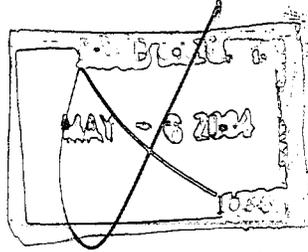


APLS

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PACE Medical, Inc.

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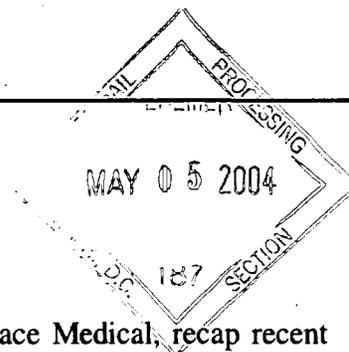
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2003 ANNUAL REPORT

*...dedicated to the improvement of patient care
without compromising the mandatory high
standards of quality and excellence.*



DEAR SHAREHOLDERS:

With this Annual Report, we hope to further acquaint you with Pace Medical, recap recent corporate developments, and highlight our plans for the future.

The Company experienced an increase in net sales for the year 2003 versus 2002 due to an increase in the Company's international business. We expect sales to improve during the year 2004 as the transition/restructuring period of our product line is completed. Several new and exciting temporary pacing devices, targeted for the year 2003, did not come to fruition. We expect, however, to have these new generation products available and approved for domestic marketing during the third and fourth quarters of 2004.

Our wholly-owned United Kingdom subsidiary, APC Medical Ltd., continues to be profitable and show increased revenues. It is well positioned to expand its international market presence throughout Europe, Eastern Europe, Middle East, India, Asia, and South America. APC Medical has a complete line of temporary cardiac pacemakers, a dual-chamber pacing analyzer, temporary pacemaker extension cables, disposable surgical extension cables, and related accessories. In addition, APC Medical offers a complete service/repair facility for our international customers.

In the coming months, we will concentrate our efforts on obtaining new product approvals and expanding our customer base in the United States and abroad. Also, our ISO 13485 certification from the British Standards Institution, Inc. enables us to CE mark our products and enhance our position as well as our reputation throughout the worldwide marketplace. We have in place the necessary ingredients — a highly-qualified management team, an established international distribution network, and a new generation of products soon to be introduced — to further penetrate the rapidly growing medical device marketplace.

We thank our valued shareholders for their continued support and confidence in Pace Medical, Inc.

Sincerely,

Ralph E. Hanson
Chairman, President and Chief Executive Officer

CORPORATE PROFILE

Pace Medical, Inc. has positioned itself to become a market leader by being the only company exclusively dedicated to designing, manufacturing, and marketing a complete line of high-quality temporary cardiac pacing products to meet the expanding needs of the medical profession worldwide. These products include both single and dual-chamber temporary cardiac pacemakers, a dual-chamber pacing analyzer, reusable temporary pacemaker extension cables, disposable surgical extension cables, and related accessories.

Our single-chamber temporary cardiac pacemakers include a Model 4170 Bedside™ which attaches to the patient's bedrail and miniature models that enable the patient to remain ambulatory during treatment. The Company's MICRO-PACE™, dual-chamber temporary cardiac pacemaker, is software programmable and capable of multi-parameter, multi-mode operation. It has the ability to sense and pace at high rates in the DDD mode; thereby, restoring A-V synchrony and improving cardiac output. The device will greatly assist the recovery of patients, regardless of age, who have very fast atrial heart rates (180-210 bpm) and who have developed temporary heart block, following open-heart surgery.

Our state-of-the-art AccuPace™, dual-chamber pacing analyzer, combines the benefits of dual-chamber multi-mode, multi-parameter pacing with testing features that evaluate, display, store, and print-out the important characteristics of the patient's lead system. The temporary pacing feature allows the physician to perform pre-implant stimulation studies of the basic pacing parameters and functions on the patient prior to the implantation of a permanent pulse generator. Once again, considerable attention has been paid to the "user-friendly" aspects of its operation.

Our line of disposable products—shrouded pin surgical extension cables and adapters—are designed to enhance our ability to offer a complete line of highly-competitive temporary pacing products to our customers.

APC Medical Ltd., our wholly-owned subsidiary in the United Kingdom, is well-positioned to expand our business throughout the European Economic Community (EEC) and elsewhere in Europe, Eastern Europe, Middle East, India, Asia, and South America. Like Pace Medical, APC Medical offers a complete line of temporary cardiac pacing products (some of which are uniquely its own), and related accessories. A complete service/repair facility is provided by APC Medical to address the needs of the Company's many international customers.

At present, Pace Medical has production facilities in both the United States and the United Kingdom. Our products are sold to both the domestic and international markets through independent sales representatives, distributors, and OEM accounts.

HISTORY AND BACKGROUND

Your Company began operations in March 1985, when we acquired APC Medical Ltd. from American Pacemaker Corporation, a wholly-owned subsidiary of Intermedics, Inc. APC Medical is the successor to Devices Ltd., a United Kingdom medical equipment manufacturer and pioneer in the pacing industry.

Our United Kingdom facility can accommodate extensive production expansion. Being located within the European Common Market also provides the Company with many international marketing advantages. Pace Medical's research and development is conducted at its corporate office in the U.S.A.

OUR BUSINESS

TEMPORARY CARDIAC PACEMAKERS, PACING ANALYZER, AND ACCESSORIES

Temporary cardiac pacemakers have three principal uses: therapeutic, prophylactic, and diagnostic. The most common use is therapeutic. For example, when a patient is admitted to a hospital with an inadequate or grossly irregular heart rhythm, a pacemaker stabilizes the rhythm and improves the rate. Prophylactic use describes the application of a pacemaker to a patient as a precaution when their condition is unstable. This too is common. Finally, pacemakers, particularly those which are more sophisticated, serve a valuable purpose as a diagnostic tool; assisting a physician in making a diagnosis or simply evaluating a specific condition in a patient.

In the United Kingdom, APC Medical Ltd. is the market leader for temporary cardiac pacemakers where we set the industry standard and supply the majority of the units sold. The Company manufactures two types of single-chamber, VVI, demand temporary pacemakers. These include a battery operated Model 4170 Bedside™ which attaches to a patient's bedrail and Models EV4542/43 miniature devices which enable patients to remain ambulatory during treatment. The MICRO-PACE, dual-chamber, temporary cardiac pacemaker in its most sophisticated mode, DDD, is designed to sense and pace in both the atria and the ventricles; thereby, restoring A-V synchrony and improving cardiac output. The growing reliance on dual-chamber pacing devices underscores physician recognition of the importance of A-V synchrony in those cardiac patients for whom increased cardiac output is needed.

The Model 4800, dual-chamber, pacing analyzer combines the benefits of dual-chamber, multi-mode, multi-parameter pacing with testing features that evaluate, display, store, and print-out the important characteristics of the patient's lead system.

REASONS TO USE A TEMPORARY PACEMAKER

1. In an emergency to control cardiac rhythm until a pacemaker can be implanted.
2. To stabilize a patient until drug therapy can take effect.
3. During surgery to control heart rate, maintain A-V synchrony and increase cardiac output when necessary.
4. After open-heart surgery until the heart recovers.
5. To ascertain the thresholds for pacing and sensing on a permanent lead in the absence of a properly functioning pacing analyzer.
6. To overdrive rapid atrial arrhythmias so that normal sinus rhythm may be re-established.

CURRENT PRODUCTS

MODEL 4570 MICRO-PACE™

THE MICRO-PACE, dual-chamber, temporary cardiac pacemaker utilizes a copyrighted software-based microprocessor design that is on the forefront of cardiac pacing technology. This design also provides the basis for the development of non-invasive electrical stimulation products.

This state-of-the-art temporary pacemaker has the ability to sense, pace, and track in the DDD mode at high-rates; thus, allowing cardiologists and surgeons to address the needs of post-operative, open-heart patients, regardless of their age. In particular, the device will greatly assist the recovery of both infants and young children, who have very fast atrial heart rates (180-210 bpm) and who have developed temporary heart block, following open-heart surgery.

In addition, the MICRO-PACE™ has a constant voltage output feature which greatly improves the ability to establish and maintain capture when using low impedance pacing leads such as heartwires. The amount of energy in micro joules delivered to the patient could be approximately three times that of constant current devices, thereby, preventing loss of capture.

MODELS 4170 BEDSIDE™

The Model 4170 Bedside™, single-chamber temporary cardiac pacemaker is housed in a rugged metal case and has "new generation" high-accuracy, digital electronic circuitry. The design features include control knobs for convenient, user-friendly operation, increased ranges for rate, output and sensitivity, a 15 volt maximum constant voltage output and a high-rate atrial pacing capability. In addition, a new FDA approved extension cable which is autoclavable with a universal patient connector is included with each bedside. This cable eliminates the need for any adapters

MODELS EV4542/EV4543 MINI-PACERS

Models EV4542 and EV4543 are single-chamber temporary cardiac pacemakers designed to provide acute therapeutic, prophylactic, and diagnostic pacing support. Both models are capable of operating in the demand or asynchronous mode and include adjustable rate, output, and sensing controls. The EV4543 has the added feature of a rate-tripling (x3) control which provides for high-rate pacing up to 450 ppm for use in rapid atrial stimulation.

The EV series pacemakers have constant voltage outputs which are capable of delivering more energy to the patient than similar constant current devices. This feature provides a definite advantage in establishing and maintaining capture when encountering low stimulation impedance in pacing leads.

All models are powered by standard 9-volt batteries and are compatible with most endocardial and myocardial lead systems. All devices come complete with carrying case, arm straps, extension cable, and instruction manual.

MODEL 4800 ACCUPACE™

The Model 4800 AccuPace™, dual-chamber, pacing analyzer combines the benefits of dual-chamber, multi-mode, multi-parameter pacing with testing features that evaluate, display, store, and print-out the important characteristics of the patient's lead system. The temporary pacing feature allows the physician to perform pre-implant stimulation studies of the basic pacing parameters and functions on the patient prior to the implantation of a permanent pulse generator. Considerable attention has been paid to the design of this product in the "user-friendly" aspects of its operation.

TEMPORARY CARDIAC PACEMAKER UNIVERSAL EXTENSION CABLES

The Model 4265, 4265A, and 4265V cables are approximately eight feet in length and are autoclavable. All cables on the patient end have molded, color-coded positive closure collet terminals in combination with color-coded, protected connector pin sockets. This allows for easy and reliable connection to heartwires or temporary pacing leads using 2 mm shrouded connector pins, without the use of adapters.

The device end has "booted" 2 mm connector pins that terminate in a molded, color-coded block positioned 1-1/4" on center. The molded silicone rubber "boots" slip over the pacemaker collet terminals during insertion. They freely rotate to tighten and/or loosen the collet terminals. All cables are designed for use with Pace Medical, Inc. and APC Medical Ltd. single and dual-chamber temporary cardiac pacemakers. The Models 5265, 5265A, and 5265V utilize a redel connector on the device end instead of the booted 2 mm connector pins.

TEMPORARY PACING ANALYZER EXTENSION CABLES

These are supplied either as disposable, single-use, sterile cables or permanent, multi-use, cables that are autoclavable. The Model 4250 disposable cable is 3.0 meters (10 feet) in length with color-coded 2 mm diameter shrouded connector pins on one end and alligator clips with insulating covers on the other end. They are packaged sterile, five per box. The Model 4255 and 4260 disposable cables utilize a redel connector on the device end and alligator clips or molded collect terminals on the other end for pacing lead connection.

The Model 4280, 4280A, and 4280V multi-use cables are 3 meters (10 feet) in length, autoclavable, and bifurcated on one end using color-coded insulated alligator clips with 2 mm diameter connector pins in a molded, color-coded block positioned 1-1/4" on center on the other end. The cables are provided with "booted" male connector pins. The molded silicone rubber "boots" slip over the caps of the collet terminals during connector pin insertion then freely rotate the boots to tighten and/or loosen the terminal caps. The Models 5280A and 5280V utilize a redel connector on the device end instead of the booted 2mm connector pins.

ADAPTERS

The Model 4815 adapter utilizes a redel connector for connection to our disposable cables (Models 4255 and 4260). It can easily be attached to the collet terminals located on the Models EV4543 and 4570 temporary cardiac pacemakers as well as the Model 4800 pacing analyzer.

With the Model 4825 universal adapter installed, the Model 4250 disposable surgical extension cable or temporary pacing leads, utilizing the 2 mm shrouded pin connector design, can be connected easily to Pace Medical's temporary cardiac pacemakers or pacing analyzer. The universal adapter also includes collect terminals that allow for exposed pins (heartwires, etc.) to be readily connected to the pacing devices.

NEW PRODUCTS

OTHER

Two "new generation" products: Model 4170 Bedside™, single-chamber, temporary cardiac pacemaker and Model 4580 Micro-pace, dual-chamber, temporary pacemaker have received FDA (SPMA) approval.

Several new state-of-the-art temporary cardiac pacing devices are in development. This line of "new generation" products will determine the future growth of the Company. They are targeted for introduction during the third and fourth quarters of 2004.

MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's Common Stock is quoted on the National Association of Securities Dealers, Inc.'s OTC Bulletin Board under the symbol PMDL. The following table sets forth, for the periods indicated, the closing quote on the OTC Bulletin Board. Such quotations reflect inter-dealer prices, without retail mark-up, mark-down, or commission, and may not reflect actual transactions.

	<u>Closing Quote</u>
Fiscal Year Ended December 31, 2002 (OTC)	
First Quarter	\$ 0.30
Second Quarter	0.35
Third Quarter	0.45
Fourth Quarter	0.20
Fiscal Year Ended December 31, 2003 (OTC)	
First Quarter	0.25
Second Quarter	0.27
Third Quarter	0.32
Fourth Quarter	0.29

There are approximately 81 record holders of the Company's Common Stock.

The Company has never paid any dividends and does not have any intention of paying any dividends in the foreseeable future.

**PACE MEDICAL, INC. AND WHOLLY-OWNED SUBSIDIARY
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL
CONDITION AND RESULTS OF OPERATIONS**

FINANCIAL CONDITION

As of December 31, 2003, the Company had cash and cash equivalents of \$1,060,791 and working capital of \$1,464,578. This contrasts to comparable cash and working capital positions at December 31, 2002 of \$1,115,690 and \$ 1,711,656.

Management continues to believe that the current level of working capital, coupled with the flexibility of the Company's cost structure, should suffice to ensure that its on-going operations are financed adequately in fiscal 2004. On this basis, management has no immediate plans to seek additional financing. In the long term, however, additional equity financing may be sought to continue to fund research and development and to expand the Company's marketing operation.

**RESULTS OF OPERATIONS—YEAR ENDED DECEMBER 31, 2003
VERSUS YEAR ENDED DECEMBER 31, 2002**

Sales increased from \$1,204,613 in 2002 to \$1,319,642 in 2003, primarily due to an increase in the Company's international business.

Gross margins for 2003 were approximately 37%. This was due to the product mix, unfavorable production variances and warranty accruals. As the Company moves into fiscal 2004, management expects the margin to improve over 2003.

Operating expenses increased from \$776,079 in 2002 to \$851,832 in 2003. This increase was primarily attributable to an increase in engineering and administrative expenses. Management believes that operating expenditures will increase slightly during fiscal year 2004.

The Company has reflected a tax provision of \$32,163 on its financial statements for 2003 representing taxes paid in the UK as APC Medical income. The Company lost approximately \$377,107 or \$0.11 per share for the year ended December 31, 2003. This contrasts with a 2002 loss of \$196,734 or \$0.06 per share.

INDEPENDENT AUDITORS' REPORT

To the Shareholders and Board of Directors
Pace Medical, Inc.
Waltham, Massachusetts

We have audited the accompanying consolidated balance sheets of Pace Medical, Inc. and subsidiary (the "Company") as of December 31, 2003 and 2002, and the related consolidated statements of operations, changes in shareholders' equity and comprehensive loss, and cash flows for the years then ended. 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 in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2003 and 2002, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Deloitte + Touche LLP

March 22, 2004

PACE MEDICAL, INC. AND SUBSIDIARY

**CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2003 AND 2002**

ASSETS	2003	2002	LIABILITIES AND SHAREHOLDERS' EQUITY	2003	2002
CURRENT ASSETS:			CURRENT LIABILITIES:		
Cash and cash equivalents	\$ 1,060,791	\$ 1,115,690	Accounts payable	\$ 326,419	\$ 219,506
Accounts receivable	13,973	91,840	Accrued expenses	125,852	90,656
Accounts receivable—related party	250,845	261,789			
Inventories:			Total current liabilities	452,271	310,162
Raw materials	257,019	290,266			
Work in process	179,766	146,180	COMMITMENTS AND CONTINGENCIES (Note 3)		
Finished goods	112,804	90,261			
Total inventories	549,589	526,707	SHAREHOLDERS' EQUITY:		
Prepaid expenses	41,651	25,792	Common stock, \$.01 par value—authorized, 5,000,000 shares, issued and outstanding, 3,400,870 shares	34,009	34,009
Total current assets	1,916,849	2,021,818	Additional paid-in capital	3,147,151	3,147,151
			Accumulated other comprehensive income	244,512	119,114
			Accumulated deficit	(1,659,123)	(1,282,016)
PROPERTY AND EQUIPMENT:			Total shareholders' equity	1,766,549	2,018,258
Machinery and equipment	55,516	55,100	Treasury stock, at cost (46,000 shares in 2003 and 2002)	(31,747)	(31,747)
Office furniture, equipment, and improvements	65,746	59,766	Shareholders' equity—net	1,734,802	1,986,511
Computer equipment	93,281	92,505			
Total property and equipment	214,543	207,371			
Less accumulated depreciation and amortization	(193,416)	(171,977)			
Property and equipment—net	21,127	35,394			
OTHER ASSETS—Net	249,097	239,461			
TOTAL ASSETS	\$ 2,187,073	\$ 2,296,673	TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 2,187,073	\$ 2,296,673

See notes to consolidated financial statements.

PACE MEDICAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS YEARS ENDED DECEMBER 31, 2003 AND 2002

	2003	2002
NET SALES:		
Customers	\$ 89,703	\$ 199,526
Related party	<u>1,229,939</u>	<u>1,005,087</u>
Total net sales	1,319,642	1,204,613
COST OF SALES	<u>835,275</u>	<u>623,382</u>
GROSS PROFIT	484,367	581,231
OPERATING EXPENSES:		
Selling, general, and administrative	649,321	609,545
Engineering/development	<u>202,511</u>	<u>166,534</u>
LOSS FROM OPERATIONS	(367,465)	(194,848)
OTHER INCOME—Primarily interest	<u>22,521</u>	<u>28,914</u>
LOSS BEFORE INCOME TAX EXPENSE	(344,944)	(165,934)
INCOME TAX EXPENSE	<u>32,163</u>	<u>30,800</u>
NET LOSS	<u>\$ (377,107)</u>	<u>\$ (196,734)</u>
NET LOSS PER SHARE—Basic and diluted	<u>\$ (0.11)</u>	<u>\$ (0.06)</u>

See notes to consolidated financial statements.

PACE MEDICAL, INC. AND SUBSIDIARY

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY AND COMPREHENSIVE LOSS
YEARS ENDED DECEMBER 31, 2003 AND 2002**

	Common Stock Shares	Value	Additional Paid-In Capital	Accumulated Deficit	Comprehensive Loss	Accumulated Other Comprehensive Income	Treasury Stock	Total Shareholders' Equity
BALANCE—January 1, 2001	3,400,870	\$ 34,009	\$ 3,147,151	\$ (1,085,282)		\$ 16,555	\$ (31,747)	\$ 2,080,686
Net loss				(196,734)	\$ (196,734)			(196,734)
Cumulative translation adjustments					102,559	102,559		102,559
Comprehensive loss					\$ (94,175)			
BALANCE—December 31, 2002	3,400,870	34,009	3,147,151	(1,282,016)		119,114	(31,747)	1,986,511
Net loss				(377,107)	(377,107)			(377,107)
Cumulative translation adjustments					125,398	125,398		125,398
Comprehensive loss					\$ (251,709)			
BALANCE—December 31, 2003	3,400,870	\$ 34,009	\$ 3,147,151	\$ (1,659,123)		\$ 244,512	\$ (31,747)	\$ 1,734,802

See notes to consolidated financial statements.

PACE MEDICAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS YEARS ENDED DECEMBER 31, 2003 AND 2002

	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$ (377,107)	\$ (196,734)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation and amortization	17,332	21,209
Unrealized foreign exchange transaction gain (loss)	8,780	(8,096)
Loss on disposal of fixed asset	804	
Changes in assets and liabilities:		
Accounts receivable	115,772	(129,384)
Prepaid expenses	(14,336)	1,925
Inventories	1,994	(65,171)
Accounts payable	98,028	83,515
Accrued expenses	27,361	(14,693)
Cash used in operating activities	(121,372)	(307,429)
CASH FLOWS USED IN INVESTING ACTIVITIES—Purchases of property and equipment	(11,790)	(84,017)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	78,263	70,770
DECREASE IN CASH AND CASH EQUIVALENTS	(54,899)	(320,676)
CASH AND CASH EQUIVALENTS—Beginning of year	1,115,690	1,436,366
CASH AND CASH EQUIVALENTS—End of year	<u>\$ 1,060,791</u>	<u>\$ 1,115,690</u>

See notes to consolidated financial statements.

PACE MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2003 AND 2002

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Consolidation—The consolidated financial statements include the accounts of Pace Medical, Inc. and its subsidiary, APC Medical Ltd. (“APC”), a United Kingdom company (“Pace” or the “Company”). The Company manufactures and sells temporary external pacemakers, related accessories, and temporary heart pacemaker leads to various customers throughout the world. All intercompany transactions, balances, and profits are eliminated.

Use of Estimates—The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Product Liability and Limits of Insurance Coverage—Because the Company’s temporary cardiac pacemakers and pacing analyzers may be life-supporting medical devices, the Company’s liability for any presently unknown product design or manufacturing deficiencies could be substantial and could exceed the limits under existing product liability insurance. The Company maintains product liability coverage outside the United States with annual limits of £1,000,000 (approximately \$1,779,000 as of December 31, 2003). The Company does not have product liability insurance in the United States. The Company believes, based upon management’s experience, that its liability exposure is lessened because it does not manufacture or sell permanent implantable cardiac pacemakers or leads. Management does not believe that any potential claims would therefore have a material impact on the financial condition or the results of operations.

Revenue Recognition—Sales are recognized when products are shipped, persuasive evidence of an arrangement exists, the sales price is fixed or determinable, and collectibility is reasonably assured. Historical experience has been such that no allowances for sales returns or bad debts are currently provided.

Cash and Cash Equivalents—Cash and cash equivalents include highly liquid investments with remaining maturities of three months or less at date of purchase.

Inventories—Inventories are stated at the lower of cost (first-in, first-out method) or market.

Property and Equipment—Property and equipment are stated at cost. Depreciation is recorded under the straight-line method based on the estimated useful lives of the related assets, ranging from three to seven years. Repairs and maintenance are expensed as incurred, while costs of betterments are capitalized. Depreciation expense approximated \$15,178 and \$16,252 for the years ended December 31, 2003 and 2002, respectively.

Other Assets—Other assets consist of deferred tooling costs, which are amortized using the straight-line method, primarily over five years. Amortization expense for 2003 and 2002 aggregated approximately \$2,154 and \$4,957, respectively. Accumulated amortization aggregated \$37,391 and \$35,237 at December 31, 2003 and 2002, respectively. The amortization expense for the next five years will be approximately \$5,000 per year.

Long-Lived Assets—The Company evaluates long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted net cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds the fair value of the assets.

Translation of Foreign Currencies—Assets and liabilities of APC are translated at exchange rates in effect on reporting dates, while income and expenses are translated at rates which approximate those in effect on transaction dates (generally the average rate for the period). Differences due to changing exchange rates are charged or credited to accumulated other comprehensive income (loss) in shareholders' equity. Gains and losses from foreign currency transactions are included in net income.

Income Taxes—Deferred taxes are provided for temporary differences between book and tax bases of the Company's assets and liabilities and loss and credit carryforwards based on tax rates and laws enacted as of the balance sheet date. The Company has provided a valuation allowance against net deferred tax assets due to uncertainty regarding the recoverability of tax carryforwards and other temporary differences.

Warranty—The Company warrants its temporary cardiac pacemakers for one year. The Company records a liability for specific warranty matters when they become known and are reasonably estimable. The Company's product warranty obligations are included in accrued expenses. The warranty reserve as of December 31, 2003 and 2002 was approximately \$100,000 and \$0, respectively.

Loss Per Share—The Company determines basic net loss per share using the weighted-average common shares outstanding for the year. The shares used to determine diluted net loss per share include the shares used in the calculation of basic net loss per share plus dilutive weighted-average options and warrants outstanding during the year using the treasury-stock method.

Comprehensive Loss—Comprehensive loss includes net loss and foreign currency translation adjustments.

Stock-Based Compensation—Compensation expense associated with awards of stock or options to employees is measured using the intrinsic-value method. Compensation expense associated with awards to nonemployees is measured using the fair-value method. No stock based compensation expense was recorded in 2003 and 2002. If the Company had used the fair value method to measure compensation, reported net loss would have been \$380,969 and basic and diluted net loss per share would have been \$(0.11) for the year ended December 31, 2003. The Company did not grant any stock options in 2002.

The fair value of stock options on their grant date was measured using the Black-Scholes option-pricing model. Key assumptions used to apply this pricing model are as follows in 2003: risk-free interest rate, 2.27%; expected life of the option grants, 4.5 years; expected volatility of underlying stock, 58%; and no expected dividend payment.

The option-pricing model used was designed to value readily tradable stock options with relatively short lives. The options are not tradable with contractual lives of up to five years. However, management believes that the assumptions used to value the options and the model applied yield a reasonable estimate of the fair value of the grants made under the circumstances.

Concentration of Credit Risk—The Company sells its products primarily to a limited number of distributors (see Note 7). The Company generally requires no collateral from its distributors.

2. RELATED-PARTY TRANSACTIONS

In March 1990, the Company entered into an agreement with APC Cardiovascular Ltd. (“Cardiovascular”). This agreement specified that Cardiovascular would act as Pace’s distributor in the United Kingdom. A director and significant shareholder of Cardiovascular is also a director of Pace. Sales to Cardiovascular amounted to \$1,229,939 and \$1,005,087 in 2003 and 2002, respectively (see Note 7). Receivables from Cardiovascular at December 31, 2003 and 2002 were \$250,845 and \$261,789, respectively.

3. COMMITMENTS AND CONTINGENCIES

Lease Obligations—APC leases its plant and office facility under a renewable operating lease which expires in 2006. The annual rent is £29,550 (\$48,613 at December 31, 2003). The lease requires payment of a pro-rata share of insurance and maintenance costs in addition to the rental payment. Future minimum rental payments under the lease total \$52,466 in each of the next five years.

On November 1, 2002, Pace entered into a lease agreement for its facility in the United States. The lease agreement was for a one-year term, from November 1, 2002 through October 31, 2003. On November 1, 2003, Pace became a tenant-at-will. Annual rent is approximately \$63,000.

Rental expense for all operating leases, including leases with terms of less than one year, amounted to approximately \$115,000 and \$122,000 in 2003 and 2002, respectively.

Contracts—The Company has entered into a three-year employment agreement with its chairman that provides for annual compensation of \$139,000. The agreement expires on May 31, 2004.

Contingencies—The Company is engaged in legal proceedings arising in the ordinary course of business. We believe that the ultimate outcome of these proceedings will not have a material adverse impact on our consolidated financial position, results of operations or cash flows.

4. INCOME TAXES

The provision for income taxes consists of the following for the years ended December 31:

	2003	2002
Current—foreign	\$32,163	\$30,800
Deferred:		
Federal		
State		
Foreign		
Provision for income taxes	<u>\$32,163</u>	<u>\$30,800</u>

A reconciliation of the statutory U.S. rate to the effective rate, expressed in dollars, for the years ended December 31 is as follows:

	2003	2002
Statutory U.S. rate	\$ (62,070)	\$ (63,000)
State taxes—net of federal benefit	(11,450)	(10,650)
Rate difference on foreign taxes	(76,870)	(22,500)
Valuation allowances provided	<u>182,553</u>	<u>126,950</u>
Provision for income taxes	<u>\$ 32,163</u>	<u>\$ 30,800</u>

Deferred tax assets and liabilities, before valuation allowances, at December 31 were as follows:

	2003	2002
Net operating loss carryforwards	\$ 1,029,800	\$ 829,950
Research and development credits	180,400	180,000
Inventory	25,200	28,000
Depreciation and amortization	(57,700)	(21,000)
Other	<u>3,803</u>	<u>(18,000)</u>
	<u>\$1,181,503</u>	<u>\$ 998,950</u>

Deferred tax assets have been fully reserved. Valuation allowances were increased by \$182,553 and \$126,950 in 2003 and 2002, respectively, principally due to the generation of loss carryforwards in the United States which are unlikely to be realized.

At December 31, 2003, Pace has federal income tax loss carryforwards for financial and tax reporting purposes of \$2,636,150, which will expire in the years 2004 through 2024, and state income tax carryforwards of \$1,405,300, which will expire in the years 2004 through 2009. Pace has no foreign loss carryforwards available to benefit income earned by APC.

5. SHAREHOLDERS' EQUITY

Stock Options—During 2003, by authorization of the Board of Directors, options were granted to purchase 35,000 shares of common stock under nonqualified stock option agreements. During 2002, no options were granted. The options were granted at the fair market value of the Company's common stock on the date of grant, vest at the date of grant, and are of a five-year duration. A summary of all stock option activity is as follows:

	Number of Options	Average Exercise Price	Average Fair Value
Outstanding and exercisable—January 1, 2002 and 2003	380,000	\$ 0.36	
Granted in 2003	35,000	0.24	\$ 0.11
Expired in 2003	<u>(35,000)</u>	<u>0.50</u>	
Outstanding and exercisable—December 31, 2003	<u>380,000</u>	<u>\$ 0.33</u>	
Outstanding and exercisable—December 31, 2002	<u>380,000</u>	<u>\$ 0.36</u>	

At December 31, 2003, the options outstanding and exercisable had weighted-average remaining contractual lives of 2.12 years.

Stock Repurchase Program—In March 1998, the Company announced a stock repurchase program pursuant to which the Company is authorized to acquire up to 100,000 shares of its common stock. As of December 31, 2003, 46,000 shares had been repurchased under the program for \$31,747.

6. NET LOSS PER SHARE

The following table sets forth the computation of basic and diluted net loss per share for the years ended December 31:

	2003	2002
Net loss	<u>\$(377,107)</u>	<u>\$(196,734)</u>
Weighted-average shares outstanding	<u>3,354,850</u>	<u>3,354,850</u>
Basic and diluted net loss per share	<u>\$ (0.11)</u>	<u>\$ (0.06)</u>

The impact of stock options have been excluded from the calculation of the weighted-average shares outstanding as they are anti dilutive due to the Company's net loss position at December 31, 2003 and 2002.

7. GEOGRAPHIC, SEGMENT, AND CUSTOMER DATA

The Company primarily manages its business based on geographic regions consisting of the United States and the United Kingdom through which it sells its external pacing devices and accessories. Geographic and segment data is set forth in the following table:

	United States	United Kingdom	Eliminations	Consolidated
2003				
Sales and transfers	\$ 333,030	\$ 1,297,007	\$ (310,395)	\$1,319,642
Depreciation and amortization	5,831	11,501		17,332
Net loss	(396,572)	19,465		(377,107)
Other income—primarily interest	4,507	18,014		22,521
Capital expenditures	11,790			11,790
Long-lived assets	254,735	15,489		270,224
Total assets	776,504	1,410,569		2,187,073
2002				
Sales and transfers	\$ 445,349	\$ 1,081,019	\$ (321,755)	\$1,204,613
Depreciation and amortization	9,266	11,943		21,209
Net (loss) income	(323,157)	126,423		(196,734)
Other income—primarily interest	10,810	18,104		28,914
Capital expenditures	78,576	5,441		84,017
Long-lived assets	249,580	25,275		274,855
Total assets	1,045,088	1,251,585		2,296,673

Transfers between areas are valued at cost plus a markup. Direct sales to foreign customers from domestic operations were not material.

Sales to major customers for the years ended December 31 were as follows:

	2003		2002	
	Amount	Percent	Amount	Percent
Cardiovascular (related party)	\$ 1,229,939	93%	\$ 1,005,087	83%

During 2003 and 2002, only sales to the one customer accounted for more than 10% of the net sales.

* * * * *

BOARD OF DIRECTORS

Ralph E. Hanson

Chairman, President & Chief Executive Officer, Pace Medical, Inc.

Derrick Ebden

Managing Director, APC Cardiovascular Ltd., England

George F. Harrington

President, Boston Equity Management Company

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Ralph E. Hanson

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APC MEDICAL LTD., ENGLAND

BOARD OF DIRECTORS

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Director

Steven E. Hanson

Director

COUNSEL

Lynch, Brewer, Hoffman & Fink, LLP

Boston, Massachusetts 02110

AUDITOR

Deloitte & Touche LLP

Boston, Massachusetts 02110

TRANSFER AGENT

American Stock Transfer & Trust Company

New York, New York 10022

INVESTOR RELATIONS

Web site: www.pacemedicalinc.com

ANNUAL REPORT TO SEC

The Form 10-K Annual Report to the Securities and Exchange Commission provides certain additional information and is available to Pace Medical, Inc.'s shareholders without charge. Written requests should be addressed to:

Pace Medical, Inc.

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Waltham, MA 02451

OTC BULLETIN BOARD SYMBOL: PMDL

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