

DIGITAL ANGEL CORPORATION

ANNUAL REPORT

TO STOCKHOLDERS

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DESCRIPTION OF BUSINESS

Background Information

On March 27, 2002, Digital Angel Acquisition Co. (“Acquisition”), then a wholly-owned subsidiary of Medical Advisory Systems, Inc. (“MAS”), merged with and into the former Digital Angel Corporation, which was then a 93% owned subsidiary of Applied Digital Solutions, Inc. (“ADS”). In the merger, the corporate existence of Acquisition ceased, the former Digital Angel Corporation became a wholly-owned subsidiary of MAS and was renamed “Digital Angel Technology Corporation,” 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 the former Digital Angel Corporation, comprised the Advanced Wireless Group (“AWG”). As a result of this contribution by ADS, Timely Technology Corp. became a wholly-owned subsidiary of MAS and Signature Industries, Limited became an 85% subsidiary.

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 MAS, 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.

Business of the Company

Digital Angel Corporation and its three subsidiaries – Digital Angel Technology Corporation, Timely Technology Corporation and Signature Industries, Limited – are engaged in the development and commercialization of proprietary technologies used to identify, locate and monitor people, animals and objects and provide medical assistance and technical products and services. As used in this Annual Report to Stockholders, the term “Company” means Digital Angel Corporation and its three subsidiaries. The Company’s business is organized into four segments – Animal Applications, Digital Angel Systems, GPS and Radio Communications, and Physician Call Center and Other.

Animal Applications

The Company’s Animal Applications segment develops, manufactures and markets radio, electronic and visual identification devices for the companion animal, livestock, laboratory animal, fish and wildlife markets worldwide. Its radio frequency identification products consist of miniature electronic microchips, readers and injection systems. The Company holds patents on its syringe-injectable microchip, which is encased in a glass or glass-like material capsule and incorporates an antenna and a microchip with a unique permanent identification code for the animal in which it is implanted. The microchip is typically injected under the skin using a hypodermic syringe, without requiring surgery. An associated reader device uses radio frequency to interrogate the microchip and read the code.

The Animal Applications segment’s pet identification system involves the insertion of a microchip with identifying information in the animal. Readers at animal shelters, veterinary clinics and other locations can determine the animal’s owner and other information. The pet identification system is marketed in the United States by Schering-Plough Pharmaceutical under the brand name “Home Again,” in Europe by Merial Pharmaceutical, and in Japan by Dainippon Pharmaceutical.

In addition to pursuing the market for permanent identification of companion animals, the Company’s Animal Applications segment also produces visual and electronic identification products, including numbered eartags, principally for livestock producers. The segment also produces and markets products to promote permanent electronic identification of livestock. Management believes that implantable electronic identification devices will be used in an increasing number of programs to manage herds, improve genetics, reduce the loss of livestock, implement feeding programs, and track, control and eradicate diseased livestock.

The United States Department of Agriculture (USDA) has given clearance for implanting microchips in food animals, enabling the Company's animal applications segment to market its electronic identification products to the United States livestock market. The Animal Applications segment is now able to promote actively its implantable system in the United States, and management anticipates that USDA clearance will result in increased use of microchips in connection with disease control programs.

Some of the Animal Applications segment's customers, such as the U.S. Department of Energy ("DOE"), track fish, such as salmon, to locate and protect spawning pools and to track migratory patterns for research and fishing purposes. The Company's fish scanning system has become the DOE's standard and the Company has been installing its high-speed scanners at selected dam sites in the Columbia River basin since 1998.

Digital Angel Systems

The Digital Angel Systems segment develops and markets advanced technology to gather location data and local sensory data and to communicate that data to an operations center. It is continuously developing its technology, which the Company refers to as its Digital Angel™ technology. Digital Angel™ technology is the integration and miniaturization into marketable products of three technologies – wireless communication (that is, cellular technology), sensors (including bio-sensors) and position location technology (including global positioning systems (GPS) and other systems).

The Digital Angel™ technology gathers location data and local sensory data and communicates that data to an operations center. The operations center can then perform an action based on the data received (for example, alert a doctor or update shipment information). Management plans to introduce this technology into a variety of products to suit different applications ranging from medical monitoring to asset management. The first Digital Angel product was launched in November 2001.

The Company's Digital Angel Systems segment includes Timely Technology Corp. which operates a system for managing the data to be communicated from products using the Digital Angel™ technology. The Company refers to this system as the Digital Angel Delivery System (DADS). DADS manages data in an application-specific format. It works by combining highly complex software that is responsible for data collection and delivery with the advanced infrastructure needed to operate it.

Timely Technology Corp. is also engaged in the business of software and systems development for the Company, including management information systems used in the Company's Animal Applications segment, the design and marketing of financial and accounting software packages for school districts, processing the data associated with product returns for customers on a contract basis and other services.

GPS and Radio Communications

Signature Industries operates the Company's GPS and Radio Communications segment. This segment consists of the design, manufacture and support of secure GPS enabled search and rescue equipment (such as personal locator beacons) and intelligent communications products and services for telemetry, mobile data and radio communications applications serving commercial and military markets. This segment includes the design, manufacture and distribution of intrinsically safe sounders (horn alarms) for industrial use and other electronic components. The Company's GPS and Radio Communications segment also includes a growing business in high grade communications equipment leasing and complementary data systems that customers can use to locate and monitor their assets.

Physician Call Center and Other

The Company's Physician Call Center segment provides the following medical assistance and technical products and services.

24/7 Medical Response and Assistance Services. A staff of communications specialists and physicians operating from the Company's medical telecommunications response center provides medical advice and/or assistance service to people traveling anywhere in the world, 24-hours-a-day, 7 days per week. Assistance is provided by telephone, satellite, high frequency radio, fax and telex. A major market for these services is the

maritime industry and the international travel insurance and assistance industry. Services include coordination of medical care, physician consultation, translation assistance, claims handling and cost containment on behalf of assistance companies, insurance companies or managed care organizations.

Pharmaceutical Kits and Equipments. The Physician Call Center segment sells a variety of kits containing pharmaceutical and medical supplies. Included in the kits are both prescription and non-prescription medications and controlled substances. The Company's Physician Call Center segment directly supplies pharmaceuticals to its maritime and airline customers through its warehouse facility, which stocks various commonly needed pharmaceuticals and supplies.

Other. The Company staffs and operates an outpatient health services clinic at its headquarters in Owings, Maryland. This clinic was established in 1998 and provides primary care and laser treatment for hair and tattoo removal. The clinic is operated during normal business hours. The Physician Call Center segment also offers medical training services to the maritime industry.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS FOR DIGITAL ANGEL CORPORATION
FOR THE SIX MONTHS ENDED JUNE 30, 2002 AND 2001**

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. The Company consists of Digital Angel Corporation (formerly Medical Advisory Systems, Inc.) and its three subsidiaries, which formerly were subsidiaries of Applied Digital Solutions -- Digital Angel Technology Corporation (formerly Digital Angel Corporation), Timely Technology Corp. and Signature Industries, Limited. These three subsidiaries, when owned by Applied Digital Solutions, were known as the Advanced Wireless Group. 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. The former Digital Angel Corporation resulted from the merger in September 2000 of Destron Fearing Corporation and Digital Angel.net Inc., which was then a wholly-owned subsidiary of Applied Digital Solutions. Before March 27, 2002, AWG's business was operated in four segments: Animal Tracking, Digital Angel™ Technology, Digital Angel Delivery System, and Radio Communications and Other. Following the merger with 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 the segment previously identified as Animal Tracking. The Company combined its Digital Angel™ Technology Segment with its 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 the 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 the Company's results of operations as a percentage of net operating revenue for the six months ended June 30, 2002 and 2001 and is derived from the accompanying consolidated and combined statements of operations included in this report.

	Six Months Ended June 30,	
	2002 %	2001 %
Product revenue	94.8	89.7
Service revenue	5.2	10.3
Total net revenue	100.0	100.0
Cost of products sold	53.8	53.3
Cost of services sold	2.9	5.5
Total cost of products and services sold	56.7	58.8
Gross profit	43.3	41.2
Selling, general and administrative expenses	150.7	25.5
Management fees - Applied Digital Solutions, Inc.	1.1	2.0
Research and development expenses	9.1	12.9
Depreciation and amortization expenses	10.8	28.9
Interest income	0.0	(0.1)
Interest expense	11.4	0.8
Loss before provision (benefit) for income taxes, minority interest and equity in net loss of affiliate	(139.8)	(28.8)
Provision (benefit) for income taxes	0.0	0.6
Loss before minority interest and equity in net loss of affiliate minority interest	(139.8)	(29.4)
Minority interest	(0.2)	(0.1)
Equity in net loss of affiliate	1.7	0.3
Net loss	<u>(141.3)</u>	<u>(29.6)</u>

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:

	Six Months Ended June 30,		Six Months Ended June 30,	
	2002		2001	
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	\$	<u>16,993</u>	\$	<u>18,674</u>

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:

	<u>Six Months Ended June 30,</u> <u>2002</u>	<u>Six Months Ended June 30,</u> <u>2001</u>
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	<u>\$ 7,360</u>	<u>\$ 7,685</u>

Gross profit margin from operations for each operating segment was:

	<u>Six Months Ended June 30,</u> <u>2002</u> %	<u>Six Months Ended June 30,</u> <u>2001</u> %
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	<u>43.3</u>	<u>41.2</u>

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 AngelTM 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:

	<u>Six Months Ended June 30,</u> <u>2002</u>	<u>Six Months Ended June 30,</u> <u>2001</u>
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	<u>\$ 6,941</u>	<u>\$ 4,768</u>

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

	<u>Six Months Ended June 30,</u> <u>2002</u> <u>%</u>	<u>Six Months Ended June 30,</u> <u>2001</u> <u>%</u>
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	<u>40.8</u>	<u>25.5</u>

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 AngelTM 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, the Company no longer pays 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:

	<u>Six Months Ended June 30,</u> <u>2002</u>	<u>Six Months Ended June 30,</u> <u>2001</u>
Animal Applications	\$ 605	\$ 555
Digital Angel Systems	701	1,855
GPS and Radio Communications	239	—
Physician Call Center and Other	—	—
Total	<u>\$ 1,545</u>	<u>\$ 2,410</u>

The decrease in expense is primarily due to the completion of some Digital Angel™ 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:

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

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' 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' 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 16.6% 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' 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' 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' 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. IBM Credit waived 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' 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' 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, 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.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR ADVANCED WIRELESS GROUP FOR THE THREE YEARS ENDED DECEMBER 31, 2001, 2000 AND 1999

Results of Operations --Fiscal Year Ended December 31, 2001 Compared to Fiscal Year Ended December 31, 2000 and Fiscal Year Ended December 31, 1999

Net Loss

Net loss was \$17.4 million, \$3.9 million and \$1.0 million in 2001, 2000 and 1999, respectively. The net loss in 2001 and 2000 was primarily the result of goodwill amortization associated with the acquisitions of the former Digital Angel Corporation and Timely Technology during 2000 and research and development expenses incurred in connection with the Digital Angel Technology and Animal Tracking segments. Also, a portion of the loss for 2001 was attributed to the allocation of interest expense associated with Applied Digital Solutions' borrowings under its credit agreement with IBM Credit Corporation. The net operating results for 1999 consisted of the performance of the Radio Communications and Other segment as more fully discussed below.

The following table summarizes AWG's results of operations as a percentage of net operating revenue for the years ended December 31, 2001, 2000 and 1999 and is derived from AWG's combined financial statements.

	Year Ended December 31, 2001	Year Ended December 31, 2000	Year Ended December 31, 1999
	%	%	%
Product revenue	93.0	88.1	100.0
Service revenue	7.0	11.9	---
Total net revenue	100.0	100.0	100.0
Cost of products sold	56.7	51.8	55.4
Cost of services sold	5.7	6.4	---
Total cost of products and services sold	62.4	58.2	55.4
Gross profit	37.6	41.8	44.6
Selling, general and administrative expense	29.3	35.2	48.3
Research and development expense	14.2	10.0	---
Asset impairment	2.0	---	---
Depreciation and amortization	34.5	13.3	3.9
Interest income	---	(0.1)	---
Interest expense	5.9	0.5	0.3
Loss before provision for income taxes, minority interest and equity in net loss of affiliate	(48.3)	(17.1)	(7.9)
Provision for income taxes	0.1	0.3	---
Loss before minority interest and equity in net loss of affiliate	(48.4)	(17.4)	(7.9)
Minority interest	(0.6)	---	(1.2)
Equity in net loss of affiliate	0.9	---	---
Net loss	(48.7)	(17.4)	(6.7)

Net Loss

Net loss for the three years ended December 31, 2001, 2000 and 1999 each of the operating segments was as follows:

	<u>Year Ended</u> <u>December 31,</u> <u>2001</u>	<u>Year Ended</u> <u>December 31,</u> <u>2000</u>	<u>Year Ended</u> <u>December 31,</u> <u>1999</u>
		(In thousands)	
Animal Tracking	\$ (9,806)	\$ (2,335)	\$ ---
Digital Angel Technology	(4,040)	(2,038)	---
Digital Angel Delivery System	(2,333)	526	---
Radio Communications and Other	<u>(1,230)</u>	<u>(23)</u>	<u>(968)</u>
Total	<u>\$ (17,409)</u>	<u>\$ (3,870)</u>	<u>\$ (968)</u>

Net loss as a percentage of revenue for the three years ended December 31, 2001, 2000 and 1999 for each operating segment was as follows:

	<u>Year Ended</u> <u>December 31,</u> <u>2001</u>	<u>Year Ended</u> <u>December 31,</u> <u>2000</u>	<u>Year Ended</u> <u>December 31,</u> <u>1999</u>
	%	%	%
Animal Tracking	(44.4)	(35.3)	---
Digital Angel Technology	N/A	N/A	---
Digital Angel Delivery System	(92.6)	19.9	---
Radio Communications and Other	<u>(11.0)</u>	<u>(0.2)</u>	<u>(6.7)</u>
Total	<u>(48.7)</u>	<u>(17.4)</u>	<u>(6.7)</u>

The Animal Tracking segment had a net loss of \$9.8 million, or 44.4% of revenue, for 2001 and \$2.3 million, or 35.3% of revenue, for 2000 due primarily to the amortization of goodwill associated with the acquisition of Destron Fearing on September 8, 2000. In addition, a portion of the net loss for 2001 was attributed to the allocation of interest expense associated with Applied Digital Solutions' indebtedness to its lender, IBM Credit Corporation. The Advanced Wireless Group did not generate net income or loss from this segment during 1999.

The Digital Angel Technology segment had a net loss of \$4.0 million for 2001 and \$2.0 million for 2000. The losses were attributed primarily to research and development expenses. The Digital Angel Technology segment was founded in late 1999 and research and development of products began during 2000. The Digital Angel product was launched in late November 2001.

The Digital Angel Delivery System segment had a net loss of \$2.3 million, or 92.6% of revenue, for 2001, and net income of \$0.5 million, or 19.9% of revenue, for 2000. The loss for 2001 was attributed primarily to the amortization of goodwill associated with the acquisition of Timely Technology, acquired on April 1, 2000, and the amortization of software acquired during the second quarter of 2001. In addition, a portion of the net loss in 2001 was attributed to the allocation of interest expense associated with Applied Digital Solutions' indebtedness to its lender, IBM Credit Corporation. The net income generated during 2000 resulted from web hosting and transaction processing support services. AWG did not generate net income or loss from this segment during 1999.

The Radio Communications and Other segment had a net loss of \$1.2 million for 2001, \$0.02 million for 2000 and \$1.0 million for 1999. The net loss for 2001 was attributed primarily to a decline in sales, and related gross profits, in the electrical parts and mobile data businesses. In addition, a portion of the net loss for 2001 was attributed to the allocation of interest expense associated with Applied Digital Solutions' indebtedness to its lender, IBM Credit Corporation. The improved operating performance during 2000 was attributed primarily to a reduction in selling, general and administrative expense.

Revenue

Revenue from operations for 2001 was \$35.7 million, an increase of \$13.5 million, or 60.6%, from 2000. Revenue for 2000 was \$22.3 million, an increase of \$7.9 million, or 54.7%, from \$14.4 million for 1999.

Revenue for the three years ended December 31, 2001, 2000 and 1999 each of the operating segments was as follows:

	<u>Year Ended</u> <u>December 31,</u> <u>2001</u>	<u>Year Ended</u> <u>December 31,</u> <u>2000</u>	<u>Year Ended</u> <u>December 31,</u> <u>1999</u>
		(In thousands)	
Animal Tracking – Product	\$22,074	\$ 6,618	\$ ---
Digital Angel Technology – Product	---	---	---
Digital Angel Delivery System – Service	2,520	2,647	---
Radio Communications and Other – Product	<u>11,144</u>	<u>12,986</u>	<u>14,380</u>
Total	<u>\$35,738</u>	<u>\$22,251</u>	<u>\$14,380</u>

The Animal Tracking segment's revenue increased \$15.5 million for 2001 compared to 2000, and increased \$2.2 million for 2001 when compared to 2000 on an annualized basis. The increase in revenue on an annualized basis was attributed to increased sales of pet identification products in the United States and European markets. The \$6.6 million increase in revenue during 2000 was due to the acquisition of Destron Fearing on September 8, 2000. The Advanced Wireless Group did not generate revenue from this segment during 1999.

The Digital Angel Delivery System segment revenue decreased \$0.1 million for 2001 compared to 2000. However, revenue decreased \$1.0 million for 2001 when compared to revenue for 2000 on an annualized basis. The decrease in revenue on an annualized basis was attributed primarily to the completion of existing client projects. Revenue increased \$2.6 million in 2000 compared to 1999. Timely Technology, acquired on April 1, 2000, contributed all of the increase. AWG did not generate revenue from this segment during 1999.

The Radio Communications and Other segment's revenue decreased by \$1.9 million, or 14.2%, for 2001 compared to 2000 and decreased \$1.4 million, or 9.7%, for 2000 compared to 1999. The decrease during 2001 was attributed to a decline in sales of the electrical parts and mobile data businesses. The decrease during 2000 was attributed to the loss of a manufacturing contract in mid-1999.

Gross Profit and Gross Profit Margin

Gross profit from operations for 2001 was \$13.4 million, an increase of \$4.1 million, or 44.5%, from 2000. Gross profit from operations for 2000 was \$9.3 million, an increase of \$2.9 million, or 45.0%, from \$6.4 million in 1999. Gross profit margin was 37.6%, 41.8% and 44.6%, of revenue for the years ended December 31, 2001, 2000 and 1999, respectively.

Gross profit from operations for the three years ended December 31, 2001, 2000 and 1999 for each operating segment was as follows:

	<u>Year Ended</u> <u>December 31,</u> <u>2001</u>	<u>Year Ended</u> <u>December 31,</u> <u>2000</u>	<u>Year Ended</u> <u>December 31,</u> <u>1999</u>
		(In thousands)	
Animal Tracking	\$ 7,822	\$ 2,201	\$ ---
Digital Angel Technology	---	---	---
Digital Angel Delivery System	473	1,213	---
Radio Communications and Other	<u>5,144</u>	<u>5,886</u>	<u>6,416</u>
Total	<u>\$13,439</u>	<u>\$ 9,300</u>	<u>\$6,416</u>

Gross profit margin from operations for the three years ended December 31, 2001, 2000 and 1999 for each operating segment was as follows:

	<u>Year Ended</u> <u>December 31,</u> <u>2001</u>	<u>Year Ended</u> <u>December 31,</u> <u>2000</u>	<u>Year Ended</u> <u>December 31,</u> <u>1999</u>
	%	%	%
Animal Tracking	35.4	33.3	---
Digital Angel Technology	---	---	---
Digital Angel Delivery System	18.8	45.8	---
Radio Communications and Other	<u>46.2</u>	<u>45.3</u>	<u>44.6</u>
Total	<u>37.6</u>	<u>41.8</u>	<u>44.6</u>

The Animal Tracking segment's gross profit increased \$5.6 million for 2001 compared to 2000 and increased \$1.2 million for 2001 when compared to 2000 on an annualized basis. The increase was attributed primarily to the previously discussed increase in sales. Gross profit increased \$2.2 million in 2000 from 1999 due to the acquisition of Destron Fearing on September 8, 2000. Margins were 35.4%, 33.3% and 0.0% in 2001, 2000 and 1999, respectively. Gross profit and margins increased for 2001 compared to 2000 due to a favorable product mix in electronic products. This segment did not contribute gross profit during 1999.

The Digital Angel Delivery System segment's gross profit decreased \$0.7 million for 2001 compared to 2000 and decreased \$1.1 million for 2001 when compared to annualized gross profit for 2000. The decrease in 2001 gross profit was attributed to the previously discussed decline in sales and increased investment in software engineering to support the development of the Digital Angel™ product. Gross profit increased \$1.2 million for 2000 compared to 1999. Timely Technology, which was acquired on April 1, 2000, contributed all of the increase. The gross profit generated during 2000 resulted from sales of web hosting and transaction processing support revenues. The Advanced Wireless Group did not generate gross profit from this segment during 1999. The gross margin percentage was 18.8% and 45.8% during 2001 and 2000, respectively.

The Radio Communications and Other segment's gross profit decreased by \$0.7 million, or 12.6%, for 2001 compared to 2000 due to the previously discussed decline in sales. Gross profit decreased by \$0.5 million, or 8.3%, for 2000 compared to 1999 due to the loss of a manufacturing contract in mid-1999. The gross margin percentage was 46.2%, 45.3% and 44.6% during 2001, 2000 and 1999, respectively. The increase in margins during 2001 was attributed to improved product mix in the GPS locator products.

Selling, General and Administrative Expense

Selling, general and administrative expense from operations was \$10.5 million for 2001, an increase of \$2.7 million, or 33.7%, from \$7.8 million in 2000. Selling, general administrative expense for 2000 increased \$0.9 million, or 12.7%, from \$6.9 million in 1999. As a percentage of revenue, selling, general and administrative expense was 29.3%, 35.2% and 48.3% during 2001, 2000 and 1999, respectively.

Selling, general and administrative expense for the years ended December 31, 2001, 2000 and 1999 for each of the operating segments was as follows:

	<u>Year Ended</u> <u>December 31,</u> <u>2001</u>	<u>Year Ended</u> <u>December 31,</u> <u>2000</u>	<u>Year Ended</u> <u>December 31,</u> <u>1999</u>
		(In thousands)	
Animal Tracking	\$ 4,888	\$ 1,955	\$ ---
Digital Angel Technology	---	---	---
Digital Angel Delivery System	451	508	---
Radio Communications and Other	<u>5,128</u>	<u>5,367</u>	<u>6,948</u>
Total	<u>\$10,467</u>	<u>\$ 7,830</u>	<u>\$6,948</u>

Selling, general and administrative expense as a percentage of revenue for the years ended December 31, 2001, 2000 and 1999 for each of the operating segments was as follows:

	Year Ended <u>December 31,</u> <u>2001</u>	Year Ended <u>December 31,</u> <u>2000</u>	Year Ended <u>December 31,</u> <u>1999</u>
	%	%	%
Animal Tracking	22.1	29.5	---
Digital Angel Technology	---	---	---
Digital Angel Delivery System	17.9	19.2	---
Radio Communications and Other	<u>46.0</u>	<u>41.3</u>	<u>48.3</u>
Total	<u>29.3</u>	<u>35.2</u>	<u>48.3</u>

The Animal Tracking segment's selling, general and administrative expense increased \$2.9 million for 2001 from 2000 and decreased \$1.0 million for 2001 compared to 2000 on an annualized basis. As a percentage of revenue, selling, general and administrative expense decreased to 22.1% from 29.5% in 2000. The decrease in selling, general and administrative expense on an annualized basis was attributed to reduced expenses for legal, accounting and investor relations. The increase in 2000 was the result of the acquisition of Destron Fearing in September 2000. Accordingly, selling, general and administrative expense was not incurred for this segment during 1999.

The Digital Angel Technology segment was founded in late 1999 and was in the product development stage during the majority of 2001, and all of 2000 and 1999. Accordingly, it did not incur selling, general and administrative expenses during the periods presented.

The Digital Angel Delivery System segment's selling, general and administrative expenses decreased \$0.06 million in 2001 as compared to 2000. Selling, general and administrative expense increased \$0.2 million for 2001 when compared to 2000 on an annualized basis. The increase for 2001 was attributed to investment spending to support the introduction of the Digital Angel™ products. Selling, general and administrative expense increased \$0.5 million in 2000 from 1999. Timely Technology, acquired on April 1, 2000, contributed all of the increase. Accordingly, the Advanced Wireless Group did not incur selling, general and administrative expense from this segment during 1999.

The Radio Communications and Other segment's selling, general and administrative expenses decreased \$0.2 million for 2001 and as a percentage of revenue increased to 46.0% from 41.3% for 2000. Selling general and administrative expense decreased \$1.6 million for 2000 compared to 1999 and as a percentage of revenue decreased to 41.3% from 48.3% in 1999 primarily as a result of a staff reduction.

Research and Development Expense

Research and development expense from operations was \$5.1 million for 2001, an increase of \$2.9 million, or 126.9%, from \$2.2 million in 2000. The Advanced Wireless Group did not incur research and development expense during 1999. As a percentage of revenue, research and development expense was 14.2% and 10.0% for 2001 and 2000, respectively.

Research and development expense for the years ended December 31, 2001, 2000 and 1999 for each of the operating segments was as follows:

	Year Ended <u>December 31,</u> <u>2001</u>	Year Ended <u>December 31,</u> <u>2000</u>	Year Ended <u>December 31,</u> <u>1999</u>
		(In thousands)	
Animal Tracking	\$ 1,057	\$ 197	\$ ---
Digital Angel Technology	4,014	2,038	---
Digital Angel Delivery System	---	---	---
Radio Communications and Other	---	---	---
Total	<u>\$ 5,071</u>	<u>\$2,235</u>	<u>\$---</u>

The Animal Tracking segment research and development expense increased \$0.9 million for 2001 from 2000 and increased \$0.5 million for 2001 compared to 2000 on an annualized basis. As a percentage of revenue, research and development expense increased to 4.8% from 3.0% in 2000. The increase in research and development

expense was attributed to investments made to develop products in the livestock and fisheries businesses. Research and development expense increased in 2000 by \$2.2 million. The increase in 2000 was the result of the acquisition of Destron Fearing in September 2000. Accordingly, research and development expense was not incurred for this segment during 1999.

The Digital Angel Technology segment was founded in late 1999 and research and development of products began during 2000. These expenses were attributed primarily to the development of the Digital Angel™ product.

Depreciation and Amortization

Depreciation and amortization expense from operations was \$12.3 million in 2001, an increase of \$9.4, or 316.3%, from 2000. Depreciation and amortization expense was \$3.0 million in 2000, an increase of \$2.4 million, or 424.2%, from 1999. As a percentage of revenue, depreciation and amortization expense was 34.5%, 13.3% and 3.9% for 2001, 2000 and 1999, respectively.

In conjunction with the review for impairment of goodwill and other intangible assets in the fourth quarter of 2000, the Advanced Wireless Group reviewed the useful lives assigned to acquisitions and, effective October 1, 2000, reduced the lives to periods ranging from 5 to 10 years, from periods ranging from 10 to 20 years, to reflect current economic trends associated with the nature of recent acquisitions. The impact in 2000 of this change was an increase in amortization of approximately \$1.0 million.

Depreciation and amortization expense for the three years ended December 31, 2001, 2000 and 1999 for each of the operating segments was as follows:

	Year Ended <u>December 31,</u> <u>2001</u>	Year Ended <u>December 31,</u> <u>2000</u>	Year Ended <u>December 31,</u> <u>1999</u>
		(In thousands)	
Animal Tracking	\$ 9,385	\$ 2,314	\$ ---
Digital Angel Technology	25	15	---
Digital Angel Delivery System	2,310	120	---
Radio Communications and Other	<u>611</u>	<u>513</u>	<u>565</u>
Total	<u>\$12,331</u>	<u>\$ 2,962</u>	<u>\$565</u>

The increases in depreciation and amortization expense for the Animal Tracking and Digital Angel Delivery System segments for 2001 and 2000 were attributed primarily to goodwill amortization resulting from the acquisitions of Destron Fearing Corporation and Timely Technology in 2000. The increase for 2001 compared to 2000 for the Radio Communications and Other segment was attributed to the change in the goodwill life from 20 to 10 years effective October 1, 2000, and the decrease for 2000 compared to 1999 to reduced levels of capital investment during 1999.

Asset Impairment

The Radio Communications and Other segment incurred an impairment charge of \$0.7 million for the year ended December 31, 2001 in connection with the impairment of goodwill associated with a prior acquisition.

Interest Expense

Interest expense was \$2.1 million, \$0.1 million and \$0.04 million for 2001, 2000 and 1999, respectively. Interest expense for 2001 was attributed primarily to an allocation of interest expense associated with the borrowings under the IBM credit agreement for the fourth quarter of 2001. Because the outstanding borrowings were not considered an obligation of AWG until September 30, 2001, interest was only allocated to the Advanced Wireless Group during the fourth quarter of 2001. Interest expense for 2000 and 1999 was a function of the level of outstanding debt and was principally associated with notes payable and advances from Applied Digital Solutions.

Income Taxes

AWG had an effective income tax rate of 0.2% and 1.5% for 2001 and 2000, respectively. The Advanced Wireless Group did not incur a provision for income taxes for 1999. Differences in the effective income tax rates from the statutory federal income tax rates arose primarily from the increase or reduction of valuation allowances related to net operating loss carryforwards, non-deductible goodwill amortization associated with acquisitions and

state taxes net of federal benefits. The Advanced Wireless Group recorded valuation allowances against certain of its gross deferred tax assets because the realization of those assets was dependent on future earnings, which were uncertain. During 2001 and 2000, Digital Angel Corporation and Timely Technology, the United States companies, were included in Applied Digital Solutions' consolidated federal income tax return.

Liquidity and Capital Resources

As of December 31, 2001, cash and cash equivalents totaled \$0.6 million, an increase of \$0.4 million, or 189.3%, from \$0.2 million at December 31, 2000. The Advanced Wireless Group utilized a cash management system to apply excess cash on hand against advances due to Applied Digital Solutions. Cash used in operating activities totaled \$3.2 million for 2001. The use of cash was due to the net loss, after adjusting for non-cash charges, and increases in accounts receivable and inventory. Partially offsetting these uses of cash were increases in cash from accounts payable and accrued expenses and prepaid expenses. During 2000, cash of \$1.4 million was used. The use of cash was due to the net loss, after adjusting for non-cash charges, and increases in inventory and prepaid expenses. Partially offsetting the uses was \$0.8 million from accounts receivable.

Accounts receivable, net of allowance for doubtful accounts, remained relatively constant at \$5.4 million at December 31, 2001 from \$5.3 million at December 31, 2000.

Inventory levels increased by \$0.4 million, or 8.4%, to \$5.8 million at December 31, 2001 compared to \$5.4 million at December 31, 2000. The increase in inventory was attributed to normal seasonal fluctuations in response to the timing of customer shipping orders.

Current assets increased by \$1.1 million, or 9.7%, to \$12.5 million at December 31, 2001 compared to \$11.4 million at December 31, 2000. The increase was attributed primarily to increases in cash and inventories as discussed above.

Property and equipment increased by \$9.1 million, or 167.7%, to \$14.5 million at December 31, 2001 compared to \$5.4 million at December 31, 2000. This increase was due primarily to the acquisition of software associated with the Digital Angel Delivery System during 2001.

Goodwill decreased to \$72.9 million at December 31, 2001 compared to \$77.6 million at December 31, 2000 due to amortization. The amortization was partially offset by an increase in goodwill associated with an earnout payment achieved in the second quarter of 2001.

Investment in affiliate, was \$6.8 million at December 31, 2001. This investment relates to Digital Angel Corporation's acquisition of a 16.6% interest in Medical Advisory Systems during February of 2001.

Accounts payable increased by \$1.2 million, or 45.0%, to \$3.8 million at December 31, 2001 from \$2.6 million at December 31, 2000. The increase is a result of improved management of cash.

Accrued expenses increased by \$0.2 million, or 11.8%, to \$2.0 million at December 31, 2001 from \$1.8 million at December 31, 2000. The increase was attributed primarily to Digital Angel™ related expenses.

Current liabilities increased by \$83.9 million, or 1883.04%, to \$88.4 million at December 31, 2001 compared to \$4.5 million at December 31, 2000. This increase was primarily due to the allocation of Applied Digital Solutions' outstanding borrowings under its USA revolving credit line and term loans with IBM Credit Corporation. These borrowings, which totaled \$82.6 million, were reflected as a current obligation of the Advanced Wireless Group at December 31, 2001 as a result of Applied Digital Solutions' determination that it would not be able to repay its obligations under its credit line and term loans with IBM Credit Corporation. IBM Credit Corporation maintained liens and security interests in the common stock and assets of the Advanced Wireless Group's businesses, which necessitated the allocation of Applied Digital Solutions' obligations to the Advanced Wireless Group's financial statements at December 31, 2001. See Note 2 to the Advanced Wireless Group's Combined Financial Statements for the Years Ended December 31, 2001 and 2000 and the discussion below under the heading Debt Covenant Compliance and Liquidity.

Long-term debt and notes payable remained relatively constant at \$2.4 million and \$2.5 million at December 31, 2001 and December 31, 2000, respectively. Long-term debt and notes payable consists of mortgage notes payable collateralized by land and buildings.

Investing activities used cash of \$1.3 million for 2001 and provided cash of \$1.1 million for 2000. During 2001, \$1.3 million was spent to acquire property and equipment. During 2000, \$1.9 million was provided by acquired businesses and \$0.8 million was spent to acquire property and equipment.

Financing activities provided cash of \$4.9 million for 2001 and \$0.4 million for 2000. This activity was attributed primarily to additional investment by Applied Digital Solutions. In addition, during 2000, we used \$0.2 million to pay notes payable.

The Advanced Wireless Group incurred research and development expense of \$5.1 million and \$2.2 million during 2001 and 2000, respectively. Since inception, the Advanced Wireless Group incurred research and development expense of approximately \$7.3 million. These expenses were funded by a combination of advances from Applied Digital Solutions and from cash provided by operations.

Debt, Covenant Compliance and Liquidity

ADS maintains a term and revolving credit agreement with IBM Credit Corporation. The IBM credit agreement provides for a revolving credit line in the United States, a revolving credit line in Canada and certain term loans. Under the credit agreement in effect at December 31, 2001, IBM Credit Corporation maintained liens and security interests in the outstanding capital stock of the businesses comprising the Advanced Wireless Group as well as liens on and security interests in the assets the Advanced Wireless Group's businesses. These liens and security interests collateralized borrowings under the United States revolving credit line and term loans.

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 Corporation granted IBM Credit Corporation warrants to acquire 1.2 million shares of Digital Angel Corporation'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. Management's business plans for ADS anticipated year to year increases in revenues due to increased volumes, improved working capital management, reduced capital spending, successful implementation of on-going cost savings initiatives, improved operating efficiencies, and the disposition of non-core businesses.

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 31, 2001 and it again had a collateral shortfall. As of December 31, 2001, ADS was not in compliance with various financial covenants, including: negative Tangible Net Worth of \$71.8 million, or \$37.3 million less than the minimum requirement, actual EBITDA was a negative \$142.2 million, or \$153.2 million less than the Minimum EBITDA covenant, Current Assets to Current Liabilities was 0.33 to 1.0 compared to a minimum requirement of 0.80 to 1.0 and ADS had a collateral shortfall of \$42.7 million, or \$35.7 million more than the allowable shortfall of \$7.0 million. The IBM credit agreement was amended and restated on October 17, 2000 and further amended on March 30, 2001, 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 of \$4.2 million and \$2.9 million, respectively, until April 2, 2002.

The total amounts outstanding on March 27, 2002, the effective date of the new credit agreement, were \$82.6 million. As part of the amendments to the agreement with IBM Credit Corporation, ADS paid bank fees of \$0.4 million in April 2001 and \$0.3 million in March 2002 and issued warrants to IBM Credit Corporation valued at \$1.9 million in April 2001. The bank fees and fair value of the warrants are recorded as deferred financing fees and are being amortized over the life of the debt as interest expense.

As a result of the events of default under the IBM credit agreement and continued operating losses in fiscal 2001, it was determined during the third quarter of fiscal 2001, that substantial doubt existed about ADS' ability to continue as a going concern. At December 31, 2001, outstanding borrowings under the United States revolving credit line and term loans totaled \$82.6 million. At September 30, 2001, ADS did not have the funds available to repay the borrowings under the IBM credit agreement. Accordingly, the \$82.6 million of outstanding borrowings was allocated to the Advanced Wireless Group at 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 the Advanced Wireless Group from the period September 30, 2001 to December 30, 2001. Because the outstanding borrowings were not considered the Advanced Wireless Group's obligation until September 30, 2001, interest was allocated to the Advanced Wireless Group from September 30, 2001. Under the terms of the agreement and plan of merger with Medical Advisory Systems, the common stock and assets of the three subsidiaries comprising the

Advanced Wireless Group were released from all liens and security interests under the IBM credit agreement, and the shares of Medical Advisory Systems common stock beneficially owned by ADS upon completion of the merger were pledged to IBM Credit Corporation as collateral for the debt.

On March 1, 2002, ADS and the Digital Angel Share Trust, a newly created Delaware business trust, and IBM Credit Corporation 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 Corporation and Medical Advisory Systems. Amounts outstanding under the new credit agreement bear interest at an annual rate of 17.0% 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 40.0% of the original principal amount outstanding plus accrued interest and expenses prior to February 28, 2003 and an additional 40.0% 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 25.0%. If not repaid by February 28, 2004, the interest rate increases to 35.0%.

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

Quantitative and Qualitative Disclosure About Market Risk

The Company's principal market risk results from changes in floating interest rates on short-term debt. The Company does not use interest rate swap agreements to mitigate the risk of adverse changes in the prime interest rate. However, the impact of a 100 basis point change in interest rates affecting the Company's short-term debt would not be material to the net loss, cash flow or working capital. The Company does not hold long-term interest sensitive assets and therefore is not exposed to interest rate fluctuations for its assets. The Company does not hold or purchase any derivative financial instruments for trading purposes.

CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

On May 23, 2002, the Company engaged Eisner LLP as its independent accountants to audit its financial statements for the fiscal year ending December 31, 2002. During 2000 and 2001 and in the subsequent interim period from January 1, 2002 through May 23, 2002, the Company did not consult with Eisner LLP on items which concern the application of accounting principles generally, or as to a specific transaction or group of either completed or proposed transactions, or as to the type of audit opinion that might be rendered on the Company's financial statements. Eisner LLP did not prepare a report on the Company's financial statements for fiscal 2000 or 2001. Therefore, no report was issued by Eisner LLP that could contain an adverse opinion or disclaimer of opinion, or a qualification or modification, as to uncertainty, audit scope or accounting principles.

On May 14, 2002, Grant Thornton, LLP ("Grant Thornton") notified the Company that it had resigned as the Company's certifying accountant. Since Grant Thornton was engaged on April 18, 2002, it did not prepare a report on the Company's financial statements for fiscal 2000 or 2001. Therefore, no report was issued by Grant Thornton that could contain an adverse opinion or disclaimer of opinion, or a qualification or modification, as to uncertainty, audit scope or accounting principles. Between April 18, 2002 and May 14, 2002, there were no disagreements with Grant Thornton on any matter of accounting principles or accounting practices, financial statement disclosure, or auditing scope or procedure. Grant Thornton advised the Company that its decision to resign was caused by its resignation as auditor for ADS, which was then the Company's majority shareholder.

On April 18, 2002, the Company dismissed BDO Seidman LLP ("BDO") as the Company's certifying accountant. BDO's report on the financial statements of the Company for its past two fiscal years contained no adverse opinion or disclaimer of opinion, nor was the report qualified or modified as to uncertainty, audit scope, or

accounting principle. The decision to change accountants was unanimously approved by the Company's Board of Directors, including all members of the Company's Audit Committee. During the fiscal years ending October 31, 2000 and 2001 and through the subsequent interim period beginning November 1, 2001 and ending April 18, 2002, there were no disagreements with BDO on any manner of accounting principles or practices, financial statement disclosure, or auditing scope or procedure.

MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company common stock is traded on The American Stock Exchange under the symbol "DOC". The following sets forth, for the periods indicated, the high and low prices per share of the Company's common stock as listed on The American Stock Exchange:

Fiscal Year Ended October 31, 2001	<u>High</u>	<u>Low</u>
First Quarter	\$10.25	\$2.9375
Second Quarter	4.50	3.00
Third Quarter	5.40	2.01
Fourth Quarter	5.30	1.75
 Fiscal Year Ended October 31, 2000	 <u>High</u>	 <u>Low</u>
First Quarter	\$14.625	\$9.3125
Second Quarter	18.25	7.50
Third Quarter	12.375	8.00
Fourth Quarter	11.25	9.00
 For the Six Months Ended June 30, 2002	 <u>High</u>	 <u>Low</u>
First Quarter	\$ 7.35	\$2.90
Second Quarter	7.75	2.01

The Company has never paid a cash dividend on its common stock.

SELECTED FINANCIAL DATA

(in thousands, except per share amounts)

We derived the following historical financial information from the combined financial statements of Advanced Wireless Group for the years ended December 31, 2001, 2000 and 1999, and the seven month period ended December 31, 1998 which have been audited by PricewaterhouseCoopers LLP. The unaudited financial data as of June 30, 2002 and for the six months ended June 30, 2002 and 2001 include adjustments, all of which are normal recurring adjustments, which our management considers necessary for fair presentation of our results for these unaudited periods. The results of operations for the six months ended June 30, 2002 and 2001 are not necessarily indicative of the results that may be expected for a full year. The inception of Advanced Wireless Group was June 1, 1998 when Applied Digital Solutions purchased an 85.0% interest in Signature Industries, Limited.

	For the six months ended June 30,		For the years ended December 31,			For the seven month period ended December 31,
	2002 ⁽¹⁾	2001	2001	2000 ⁽²⁾	1999	1998
	(Unaudited)					
Statement of Operations Data:						
Product revenue	\$16,113	\$16,752	\$33,220	\$19,604	\$14,380	\$9,629
Service revenue	880	1,922	2,518	2,647	-	-
Total net revenue	<u>16,993</u>	<u>18,674</u>	<u>35,738</u>	<u>22,251</u>	<u>14,380</u>	<u>9,629</u>
Cost of products sold	9,135	9,961	20,252	11,517	7,964	4,969
Cost of services sold	498	1,028	2,047	1,434	-	-
Gross profit	<u>7,360</u>	<u>7,685</u>	<u>13,439</u>	<u>9,300</u>	<u>6,416</u>	<u>4,660</u>
Selling, general and administrative expenses ⁽³⁾	25,815	5,139	10,467	7,830	6,948	3,628
Research and development expenses	1,545	2,410	5,071	2,235	-	-
Asset impairment charge	-	-	726	-	-	-
Depreciation and amortization	1,830	5,383	12,331	2,962	565	348
Interest income	-	(11)	(17)	(26)	-	-
Interest expense-Applied Digital Solutions, Inc.	1,806	-	-	-	-	-
Interest expense-others	125	151	2,119	115	41	35
Income (loss) before taxes, minority interest and equity in net loss of affiliate	<u>(23,761)</u>	<u>(5,387)</u>	<u>(17,258)</u>	<u>(3,816)</u>	<u>(1,138)</u>	<u>649</u>
Provision for income taxes	-	107	41	58	-	-
Income (loss) before taxes, minority interest and equity in net loss of affiliate	<u>(23,761)</u>	<u>(5,494)</u>	<u>(17,299)</u>	<u>(3,874)</u>	<u>(1,138)</u>	<u>649</u>

Minority interest	(43)	(27)	(217)	(4)	(170)	102
Equity in net loss of affiliate	291	67	327	-	-	-
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Net income (loss)	\$(24,009)	\$ (5,534)	\$(17,409)	\$ (3,870)	\$ (968)	\$ 547
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Balance Sheet Data:						
Cash and cash equivalents	\$ 584	\$ -	\$ 596	\$ 206	\$ 139	\$ 1
Property and equipment, net	14,951	15,503	14,476	5,408	1,115	1,325
Goodwill and other intangibles, net	106,258	76,776	72,876	77,645	2,713	2,937
Total assets	133,821	113,008	107,379	95,344	9,239	10,704
Long-term debt and notes payable	2,410	76	2,425	2,463	-	748
Total debt	2,797	2,519	85,068	2,503	-	748
Minority interest	351	585	394	612	616	786
Total stockholders' equity	122,763	104,374	16,116	87,809	5,574	5,548

- (1) Includes the results of operations of Medical Advisory Systems, Inc. from March 27, 2002
- (2) Includes the results of operations of (i) Timely Technology Corp. from April 1, 2000 and (ii) Destron Fearing Corporation from September 8, 2000.
- (3) Selling, general and administrative expenses include management fees of \$193, \$371, \$771, \$262, \$241 and \$121 for the six months ended June 30, 2002 and 2001, the years ended December 31, 2001, 2000 and 1999 and for the seven month period ended December 31, 1998, respectively

**DIGITAL ANGEL CORPORATION CONSOLIDATED FINANCIAL STATEMENTS
FOR THE SIX MONTHS ENDED JUNE 30, 2002
AND THE ADVANCED WIRELESS GROUP COMBINED FINANCIAL STATEMENTS
FOR THE SIX MONTHS ENDED JUNE 30, 2001**

DIGITAL ANGEL CORPORATION
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
Assets		
Current Assets		
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
Total Current Assets	11,809	12,550
Property And Equipment, net	14,951	14,476
Goodwill and Other Intangible Assets, net	106,258	72,876
Investment In Affiliates	256	6,779
Other Assets, net	547	698
	\$ 133,821	\$ 107,379
Liabilities and Stockholders' Equity		
Current Liabilities		
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	—
Total Current Liabilities	8,297	88,444
Long-Term Debt And Notes Payable	2,410	2,425
Total Liabilities	10,707	90,869
Commitments And Contingencies		
Minority Interest	351	394
Stockholders' Equity (See Note 1)		
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	132	94
Additional paid-in capital	167,075	37,929
Accumulated deficit	(45,709)	(21,700)
Common stock warrants	1,638	300
Treasury stock (carried at cost, 50 shares in 2002)	(43)	—
Accumulated other comprehensive loss	(330)	(507)
Total Stockholders' Equity	122,763	16,116
	\$ 133,821	\$ 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
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Product revenue	\$ 8,662	\$ 7,618	\$ 16,113	\$ 16,752
Service revenue	577	852	880	1,922
Total net revenue	<u>9,239</u>	<u>8,470</u>	<u>16,993</u>	<u>18,674</u>
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	<u>(1,500)</u>	<u>(3,488)</u>	<u>(23,761)</u>	<u>(5,387)</u>
Provision (benefit) for income taxes	<u>—</u>	<u>(8)</u>	<u>—</u>	<u>107</u>
Loss before minority interest, and equity in net loss of affiliate	<u>(1,500)</u>	<u>(3,480)</u>	<u>(23,761)</u>	<u>(5,494)</u>
Minority interest	(2)	(5)	(43)	(27)
Equity in net loss of affiliate	<u>—</u>	<u>49</u>	<u>291</u>	<u>67</u>
Net loss	<u>\$ (1,498)</u>	<u>\$ (3,524)</u>	<u>\$ (24,009)</u>	<u>\$ (5,534)</u>
Net loss per common share - basic and diluted	<u>\$ (0.06)</u>	<u>\$ (0.19)</u>	<u>\$ (1.06)</u>	<u>\$ (0.30)</u>
Weighted average number of common shares outstanding - basic and diluted	26,169	18,750	22,616	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						
Balance - December 31, 2001	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
Balance - June 30, 2002	26,448	\$ 132	\$ 167,075	\$ (45,709)	\$ 1,638	\$ (43)	\$ (330)	\$ 122,763

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)	Advanced Wireless Group (Combined)
	For the Six Months Ended June 30,	
	2002	2001
Cash Flows From Operating Activities		
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
Net Cash Used In Operating Activities	<u>(854)</u>	<u>(756)</u>
Cash Flows From Investing Activities		
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	—
Net Cash Used In Investing Activities	<u>(547)</u>	<u>(829)</u>
Cash Flows From Financing Activities		
Net amounts borrowed on notes payable	136	(2)
Payments on long-term debt	(32)	(35)
Exercise of stock options	601	—
Net transactions with Applied Digital Solutions, Inc.	684	1,416
Net Cash Provided By Financing Activities	<u>1,389</u>	<u>1,379</u>
Net Decrease In Cash And Cash Equivalents	(12)	(206)
Cash And Cash Equivalents - Beginning Of Period	<u>596</u>	<u>206</u>
Cash And Cash Equivalents - End Of Period	<u>\$ 584</u>	<u>\$ —</u>

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.

The accompanying unaudited condensed consolidated financial statements of Digital Angel 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:

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

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

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 collectibility 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

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

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
Numerator:				
Net loss	\$ (1,498)	\$ (3,524)	\$ (24,009)	\$ (5,534)
Denominator:				
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
Basic and diluted loss per share:	\$ (0.06)	\$ (0.19)	\$ (1.06)	\$ (0.30)

(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
	<u>5,206</u>	<u>5,206</u>

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:

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

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.

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

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

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:

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

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:

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

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:

<u>Company Acquired</u>	<u>Date Acquired</u>	<u>Acquisition Price</u>	<u>Acquisition Costs</u>	<u>Value of Shares, Warrants & Options Issued or Issuable</u>	<u>Common Shares Issued</u>	<u>Goodwill and Other Intangibles Acquired</u>	<u>Business Description</u>
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' 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.

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.

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
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)	\$ (1.02)	\$ (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"), Pricemart, Inc. ("Pricemart"), 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.

<u>COVENANT</u>	<u>COVENANTS REQUIREMENT</u>	
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. IBM Credit has waived 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)
MAS common shares transferred to ADS	(6,488)
MAS affiliates obtained through merger (at cost)	256
Balance June 30, 2002	<u>\$ 256</u>

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.

**ADVANCED WIRELESS GROUP
COMBINED FINANCIAL STATEMENTS FOR THE
THREE YEARS ENDED DECEMBER 31, 2001, 2000 AND 1999**

Report Of Independent Accountants

To the Board of Directors and Stockholders of Applied Digital Solutions, Inc. and Subsidiaries:

In our opinion, the accompanying combined balance sheets and the related combined statements of operations and cash flows present fairly, in all material respects, the financial position of the Advanced Wireless Group (the "Company"), comprised of businesses of Applied Digital Solutions, Inc. and Subsidiaries ("ADS") as described in the Basis of Presentation note 1 to the combined financial statements, at December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying combined financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the financial statements, the Company has suffered significant losses from operations and has not generated positive cash flows from operations in either of the two years in the period ended December 31, 2001. 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 combined financial statements do not include any adjustments that might result from the outcome of this uncertainty.

PricewaterhouseCoopers LLP
St. Louis, Missouri
May 9, 2002

ADVANCED WIRELESS GROUP

COMBINED BALANCE SHEETS
(In Thousands)

Assets

	December 31,	
	2001	2000
Current Assets		
Cash and cash equivalents	\$ 596	\$ 206
Accounts receivable (net of allowance for doubtful accounts of \$296 in 2001 and \$205 in 2000)	5,402	5,263
Inventories, net	5,819	5,370
Other current assets	733	602
Total Current Assets	12,550	11,441
Property And Equipment, Net	14,476	5,408
Goodwill, Net	72,876	77,645
Investment In Affiliate, Net	6,779	—
Other Assets, Net	698	850
	\$ 107,379	\$ 95,344

Liabilities And Net Investment In Advanced Wireless Group

Current Liabilities		
Notes payable	\$ 4	\$ 2
Current maturities of long-term debt	82,639	38
Accounts payable	3,757	2,591
Accrued expenses	2,044	1,829
Total Current Liabilities	88,444	4,460
Long-Term Debt And Notes Payable	2,425	2,463
Total Liabilities	90,869	6,923
Commitments And Contingencies (Notes 2, 3, 13 And 17)	—	—
Minority Interest	394	612
ADS' Net Investment In Advanced Wireless Group	16,116	87,809
	\$ 107,379	\$ 95,344

ADVANCED WIRELESS GROUP

COMBINED STATEMENTS OF OPERATIONS
(In Thousands)

	For The Years Ended December 31,		
	2001	2000	1999
Revenue			
Product revenue	\$ 33,220	\$ 19,604	\$ 14,380
Service revenue	2,518	2,647	—
Total Revenue	35,738	22,251	14,380
Cost Of Products And Services Sold			
Cost of products sold	20,252	11,517	7,964
Cost of services	2,047	1,434	—
Total Cost Of Products And Services Sold	22,299	12,951	7,964
Gross Profit	13,439	9,300	6,416
Selling, general and administrative expenses	10,467	7,830	6,948
Research and development	5,071	2,235	—
Interest And Non-Cash Charges:			
Asset impairment	726	—	
Depreciation and amortization	12,331	2,962	565
Interest income	(17)	(26)	—
Interest expense	2,119	115	41
	30,697	13,116	7,554
Loss Before Provision For Income Taxes, Minority Interest And Equity In Net Loss Of Affiliate	(17,258)	(3,816)	(1,138)
Provision For Income Taxes	41	58	—
Loss Before Minority Interest And Equity In Net Loss Of Affiliate	(17,299)	(3,874)	(1,138)
Minority Interest	(217)	(4)	(170)
Equity In Net Loss Of Affiliate	327	—	—
Net Loss	\$ (17,409)	\$ (3,870)	\$ (968)

ADVANCED WIRELESS GROUP

COMBINED STATEMENTS OF CASH FLOWS
(In Thousands)

	For The Years Ended December 31,		
	2001	2000	1999
Cash Flows From Operating Activities			
Net loss	\$ (17,409)	\$ (3,870)	\$ (968)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Asset impairment	726	—	—
Depreciation and amortization	12,331	2,962	565
Minority interest	(217)	(4)	(170)
Non-cash compensation expense	119	—	—
Loss on sale of assets	7	132	8
Equity in net loss of affiliate	327	—	—
Change in assets and liabilities:			
(Increase) decrease in accounts receivable	(137)	(786)	750
(Increase) decrease in inventories	(449)	1,266	375
Decrease in prepaid expenses and other current assets	169	114	74
Increase (decrease) in accounts payable and accrued expenses	1,337	(1,246)	(620)
Net Cash Provided By (Used In) Operating Activities	(3,196)	(1,432)	14
Cash Flows From Investing Activities			
(Increase) decrease in patents and other assets	3	(43)	18
Proceeds from sale of assets	—	15	—
Payments for property and equipment	(1,310)	(758)	(106)
Cash balances acquired from asset and business acquisition (net of cash used in purchase)	—	1,852	—
Net Cash Provided By (Used In) Investing Activities	(1,307)	1,066	(88)
Cash Flows From Financing Activities			
Amounts paid on notes payable	—	(179)	(747)
Net proceeds from long-term debt	11	—	—
Net transactions with ADS	4,882	612	959
Net Cash Provided By Financing Activities	4,893	433	212
Net Increase In Cash And Cash Equivalents	390	67	138
Cash And Cash Equivalents - Beginning Of Year	206	139	1
Cash And Cash Equivalents - End Of Year	\$ 596	\$ 206	\$ 139
Supplemental Disclosure Of Cash Flow Information			
Income taxes paid	\$ 28	\$ 106	\$ —
Interest paid	529	115	41

ADVANCED WIRELESS GROUP

NOTES TO COMBINED FINANCIAL STATEMENTS

December 31, 2001 And 2000

(In Thousands)

1. Organization And Summary Of Significant Accounting Policies

Basis Of Presentation

On November 1, 2001, the Board of Directors of Applied Digital Solutions, Inc. (ADS) approved in principle a plan for its wholly-owned subsidiary, Digital Angel Corporation (Digital Angel) to merge with Medical Advisory Systems, Inc. (MAS). Under the plan, ADS will also contribute all of its stock in Timely Technology Corporation (Timely Technology) and Signature Industries, Limited (Signature Industries) to MAS. Digital Angel, Timely Technology and Signature Industries are collectively referred to as the Advanced Wireless Group (the Company). At December 31, 2001, ADS owned 16.6% of MAS, which was acquired on February 27, 2001. At the effective time of the merger, options and warrants to purchase stock in Digital Angel will be converted into rights to purchase MAS stock. Subsequent to the merger, MAS will be renamed "Digital Angel Corporation".

On June 1, 1998, ADS purchased an 85% interest in Signature Industries, a United Kingdom company and accounted for this acquisition under the purchase method. Signature Industries is a manufacturer of communication and safety devices which are supplied to Search and Rescue Beacon Equipment (SARBE) and armed forces worldwide.

On April 1, 2000, ADS acquired 100% of the common shares of Timely Technology. Timely Technology's business consisted of software consulting and development services as well as monthly hosting services.

On September 8, 2000, ADS acquired a 100% interest in Destron Fearing Corporation. Destron Fearing is a producer of animal tracking and identification technology. Their products include ear tags and implantable microchips that use radio frequency for transmission. On September 8, 2000, Digital Angel was merged into Destron and Destron's name was changed to Digital Angel.

On March 27, 2002, Digital Angel merged with MAS. Pursuant to the merger agreement, ADS contributed all of its stock in Timely Technology and Signature Industries to MAS. In satisfaction of a condition to the consent to the merger by IBM Credit Corporation (IBM Credit), ADS' lender, ADS transferred to a Delaware business trust controlled by an advisory board all shares of MAS common stock owned by it and, as a result, the trust has legal title to approximately 77.15% of the MAS common stock. The trust has voting rights with respect to the MAS common stock until ADS' obligations to IBM Credit are repaid in full. ADS retained beneficial ownership of the shares. The merger will be accounted for using the purchase method of accounting as a reverse acquisition of MAS by ADS.

Signature Industries, Timely Technology and Digital Angel, all of which are substantially wholly-owned subsidiaries of and under the common control of ADS at December 31, 2001, have been included in the combined balance sheets and statements of operations and of cash flows of the Advanced Wireless Group since their respective acquisitions. ADS' historical cost basis of the assets and liabilities of the Advanced Wireless Group has been reflected in these combined financial statements.

The financial statements include the financial position, results of operations and cash flows of the Advanced Wireless Group. The financial information in these financial statements include an allocation of expenses incurred by ADS on behalf of the Advanced Wireless Group as discussed in the related party section of this Note. However, these financial statements may not necessarily be indicative of the results that have occurred had the Advanced Wireless Group been a separate, independent entity during the periods presented or of future results of the Advanced Wireless Group.

The Advanced Wireless Group is engaged in the business of developing and bringing to market proprietary technology used to identify, locate and monitor people, animals and objects. The Advanced Wireless Group

is currently organized into four segments: Animal Tracking, Digital Angel Technology, Digital Angel Delivery System and Radio Communications. Digital Angel operates the Animal Tracking and Digital Angel Technology segments. Timely Technology operates the Digital Angel Delivery System segment. Signature Industries operates the Radio Communication and Other segment.

Animal Tracking - develops, manufactures, and markets a broad line of electronic and visual identification devices for the companion animal, livestock, laboratory animal, fish and wildlife markets worldwide. The tracking of cattle and hogs are crucial both for asset management and for disease control and food safety. The principal technologies employed by the Animal Tracking Business are electronic ear tags, and implantable microchips that use radio frequency transmission.

Digital Angel Technology - develops and markets advanced technology to gather location data and local sensory data and to communicate that data to an operation center. The Digital Angel technology is actually the combination of three technologies: wireless communication (*e.g.* cellular), sensors (including bio-sensors) and position location technology (including GPS and other systems). The Company plans to introduce this Digital Angel technology into a variety of products to suit different applications ranging from medical monitoring to asset management. The Company began the rollout of Digital Angel on November 26, 2001.

Digital Angel Delivery System - following the communication of data to the operations center, the Digital Angel Delivery System manages the data in an application-specific format. The Digital Angel Delivery System works by combining software that is responsible for data collection and delivery with the advanced infrastructure needed to operate it. This segment also provides webhosting and transaction processing support services. For example, medical applications gather bio-readings such as pulse and temperature, and communicate that data, along with location data, to a ground station or call center. If the readings suggest a critical health situation, emergency aid could be dispatched. For the pet location applications, the location information is available via call center or a secure Internet site.

Radio Communications And Other - consists of the design, manufacture and support of secure GPS enabled search and rescue equipment and intelligent communications products and services for telemetry, mobile data and radio communications applications serving commercial and military markets. In addition, it designs, manufactures and distributes intrinsically safe sounders (horn alarms) and other electronic components.

Summary Of Accounting Policies

Significant accounting policies, which conform to accounting principles generally accepted in the United States and are applied on a consistent basis among all years presented, are described below.

Principles Of Combination

The financial statements of the Advanced Wireless Group include two wholly-owned subsidiaries and one majority-owned subsidiary of ADS. All significant intercompany transactions have been eliminated.

Use Of Estimates

The preparation of the financial statements requires management to make certain estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Although these estimates are based on the knowledge of current events and actions the Company may undertake in the future, they may ultimately differ from actual results.

Foreign Currencies

The Company's foreign subsidiary uses their local currency as their functional currency. Results of operations and cash flow are translated at average exchange rates during the period, and assets and liabilities are translated at end of period exchange rates. Translation adjustments resulting from this process are included in accumulated other comprehensive loss which is a component of ADS' Net Investment in Advanced Wireless Group (See Note 12).

Transaction gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the functional currency, are included in the results of operations as incurred. Transaction gains and losses have not been material.

Cash And Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Inventories, Net

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

Property And Equipment, Net

Property and equipment are carried at cost, less accumulated depreciation and amortization computed using the straight-line method. Building and leasehold improvements are depreciated and amortized over periods ranging from 10 to 30 years and software and equipment is depreciated over periods ranging from 2 to 10 years. Repairs and maintenance, which do not extend the useful life of the asset, are charged to expense as incurred. Gains and losses on sales and retirements are reflected in income.

Goodwill, Net

Goodwill and other intangible assets are carried at cost and are amortized on a straight-line basis, over the estimated future periods to be benefited (ranging from five to ten years). In conjunction with the Company's review for impairment of goodwill and other intangible assets in the fourth quarter of 2000, the Company reviewed the useful lives assigned to acquisitions and, effective October 1, 2000, changed the lives to periods ranging from five to ten years, down from periods of ten to twenty years. The impact in 2001 and 2000 of this change was an increase in amortization of \$4,124 and \$974, respectively. The Company reviews goodwill and other intangible assets quarterly for impairment whenever events or changes in business circumstances indicate that the remaining useful life may warrant revision or that the carrying amount of the long-lived asset may not be fully recoverable. Included in factors to be considered are significant customer losses, changes in profitability due to sudden economic or competitive factors, change in management's strategy for the business unit, or other factors arising in the quarterly period.

The Company annually performs undiscounted cash flow analyses to determine if an impairment exists. Earnings before interest, taxes, depreciation and amortization is used as the measure of cash flow for these analyses. If an impairment is determined to exist, any related impairment loss is calculated based on fair value. Fair value is determined based on discounted cash flows. The discount rate utilized by the Company would be the rate of return expected from the market or the rate of return for a similar investment with similar risks. As of December 31, 2001, the net book value of goodwill is \$72,876. Based on two independent valuations of the Company and the market value of the stock exchanged in the merger, we believe this goodwill is not impaired.

Revenue Recognition

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 collectibility 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.

Research And Development

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

Income Taxes

The Company's domestic subsidiaries are included in the consolidated federal income tax return filed by ADS. U.S. income tax payments, refunds, credits, provision and deferred tax components have been allocated to the Company in accordance with ADS' tax allocation policy. Such policy allocates tax components included in the consolidated income tax return of ADS to the Company to the extent such components were generated by or related to the Company. The Company accounts for income taxes under the asset and liability approach. Deferred taxes are recorded based upon the tax impact of items affecting financial reporting and tax filings in different periods. A valuation allowance is provided against net deferred tax assets where the Company determines realization is not currently judged to be more likely than not. Income taxes include U.S. and international taxes.

Comprehensive Loss

The Company's comprehensive loss consists of foreign currency translation adjustments, and is reported in Net Investment in Advanced Wireless Group (See Note 12).

Related Party Activity

Cash Management - The Company participates in a centralized cash management system administered by ADS. Cash deposits from the Company are transferred to ADS on a daily basis and ADS funds the Company's disbursement bank accounts as required. Unpaid balances of checks are included in accounts payable. Interest is charged or credited on transactions with ADS.

Shared Services - ADS provides 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 Combined Statement of Operations based on utilization, which management believes to be reasonable. Cost of these services to the Company were \$771 and \$262 for 2001 and 2000, respectively.

ADS' Net Investment in Advanced Wireless Group - Included in ADS' net investment in the Advanced Wireless Group are cumulative translation adjustments of \$186 and \$318 as of December 31, 2001 and 2000, respectively. Also included in ADS' net investment in the Advanced Wireless Group are advances to and from ADS. (See Note 12)

Impact Of Recently Issued Accounting Standards

In June 1998, the Financial Accounting Standards Board (FASB) issued SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, which provides a comprehensive and consistent standard for the recognition and measurement of derivatives and hedging activities. The statement is effective for fiscal years commencing after June 15, 2000. In June 2000, the FASB issued SFAS 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities* - an Amendment of SFAS statement 133,

which addresses implementation issues experienced by those companies that adopted SFAS 133 early. The Company adopted these statements as of January 1, 2001 and, because the Company does not use derivative instruments, the adoption of these statements did not have any effect on its results of operations, cash flows and financial position.

In July 2001, the FASB issued SFAS 141, *Business Combinations*, and SFAS 142, *Goodwill and Other Intangible Assets*. SFAS 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. SFAS 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. The Company adopted the provisions of each statement, which apply to goodwill and certain intangibles acquired prior to July 1, 2001, on January 1, 2002. The adoption of these standards will have the impact of reducing the Company's amortization of goodwill commencing January 1, 2002. Amortization of \$9,790 was recorded for the year ended December 31, 2001. The Company is in the process of completing its impairment analysis. Future impairment reviews may result in periodic write-downs.

In June 2001, the FASB issued SFAS 143, *Accounting for Asset Retirement Obligations*, which provides the accounting for the cost of legal obligations associated with the retirement of long-lived assets. SFAS 143 requires that companies recognize the fair value of a liability for asset retirement obligations in the period in which the obligations are incurred and capitalize that amount as a part of the book value of the long-lived asset. That cost is then depreciated over the remaining life of the underlying long-lived asset. This statement is effective for fiscal years beginning after June 15, 2002. The Company does not expect that the adoption of SFAS 143 will have a material impact on its operations or financial position.

In August 2001, the FASB issued SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. This standard supersedes SFAS 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. The Company adopted this statement on January 1, 2002. The adoption of FAS 144 did not have a material impact on the Company's operations or financial position.

In May 2002, the FASB issued SFAS 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*. SFAS 145 eliminates Statement 4 (and Statement 64, as it amends Statement 4), which requires gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, and thus, also the exception to applying Opinion 30 is eliminated as well. This statement is effective for fiscal years beginning after May 2002 for the provisions related to the rescission of Statements 4 and 64, and for all transactions entered into beginning May 2002 for the provision related to the amendment of Statement 13. The Company does not expect that the adoption of SFAS 145 will have a material impact on its operations or financial position.

2. Debt Covenant Compliance And Liquidity

ADS maintains a term and revolving credit agreement with IBM Credit. The IBM Credit agreement provides for a USA revolving credit line, a Canadian revolving credit line and certain term notes. Under the credit agreement in effect at December 31, 2001, IBM Credit maintains liens and security interests in the

outstanding capital stock of the businesses comprising the Advanced Wireless Group, as well as liens on and security interests in the assets of the Advanced Wireless Group. These liens and security interests collateralize borrowings under the USA revolving credit line and term loans.

ADS was not in compliance with various financial covenants at June 30, 2001, September 30, 2001 and December 31, 2001. The IBM credit agreement was amended and restated on October 17, 2000 and further amended on March 30, 2001, 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 of \$4.2 million and \$2.9 million, respectively until April 2, 2002. As part of the amendments to the agreement with IBM Credit, warrants to acquire 1.2 million shares of Digital Angel common stock valued at \$0.3 million were issued to IBM Credit in April 2001.

As a result of the events of default by ADS under the IBM credit agreement and continued operating losses in fiscal 2001, it was determined during the third quarter of fiscal 2001, that substantial doubt about ADS' ability to continue as a going concern exists. At December 31, 2001, outstanding borrowings under the USA revolving credit line and term loans totaled \$82,555. ADS does not currently have the funds available to repay the borrowings under the IBM credit agreement. Accordingly, the \$82,555 of outstanding borrowings was allocated to the Advanced Wireless Group at September 30, 2001 and has been reflected as a current obligation in the December 31, 2001 combined balance sheet. Interest associated with the borrowings was allocated to the Advanced Wireless Group for the period from September 30, 2001 through December 31, 2001.

The Company has suffered significant losses from operations and has not generated positive cash flows from operations in either of the two years in the period ended December 31, 2001. Additionally, the Company does not have an available line of credit and there can be no assurance that the Company will have access to funds necessary to provide for its ongoing operating expenses to the extent not provided from its ongoing operating revenue. These factors raise substantial doubt about the Company's ability to continue as a going concern.

On March 1, 2002, ADS and Digital Angel Share Trust, a newly created Delaware business trust, entered into a new credit agreement (new Credit Agreement) with IBM Credit, which became effective on March 27, 2002, the effective date of the merger between Digital Angel Corporation and MAS. 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 the trust, which is controlled by an advisory board, all shares of MAS common stock owned by it and, as a result, the trust has legal title to approximately 77.15% of the MAS common stock. The trust has voting rights with respect to the MAS common stock until the entire amount of ADS' obligations to IBM Credit are repaid in full. ADS retained beneficial ownership of the shares. The trust may be obligated to liquidate the shares of MAS common stock owned by it for the benefit of IBM Credit in the event ADS fails to make payments, or otherwise defaults, under the new Credit Agreement. Such liquidation of the shares of MAS common stock will be in accordance with the SEC rules and regulations governing affiliates.

Under the terms of the agreement and plan of merger with MAS, the common stock and assets of the three subsidiaries comprising the Advanced Wireless Group will be released from all liens and security interests under the new IBM Credit Agreement. As such, the Advanced Wireless Group will have no obligations to repay any amounts under the new IBM Credit Agreement.

3. Acquisitions And Dispositions

The following represents acquisitions within the Advanced Wireless Group which were purchased by ADS:

	Date Of Acquisition	Percent Acquired	Acquisition Price	Cash Consideration	Value Of Shares, Warrants And Options Issued Or Issuable	Common/ Preferred Shares Of ADS Issued	Goodwill Acquired	Business Description
2000 Acquisitions								
Timely Technology Corp.	04/01/00	100%	\$ 6,281	\$ 375	\$ 5,906	8,482	\$ 5,954	Software consulting and development service provider
Destron Fearing Corporation	09/08/00	100%	84,534	1,264	83,270	20,821	74,729	Animal identification and microchip technology company

In each of the above transactions, the value of the consideration paid by ADS was in accordance with the acquisition agreement. Based on the contractually agreed to amounts, ADS calculated the number of ADS shares issued to the sellers as of the closing date. The price of the ADS' common stock used to determine the number of shares issued was either the closing price set on a fixed date or based on a formula as specified in the agreements.

All acquisitions have been accounted for using the purchase method of accounting and, accordingly, the combined financial statements reflect the results of operations of each company 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.

Goodwill resulting from these acquisitions is being amortized on a straight-line basis over periods ranging from five to ten years. In conjunction with Company's review for impairment of goodwill and other intangible assets in the fourth quarter of 2000, the Company reviewed the useful lives assigned to acquisitions and effective October 1, 2000, changed the lives to periods ranging from 5 to 10 years, down from periods ranging from 10 to 20 years. In addition, as part of the Company's on-going review of the carrying value of goodwill, the Company recorded an impairment charge of \$726 during 2001.

Earnout And Put Agreements

The Timely Technology agreement includes additional consideration contingent on future profits. Upon earning this additional consideration, the value will be recorded as additional goodwill. In connection with the earnout, assuming all earnout profits are achieved, ADS is contingently liable for additional consideration of approximately \$3,610 in 2002 which would be payable by ADS in shares of ADS' common stock.

Major Acquisition

On September 8, 2000, the Advanced Wireless Group completed the acquisition of Destron Fearing Corporation through a merger of its wholly-owned subsidiary, Digital Angel into Destron Fearing. As a result of the merger, Destron Fearing became a wholly-owned subsidiary of ADS and was renamed Digital Angel Corporation. In connection with the merger, each outstanding share of Destron Fearing common

stock was exchanged for 1.5 shares of ADS' common stock, with fractional shares settled in cash. In addition, outstanding options and warrants to purchase shares of Destron Fearing common stock were converted into a right to purchase that number of shares of ADS common stock that the holders would have been entitled to receive had they participated in the merger. ADS issued 20.5 million shares of its common stock in exchange for all the outstanding stock of Destron Fearing and 0.3 million shares of its common stock as a transaction fee. ADS will issue up to 2.7 million shares of its common stock upon the exercise of the Destron Fearing options and warrants. The aggregate purchase price of approximately \$84.5 million, including the liabilities assumed, was allocated to the identifiable assets with the remainder of \$74.7 million recorded as goodwill, which is being amortized over 10 years.

See Note 20 for the unaudited pro forma effect of the acquisitions.

Other Investments

On February 27, 2001, ADS acquired 16.6% of the capital stock of MAS, 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' common stock. As of December 31, 2001, ADS controlled two of the seven board seats. ADS is the single largest shareholder and is accounting for this investment under the equity method of accounting. The excess of the purchase price over the estimated fair value of the shares acquired was approximately \$7.0 million (goodwill) and was being amortized on a straight-line basis over five years.

As a result of the merger between Digital Angel Corporation and MAS, which became effective on March 27, 2002, ADS now owns 77.15% of the newly combined company. 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 shares of the MAS common stock owned by it and, as a result, the trust has legal title to approximately 77.15% of the MAS common stock. The trust has voting rights with respect to the MAS common stock until ADS' obligations to IBM Credit are repaid in full. ADS has retained beneficial ownership of the shares. See Notes 2 and 9.

4. Inventories, Net

Inventories consist of:

	2001	2000
Raw materials	\$ 1,474	\$ 1,374
Work in process	176	183
Finished goods	5,611	4,992
	7,261	6,549
Less: Allowance for excess and obsolescence	(1,442)	(1,179)
	\$ 5,819	\$ 5,370

5. Other Current Assets

Other current assets consist of:

	2001	2000
Prepaid expenses and other current assets	\$ 491	\$ 388
Deposits	242	214
	\$ 733	\$ 602

6. Property and Equipment, Net

Property and equipment consists of:

	<u>2001</u>	<u>2000</u>
Land	\$ 278	\$ 278
Building and leasehold improvements	3,783	3,109
Equipment and furniture	3,573	2,892
Software	9,865	—
	<u>17,499</u>	<u>6,279</u>
Less: Accumulated depreciation	<u>(3,023)</u>	<u>(871)</u>
	<u>\$ 14,476</u>	<u>\$ 5,408</u>

Included above are vehicles and equipment acquired under capital lease obligations in the amount of \$690 and \$286 at December 31, 2001 and 2000, respectively. Related accumulated depreciation amounted to \$437 and \$192 at December 31, 2001 and 2000, respectively.

Depreciation charged against income amounted to \$2,392, \$428 and \$309 for the years ended December 31, 2001, 2000 and 1999, respectively.

During 2001, the Company disposed of assets with accumulated depreciation of \$34.

7. Goodwill, Net

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

	<u>2001</u>	<u>2000</u>
Original balance	\$ 85,201	\$ 80,578
Goodwill impairment	(726)	—
Accumulated amortization	<u>(11,599)</u>	<u>(2,933)</u>
Carrying value	<u>\$ 72,876</u>	<u>\$ 77,645</u>

Amortization expense, including goodwill amortization of \$1,161 in 2001 associated with the Company's equity investment in MAS, amounted to \$9,790, \$2,529 and \$256 for the years ended December 31, 2001, 2000 and 1999, respectively.

ADS has entered into various earnout arrangements with the selling stockholders of Timely Technology. This arrangement provides for additional consideration to be paid in future years if certain earnings levels are met. These amounts are added to goodwill as earned. These earnout arrangements totaled \$5,041 for 2001 and was paid through the issuance of 8,267 shares of ADS Common stock.

8. Other Assets, Net

Other assets consist of:

	<u>2001</u>	<u>2000</u>
Patents and other amortizable assets	\$ 373	\$ 373
Less: Accumulated amortization	<u>(154)</u>	<u>(5)</u>
	219	368
Other Investments	435	434
Other	<u>44</u>	<u>48</u>
	<u>\$ 698</u>	<u>\$ 850</u>

Patents and other amortizable assets are amortized on a straight-line basis over lives ranging from two to fifteen years. Amortization of other assets charged against income amounted to \$149 and \$5 for the years ended December 31, 2001 and 2000, respectively.

9. Notes Payable And Long-Term Debt

Notes payable of \$4 consists of an unsecured note due on demand.

Long-term debt consists of the following:

	<u>2001</u>	<u>2000</u>
Mortgage notes payable, collateralized by land and building, payable in monthly installments of principal and interest totaling \$.03, bearing interest at 8.18% in 2000, due through November 2010	\$ 2,465	\$ 2,501
Capital lease obligations	44	—
Less: Current maturities	<u>(84)</u>	<u>(38)</u>
	<u>\$ 2,425</u>	<u>\$ 2,463</u>

The scheduled maturities of long-term debt at December 31, 2001 are as follows:

<u>Year</u>	<u>Amount</u>
2002	\$ 84
2003	43
2004	46
2005	50
2006	54
Thereafter	<u>2,232</u>
	<u>\$ 2,509</u>

Interest expense on the long and short-term notes payable amounted to \$529, \$115 and \$0 for the years ended December 31, 2001, 2000 and 1999, respectively.

10. Fair Value Of Financial Instruments

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

Cash And Cash Equivalents

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

Notes Payable

The carrying amount approximates fair value because of the short-term nature of the notes and the current rates approximate market rates.

Long-Term Debt

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

Accounts Payable And Accrued Expenses

The carrying amount approximates fair value because of the short-term nature of those items.

11. Income Taxes

The provision for income taxes consists of:

	<u>2001</u>	2000	1999
Current:			
United States at statutory rates	\$ 41	\$ 58	\$ —
International	—	—	—
Current income tax provision	<u>41</u>	<u>58</u>	<u>—</u>
Deferred:			
United States	—	—	—
International	—	—	—
Deferred income taxes provision	<u>—</u>	<u>—</u>	<u>—</u>
	<u>\$ 41</u>	<u>\$ 58</u>	<u>\$ —</u>

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

	<u>2001</u>	2000
Deferred Tax Assets:		
Liabilities and reserves	\$ 299	\$ 29
Net operating loss carryforwards	<u>4,023</u>	<u>2,107</u>
Gross deferred tax assets	<u>4,322</u>	<u>2,136</u>
Valuation allowance	<u>(4,322)</u>	<u>(2,136)</u>
Net Deferred Tax Asset	<u>\$ —</u>	<u>\$ —</u>

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

	<u>2001</u>	2000
Domestic	\$ (15,811)	\$ (3,788)
International	(1,447)	(28)
	<u>\$ (17,258)</u>	<u>\$ (3,816)</u>

At December 31, 2001, the Company had aggregate net operating loss carryforwards of approximately \$10.2 million for income tax purposes which expire in various amounts through 2021. Approximately \$4 million of the net operating loss carryforwards were acquired in connection with various acquisitions and are limited as to use in any particular year based on Internal Revenue Code sections related to separate return year and change of ownership restrictions. In addition, given the ownership structure of the Company post-transaction, the Company will not be included in ADS' consolidated tax return which could further limit the utilization of the net operating loss carryforwards. The reconciliation of the effective tax rate with the statutory federal income tax rate is as follows:

	<u>2001</u>	2000	1999
Statutory rate	34%	34%	34%
Non-deductible goodwill amortization	(18)	(23)	(2)
State income taxes, net of federal benefits	(1)	(1)	—
International tax rates different from the the statutory US federal rate	(3)	—	(3)
Change in deferred tax asset valuation allowance	(11)	(14)	(28)
Other	(1)	2	(1)
	<u>—%</u>	<u>(2)%</u>	<u>—%</u>

12. Net Investment In Advanced Wireless Group

The following analyzes ADS' net investment in the businesses comprising the Advanced Wireless Group for the years ended December 31, 2001, 2000 and 1999:

	(Accumulated Deficit)	Parent Investment In Subsidiary	Accumulated Other Comprehensive Loss	Total Net Investment In Advanced Wireless Group
Balance - January 1, 1999	\$ 547	\$ 4,978	\$ 22	\$ 5,547
Net loss	(968)	—	—	(968)
Comprehensive loss - foreign				
Currency translation	—	—	(25)	(25)
Total comprehensive loss	(968)	—	(25)	(993)
Net transactions with ADS	—	1,020	—	1,020
Balance - December 31, 1999	(421)	5,998	(3)	5,574
Acquisition of Digital Angel	—	84,621	—	84,621
Acquisition of Timely Technology	—	1,240	—	1,240
Net loss	(3,870)	—	—	(3,870)
Comprehensive loss - foreign				
currency translation	—	—	(318)	(318)
Total comprehensive loss	(3,870)	—	(318)	(4,188)
Net transactions with ADS	—	562	—	562
Balance - December 31, 2000	(4,291)	92,421	(321)	87,809
Net loss	(17,409)	—	—	(17,409)
Comprehensive loss - foreign				
currency translation	—	—	(186)	(186)
Total comprehensive loss	(17,409)	—	(186)	(17,595)
MCY software purchase	—	9,865	—	9,865
IBM debt	—	(82,555)	—	(82,555)
IBM debt Interest	—	1,591	—	1,591
Timely Technology earnouts	—	5,041	—	5,041
Digital Angel stock warrants	—	300	—	300
Investment in MAS	—	8,250	—	8,250
Stock option repricing	—	119	—	119
Net advances from ADS	—	3,291	—	3,291
Balance - December 31, 2001	\$ (21,700)	\$ 38,323	\$ (507)	\$ 16,116

Included in Net Investment in Advanced Wireless Group are advances to and from ADS and the Advanced Wireless Group as follows:

	<u>2001</u>	<u>2000</u>
Due from ADS	\$ 263	\$ 97
Due to ADS	(5,140)	(1,683)
IBM debt interest	(1,591)	—
Net due to ADS	<u>\$ (6,468)</u>	<u>\$ (1,586)</u>

13. Net Commitments And Contingencies

Rentals of space, vehicles, and office equipment under operating leases amounted to approximately \$696, \$569 and \$550 for the years ended December 31, 2001, 2000 and 1999 respectively.

The approximate minimum payments required under operating leases and employment contracts that have initial or remaining terms in excess of one year at December 31, 2001 are:

<u>Year</u>	<u>Minimum Rental Payments</u>	<u>Employment Contracts</u>
2002	\$ 659	\$ 350
2003	514	50
2004	356	—
2005	312	—
2006	312	—
Thereafter	11,108	—
	<u>\$ 13,261</u>	<u>\$ 400</u>

14. Profit Sharing Plan

The Company participates in the 401(k) plan of ADS. ADS has a 401(k) Plan for the benefit of eligible United States employees. ADS has made no contributions to the 401(k) Plan.

Signature operates certain defined contribution pension plans. The Company's expense relating to the plans approximated \$175, \$135 and \$108 for the years ended December 31, 2001, 2000 and 1999, respectively.

15. Stock Options And Warrants

During 1999, Digital Angel adopted a non-qualified stock option plan (the Option Plan). Under the Option Plan, options for 5.5 million common shares were authorized for issuance to certain officers and employees of Digital Angel at December 31, 2001 and 2000 respectively, of which 5.4 million have been issued through December 31, 2001. The options may not be exercised until one to two years after the options have been granted, and are exercisable for a period of ten years. In conjunction with the completion of the merger, all outstanding and unexercised options of Digital Angel will be converted into an option to purchase shares of MAS common stock having the same terms and conditions as in effect prior to the completion of the merger.

A summary of stock option activity for 2001, 2000 and 1999 is as follows:

	2001		2000		1999	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Outstanding on January 1	4,630	\$ 0.36	2,425	\$ 0.05	—	\$ —
Granted	920	0.63	2,205	0.71	2,425	0.05
Exercised	—	—	—	—	—	—
Forfeited	(125)	(0.28)	—	—	—	—
Outstanding on December 31	5,425	0.41	4,630	0.36	2,425	0.05
Exercisable on December 31	4,555	0.37	2,155	0.05	—	—
Shares available on December 31 for options that may be granted	75		870		3,075	

The following table summarizes information about Digital Angel stock options at December 31, 2001:

Range Of Exercise Prices	Outstanding Stock Options			Exercisable Stock Options	
	Shares	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
\$0.01 to \$0.50	2,425	9.06	\$ 0.05	2,425	\$ 0.05
\$0.51 to \$1.00	3,000	9.79	0.70	2,130	0.73
\$0.01 to \$1.00	5,425		\$ 0.41	4,555	\$ 0.37

ADS has a non-qualified option plan (the ADS Plan). Under the ADS Plan, options for ten million common shares were authorized for issuance to certain officers and employees of ADS which include officers and employees of the Advanced Wireless Group. Under the ADS Plan, 373, 325 and 0 options were granted to officers and employees of the Company during 2001, 2000 and 1999, respectively. The options may not be exercised until one to three years after the grant date and are exercisable for a period of five years.

A summary of stock option activity in 2001, 2000 and 1999 for the ADS Plan as it relates to the Advanced Wireless Group employees is as follows:

	2001		2000		1999	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Outstanding on January 1	389	\$ 3.52	85	\$ 3.09	100	\$ 3.09
Granted	373	0.67	325	3.59	—	—
Exercised	—	—	(21)	2.75	—	—
Forfeited	(3)	1.09	—	—	(15)	3.09
Outstanding on December 31	759	2.13 ⁽¹⁾	389	3.52	85	3.09
Exercisable on December 31	323	\$ 3.19	50	\$ 3.09	—	\$ —

⁽¹⁾ Options to acquire 429 shares of ADS common stock were re-priced during 2001. See Note 16.

The following table summarizes information about stock options under the ADS Plan as it relates to the Advanced Wireless Group employees at December 31, 2001:

Range Of Exercise Prices	Outstanding Stock Options			Exercisable Stock Options	
	Shares	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
\$0.01 to \$3.00	526	5.06	\$ 1.24	179	\$ 2.75
\$3.01 to \$6.00	173	3.99	3.32	124	3.29
\$6.01 to \$8.00	60	5.06	6.53	20	6.53
\$0.01 to \$1.00	759		\$ 2.13	323	\$ 3.19

The Company applies APB Opinion No. 25 and related Interpretations in accounting for all the plans. Accordingly, no compensation cost has been recognized under these plans. Had compensation cost for these plans been determined based on the fair value at the grant dates for awards under these plans, consistent with the alternative method set forth under SFAS 123, *Accounting for Stock-Based Compensation*, the Company's net income applicable to common stockholders and earnings per common and common equivalent share would have been reduced. The pro forma amounts are indicated below:

	2001	2000	1999
Net Loss			
As reported	\$ (17,409)	\$ (3,870)	\$ (968)
Pro forma	(17,674)	(4,003)	(991)

The fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model. The following weighted-average assumptions were used for grants under the Option Plan in 2001, 2000 and 1999: dividend yield of 0% for the three years; expected volatility of 0% for the three years; risk-free interest rate of 4.49%, 4.98% and 6.36% for 2001, 2000 and 1999 respectively; and expected lives of ten years for the two years ended December 31, 2001 and five years for the year ended December 31, 1999. The weighted-average fair value of options granted was \$.03 for the two years ended

December 31, 2001 and \$0.00 for the year ended December 31, 1999. The weighted average assumptions used for grants under the ADS Plan in 2001 and 2000 are as follows: dividend yield of 0% for the two years; expected volatility of 68.75% and 53.32% for 2001 and 2000, respectively; risk-free interest rate of 4.49% and 4.98% for 2001 and 2000, respectively; and expected lives of 5 years for the two years. The weighted average fair value of the ADS options granted was \$0.44 and \$1.01 for the years ended December 31, 2001 and 2000, respectively.

Qualified Employee Stock Purchase Plan

During 1999, ADS adopted a qualified Employee Stock Purchase Plan (the Stock Purchase Plan). Under the Stock Purchase Plan, options are granted at an exercise price of the lesser of 85% of the fair market value on the date of grant or 85% of the fair market value on the exercise date. Under the Stock Purchase Plan, options for 3.0 million common shares were authorized for issuance to substantially all full-time employees of the Advanced Wireless Group, of which 1.0 million shares have been issued and exercised through December 31, 2001. Each participant's options to purchase shares will be automatically exercised for the participant on the exercise dates determined by the board of directors.

16. Non-Cash Compensation Expense

Non-cash compensation expense of \$119 has been included in selling, general and administrative expenses for 2001. The expense resulted primarily from re-pricing 429 ADS stock options during 2001. The options had original exercise prices ranging from \$0.69 to \$6.34 per share and were modified to change the exercise price to \$0.15 per share. Due to the modification these options are being accounted for as variable options under APB Opinion No. 25 and fluctuations in the common stock price will result in increases and decreases of non-cash compensation expense until the options are exercised, forfeited or expire.

17. Legal Proceedings

ADS is party to various legal proceedings. In the opinion of management, these proceedings are not likely to have a material adverse affect on the financial position, results of operations, cash flows or overall trends in results of the Advance Wireless Group as none of the legal proceedings relate to Advanced Wireless Group.

18. Supplemental Cash Flow Information

In the years ended December 31, 2001 and 2000, the Advanced Wireless Group had the following noncash investing and financing activities:

	<u>2001</u>	<u>2000</u>
Assets acquired for ADS common stock	\$ 17,823	\$ —
Assets acquired for long-term debt and capital leases	—	1992

ADS has entered into various earnout arrangements with the selling stockholders of Timely Technology. During 2001, the Timely Technology earned \$5,041 for their earnout, which was paid through the issuance of 8,267 shares of ADS' common stock.

During 2001, ADS issued 11.8 million shares of ADS common stock in consideration for an exclusive perpetual license to a digital encryption and distribution software system and contributed the license to Advanced Wireless Group.

19. Segment Information

Prior to 2000, the Company operated in one segment. With the acquisition of two companies in 2000, the Company now operates in four segments: Animal Tracking, Digital Angel Technology, Digital Angel Delivery System, and Radio Communications and Other. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies, except that segment data includes an allocated charge for the corporate headquarters costs. It is on this basis that management

utilizes the financial information to assist in making internal operating decisions. The Company evaluates performance based on stand alone segment operating income.

For The Year Ended December 31, 2001

(In Thousands)

	Animal Tracking	Digital Angel Technology	Digital Angel Delivery System	Radio Communications And Other	Combined
Product revenue	\$ 22,074	\$ —	\$ 2	\$ 11,144	\$ 33,220
Service revenue	—	—	2,518	—	2,518
Segment revenue	\$ 22,074	\$ —	\$ 2,520	\$ 11,144	\$ 35,738
Depreciation and amortization	\$ 9,385	\$ 25	\$ 2,310	\$ 611	\$ 12,331
Interest income	(4)	—	(13)	—	(17)
Interest expense	1,777	2	215	125	2,119
Loss from operations before provision for income taxes and minority interest	(9,806)	(4,040)	(1,965)	(1,447)	(17,258)
Segment assets	86,918	104	14,574	5,783	107,379
Expenditures for property and equipment, net	947	—	188	175	1,310

For The Year Ended December 31, 2000

(In Thousands)

	Animal Tracking	Digital Angel Technology	Digital Angel Delivery System	Radio Communications And Other	Combined
Product revenue	\$ 6,618	\$ —	\$ —	\$ 12,986	\$ 19,604
Service revenue	—	—	2,647	—	2,647
Segment revenue	\$ 6,618	\$ —	\$ 2,647	\$ 12,986	\$ 22,251
Depreciation and amortization	\$ 2,314	\$ 15	\$ 120	\$ 513	\$ 2,962
Interest income	(7)	—	(2)	(17)	(26)
Interest expense	62	—	3	50	115
Loss from operations before provision for income taxes and minority interest	(2,335)	(2,038)	584	(27)	(3,816)
Segment assets	85,837	104	1,740	7,663	95,344
Expenditures for property and equipment	241	59	250	208	758

Revenues are attributed to geographic areas based on the location of the assets producing the revenues. Information concerning principal geographic areas as of and for the years ended December 31, 2001, 2000 and 1999 was as follows (in thousands):

	United States	United Kingdom	Combined
2001			
Net revenue	\$ 24,594	\$ 11,144	\$ 35,738
Long-lived assets excluding goodwill	13,558	918	14,476
2000			
Net revenue	\$ 9,264	\$ 12,987	\$ 22,251
Long-lived assets excluding goodwill	4,449	959	5,408
1999			
Net revenue	\$ —	\$ 14,380	\$ 14,380
Long-lived assets excluding goodwill	—	1,115	1,115

20. Pro Forma Information

The following unaudited pro forma combined information of the Company for the year ended December 31, 2000 and 1999 gives effect to the acquisitions, disclosed in Note 3, as if they were effective at January 1, 2000 and 1999. The Company did not acquire any businesses during 2001. The statement gives effect to the acquisitions under the purchase method of accounting.

The unaudited pro forma information may not be indicative of the results that would have actually occurred if the acquisitions had been effective on the dates indicated or of the results that may be obtained in the future. The unaudited pro forma information should be read in conjunction with the combined financial statements and notes thereto of the Company.

	Unaudited Pro Forma December 31,	
	2000	1999
Total revenue	\$ 35,443	\$ 34,193
Net loss	(7,059)	(5,866)

21. Summarized Quarterly Data (Unaudited)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Full Year
2001					
Total revenue	\$ 10,204	\$ 8,450	\$ 9,200	\$ 7,884	\$ 35,738
Gross profit	4,294	3,392	3,324	2,429	13,439
Net loss	(2,011)	(3,844)	(4,003)	(7,551) (a)	(17,409)
2000					
Total revenue	\$ 3,923	\$ 4,066	\$ 6,732	\$ 7,530	\$ 22,251
Gross profit	1,691	1,861	2,925	2,823	9,300
Net income (loss)	(64)	50	207	(4,063) (b)	(3,870)

(a) The fourth quarter 2001 results include interest on IBM debt in the amount of \$1,591 and goodwill impairment in the amount of \$726.

(b) The fourth quarter 2000 results include amortization of Digital Angel goodwill in the amount of \$2,180. Digital Angel was acquired on September 8, 2000.

**UNAUDITED PRO FORMA
CONDENSED COMBINED FINANCIAL STATEMENTS**

The accompanying unaudited pro forma condensed combined statements of operations of Digital Angel Corporation, formerly Medical Advisory Systems, Inc. (MAS), reflects the results of its condensed combined operations for the year ended December 31, 2001 and the six months ended June 30, 2002 after giving effect to the acquisition of the Advanced Wireless Group by MAS effective March 27, 2002, as more fully described below. The Advanced Wireless Group is comprised of three subsidiaries of Applied Digital Solutions, Inc. (ADS): Digital Angel Corporation (Digital Angel), Timely Technology Corp. and Signature Industries, Limited. MAS's fiscal year ended on October 31. The Advanced Wireless Group's fiscal year ended on December 31. The unaudited pro forma condensed combined statement of operations for the six months ended June 30, 2002 gives effect to the acquisition as if it had occurred on January 1, 2002 for both MAS and the Advanced Wireless Group. The unaudited pro forma condensed combined statement of operations for the year ended December 31, 2001 gives effect to the combined results of operations for the year as if the acquisition of the Advanced Wireless Group by MAS occurred at the beginning of each company's complete fiscal year.

The pro forma adjustments reflecting the consummation of the acquisition are based upon the purchase method of accounting and upon the assumptions set forth in the notes hereto. At the effective time of the merger, each share of Digital Angel common stock issued and outstanding immediately prior to the effective time of the merger was canceled and converted into the right to receive .9375 shares of MAS's common stock. In addition, ADS contributed to MAS its ownership interest in the common stock of Timely Technology Corp. and Signature industries, Limited. At the effective time of the merger, each option or warrant to purchase shares of Digital Angel common stock which was outstanding and unexercised immediately prior to the effective time of the merger was converted into an option or warrant to purchase shares of MAS common stock having the same terms and conditions that were in effect immediately prior to the effective time of the merger. In conjunction with and upon the completion of the merger, the Advanced Wireless Group was merged into MAS and MAS was renamed Digital Angel Corporation. In satisfaction of a condition to the consent to the merger by ADS' lender, IBM Credit Corporation, ADS transferred to a Delaware business trust controlled by an advisory board all shares of MAS common stock owned by it and, as a result, the trust has legal title to approximately 77.15% of the MAS common stock. ADS has retained beneficial ownership of the shares. Given ADS' ownership in MAS upon completion of the merger, ADS was considered to be the acquirer for accounting purposes and the merger was accounted for in the financial statements of MAS as a reverse acquisition of MAS by ADS.

The pro forma adjustments do not reflect any operating efficiencies and cost savings that may be achievable with respect to the combined companies. The pro forma adjustments do not include any adjustments to historical sales for any future price changes nor any adjustments to selling and marketing expenses for any future operating changes.

The following information is not necessarily indicative of the operating results that would have occurred had the merger been consummated at the beginning of the periods for which the consummation of the merger is being given effect. The actual results could vary significantly, from the pro forma amounts reflected herein because of a variety of factors, including changes in operating results between the dates of the pro forma financial information data and the date on which the merger is completed.

UNAUDITED PRO FORMA CONDENSED STATEMENT OF OPERATIONS
For the Year Ended December 31, 2001
(in thousands, except per share data)

	Medical Advisory Systems, Inc. Historical Year Ended October 31, 2001	(1)	Advanced Wireless Group Year Ended December 31, 2001	(2)	Pro Forma Adjustments		Pro Forma Combined December 31, 2001
Total revenue	\$ 5,363		\$ 35,738		\$ (1,794)	(A)	\$ 39,307
Cost of products and services sold	<u>3,851</u>		<u>22,299</u>		<u>(1,794)</u>	(A)	<u>24,356</u>
Gross profit	1,512		13,439		-		14,951
Selling, general and administrative expense	2,681		10,467				13,148
Research and development expense	-		5,071				5,071
Depreciation and amortization	848		12,331		-	(B)	13,179
Asset impairments	2,587		726				3,313
Interest and other income	(95)		(17)				(112)
Interest expense	<u>33</u>		<u>2,119</u>				<u>2,152</u>
Loss before provision (benefit) for income taxes, minority interest and equity in net loss of affiliate	(4,542)		(17,258)		-		(21,800)
Provision for income taxes	<u>-</u>		<u>41</u>				<u>41</u>
Loss before minority interest and equity in net loss of affiliate	(4,542)		(17,299)		-		(21,841)
Minority interest	-		(217)				(217)
Equity in net loss of affiliate	<u>-</u>		<u>327</u>		<u>(327)</u>	(C)	<u>-</u>
Net loss	<u>\$ (4,542)</u>		<u>\$ (17,409)</u>		<u>\$ 327</u>		<u>\$ (21,624)</u>
Loss per share-basic and diluted							\$ (0.90)
Weighted average number of common shares outstanding—basic and diluted							23,906

(1) Represents the historical unaudited condensed results of Medical Advisory Systems, Inc. for the year ended October 31, 2001.

- (2) Represents the historical unaudited condensed combined results of Advanced Wireless Group for the year ended December 31, 2001.

The unaudited pro forma condensed combined statement of operations for the year ended December 31, 2001 gives effect to the combined results of operations for the period as if the merger of MAS and Advanced Wireless Group had occurred at the beginning of MAS's and the Advanced Wireless Group's fiscal year.

PRO FORMA ADJUSTMENTS FOR THE UNAUDITED PRO FORMA CONDENSED COMBINED STATEMENT OF OPERATIONS FOR THE YEAR ENDED DECEMBER 31, 2001 ARE AS FOLLOWS:

- (A) To conform revenue policy to that of Digital Angel Corporation.
- (B) The merger was accounted for under the provisions of Financial Accounting Standards Board ("FASB") Statements No. 141, "Business Combinations," and 142, "Goodwill and Other Intangible Assets." For purposes of this presentation, it is assumed that the excess of fair value of Medical Advisory Systems' assets and liabilities is goodwill. In accordance with FASB Statement No. 142, goodwill is not amortized.
- (C) Represents the elimination of the Advanced Wireless Group's equity in loss of MAS for the year ended December 31, 2001. The Advanced Wireless Group owned 16.6% of MAS.

UNAUDITED PRO FORMA CONDENSED COMBINED STATEMENT OF OPERATIONS
For the Six Months Ended June 30, 2002
(in thousands, except per share data)

	Medical Advisory Systems, Inc. Historical Three Months Ended March 31, 2002	(1)	Digital Angel Corporation Historical Six Months Ended June 30, 2002	(2)	Pro Forma Adjustments		Pro Forma Combined June 30, 2002
Total revenue	\$885		\$ 16,993		\$ (335)	(A)	\$ 17,543
Cost of products and services sold	685		9,633		(335)	(A)	9,983
Gross profit	200		7,360		-		7,560
Selling, general and administrative expense	1,944		25,815		(705) (18,681)	(B) (C)	8,373
Research and development expense	-		1,545				1,545
Depreciation and amortization	-		1,830		-	(D)	1,830
Interest expense	-		1,931				1,931
Loss before provision (benefit) for income taxes, minority interest and equity in net loss of affiliate	(1,744)		(23,761)		19,386		(6,119)
Provision for income taxes	1		-				1
Loss before minority interest and equity in net loss of affiliate	(1,745)		(23,761)		19,386		(6,120)
Minority interest	-		(43)				(43)
Equity in net loss of affiliate	-		291		(291)	(E)	-
Net loss	<u>\$ (1,745)</u>		<u>\$ (24,009)</u>		<u>\$ 19,677</u>		<u>\$ (6,077)</u>
Loss per share-basic and diluted							\$ (0.24)
Weighted average number of common shares outstanding –basic and diluted							25,085

(1) Represents the historical unaudited condensed results of Medical Advisory Systems, Inc. for the three months ended March 31, 2002.

(2) Represents the historical unaudited condensed consolidated results of Digital Angel Corporation for the six months ended June 30, 2002.

The unaudited pro forma condensed combined statement of operations for the six months ended June 30, 2002 gives effect to the combined results of operations for the period as if the merger of MAS and Advanced Wireless Group had occurred on January 1, 2002.

PRO FORMA ADJUSTMENTS FOR THE UNAUDITED PRO FORMA CONDENSED COMBINED STATEMENT OF OPERATIONS FOR THE SIX MONTHS ENDED JUNE 30, 2002 ARE AS FOLLOWS:

- (A) To conform revenue policy to that of Digital Angel Corporation.
- (B) Represents the reversal of expense incurred by MAS in connection with the merger transaction. This expense, reflected in the first quarter of 2002, is being reversed for purposes of these pro forma statements because it is a one-time, non-recurring charge.
- (C) Represents the reversal of non-cash compensation expense resulting from the conversion of Digital Angel options into shares of MAS common stock under the terms of the merger agreement. The conversion created a new measurement date for the valuation of the options. This expense, reflected in the first quarter of 2002, is being reversed for the purposes of these pro forma statements because it is a one-time, non-recurring charge.
- (D) The merger was accounted for under the provisions of Financial Accounting Standards Board (“FASB”) Statements No. 141, “Business Combinations,” and 142, “Goodwill and Other Intangible Assets.” For purposes of this presentation, it is assumed that the excess of fair value of Medical Advisory Systems’ assets and liabilities is goodwill. In accordance with FASB Statement No. 142, goodwill is not amortized.
- (E) Represents the elimination of the Advanced Wireless Group’s equity in loss of MAS for the three months ended March 31, 2002. The Advanced Wireless Group owned 16.6% of MAS.

DIGITAL ANGEL CORPORATION

**BOARD OF DIRECTORS
AND
EXECUTIVE OFFICERS**

Richard J. Sullivan – Chairman of the Board and Chief Executive Officer of Applied Digital Solutions, Inc.

Randolph K. Geissler – President and Chief Executive Officer of Digital Angel Corporation

Richard S. Friedland – Retired Executive Officer of General Instrument Corporation

Kenneth D. Larson – Chairman of the Board of Restaurant Technologies, Inc. and Chief Executive Officer of Classic Space, Inc.

Howard S. Weintraub, Ph.D. – Vice President, R&D, Corporate Staff for C.R. Bard, Inc.

James P. Santelli – Vice President Finance, Chief Financial Officer, Secretary and Treasurer of Digital Angel Corporation

Amro Albanna – President, Digital Angel Systems Division of Digital Angel Corporation