P. Santelli Senior Vice President and Chief Financial Officer