



PINNACLE DATA SYSTEMS, INC.

2004 ANNUAL REPORT TO SHAREHOLDERS

PINNACLE DATA SYSTEMS, INC.

2004 ANNUAL REPORT

CONTENTS

A Message from Our CEO	1
The Company	3
Five Year Selected Financial Information	4
Management's Discussion and Analysis or Plan of Operation.....	5
Financial Statements	
Balance Sheets – December 31, 2004 and 2003	12
Statements of Income – Years Ended December 31, 2004 and 2003	14
Statements of Changes in Stockholders' Equity – Years Ended December 31, 2004 and 2003.....	15
Statements of Cash Flows – Years Ended December 31, 2004 and 2003	16
Notes to Financial Statements	18
Report of Independent Registered Accounting Firm.....	27
Market for Common Equity and Related Stockholder Matters	28
Corporate Information.....	Inside Back Cover

A MESSAGE FROM OUR CEO

To Our Shareholders

In many respects, 2004 was a break-out year for our company. Implementation of growth strategies focused on Fortune Global 500 companies, initiatives to take advantage of the trend toward business process outsourcing, and efforts to broaden our scope of service offerings started to generate significant results. For the year, we achieved a new annual sales record of \$34.4 million and our third consecutive year of earnings improvement. Sales and net income for the 2004 year were up 50% and 87%, respectively, compared to 2003.

We continued to make significant progress implementing our growth strategies in 2004, gaining new global customers in the medical, telecommunications and computer equipment industries, forging partnerships that expand our marketing, technological and geographical capabilities, and improving the scalability of our organization. New customer programs included a major repair program for Silicon Graphics, Inc. ("SGI"), a global Original Equipment Manufacturer ("OEM") of high-performance computing, visualization and storage equipment, and the hardware management of a large home-based computer-learning program. Underscoring our commitment to providing the highest levels of quality and service in our industry as we grow, we achieved ISO registration for the medical (ISO13485) and telecommunications (TL9000) industries, and received the 2004 Sun Microsystems Supplier Performance Award for Best in Class Service. Committed to the future growth of our company, we've reorganized our management team at multiple levels to take better advantage of individual strengths and improve the scalability of our organization, including the promotion of an experienced leader in the growth of small companies, Christopher Winslow, to President and Chief Operating Officer.

PDSi is an outsourced provider of product lifecycle service solutions for OEMs whose products contain electronics. We manage extended product lifecycles. This is especially important for OEMs in the medical, telecommunications, defense and imaging industries, where there is a major market need that is in conflict with the traditional business models of the computer industry. The product lifecycles of these OEMs can span up to twenty years from initial development to end-of-life, whereas the lifecycle of the products supplied by the computer industry is typically 18-36 months. Historically, these OEMs bridged this gap by maintaining aggressive control of their supply chain and after-market support by performing the work themselves. This involved designing and manufacturing their own computers, as well as managing the inventory, returns and repairs of those computers over the lives of the products in which they were incorporated. Over the past decade, the trend has moved away from this approach. At first, the OEMs continued to do the design and manage the customer-interfacing activities, only outsourcing the manufacturing to others. More recently, they also used suppliers to outsource the design and moved toward the customization of off-the-shelf products while continuing to manage the logistics and customer contact themselves. Today, OEMs outsource almost any and all functions other than those directly involved with the development of their most coveted intellectual property.

We are taking advantage of this trend through a business model that supports both the OEMs and the computer manufacturers that serve them. Over the years, we have developed a portfolio of technological competencies, services, selling strategies and program management processes that allow us to offer a strong value proposition to the markets we serve. Our ability to convert new business opportunities is increasing and is expected to benefit over time from new platforms developed with our technology partners and new services based on the needs of, and developed with, our growing customer base.

We compete primarily with contract manufacturers and value-added computer resellers, as well as independent engineering and repair organizations. The estimated global revenue potential for the services we can provide exceeds \$200 billion. A market that large provides an immense number of opportunities, allowing us to focus where and how we want to, and can best, compete to gain the revenue growth and operating leverage we want to achieve. A major competitive advantage we possess is offering a broad range of technical services and capabilities combined with sophisticated and customized program management systems and processes.

As our total sales continue to grow, the mix between our various product and service sales, gross profit dollars, gross profit margins and demand from the large customer programs we operate may fluctuate significantly from quarter to quarter and in year-over-year comparisons of quarterly numbers. That is why, at this stage of our growth, we focus on improvement in annual sales and earnings. To increase the long-term value of our company, we recognize the need to balance requirements and opportunities to reinvest in the business with our commitment to improved profitability. The opportunities we have identified in our markets, coupled with the results of our sales and marketing efforts and the improvement in the scalability of our organization over the past two years, are the basis for the excitement we share about the future growth opportunity at PDSi.

Our goal is to sustain an average annual sales growth rate of approximately 25% over the next five years, achieving annual sales exceeding \$100 million by 2009, and, with additional operating leverage, significant earnings growth as well. Towards that goal, we are targeting sales growth in the 20-25% range and another profitable year in 2005, as we continue to increase our market presence and build a more scalable, market and customer-driven organization.

Thank you for your interest, investment and support. Our gratitude also extends to our supportive network of customers, technology partners, and suppliers, our employees and board of directors for their continued dedication and hard work to build this company.

We hope you will join us for our Annual Shareholders Meeting in Grove City, Ohio on May 5, 2005.

Respectfully,

A handwritten signature in cursive script that reads "John D. Bair". The signature is written in black ink and is positioned above the printed name and title.

John D. Bair
Chairman and CEO

THE COMPANY

Pinnacle Data Systems, Inc. is located at 6600 Port Road, Groveport, Ohio 43125. We provide product lifecycle service solutions to Original Equipment Manufacturers (“OEMs”) in the medical, telecommunications, defense, imaging and computer equipment industries, among others. We offer a full range of computer and computer-related product development and manufacturing services to increase product speed to market and engineered product life, and to provide service and support to units in the field through comprehensive product lifecycle management programs encompassing depot repair, advanced exchange, contact center support and end-of-life control. For the fiscal year ended December 31, 2004, our operations are reported in two business segments: Product and Service.

Product

Our products are custom-engineered to meet specific customer or niche-industry requirements that generally cannot be met by an off-the-shelf solution. They are sold to OEMs and then typically resold to end-users as components of the OEMs’ final products. Our products are usually developed as a result of us helping OEMs design, engineer, manufacture, assemble, modify, and/or integrate computer systems or components to fit their specific application needs. Many of our products are based on the high performance computer processing technologies of Sun Microsystems, Inc. (“Sun”), Intel Corporation (“Intel”) and Advanced Micro Devices, Inc. (“AMD”), three of world’s leading producers of computer components and systems. We combine their products and other vendor off-the-shelf computer components or peripherals with technologies that we engineer and develop, such as customized circuit boards, enclosures, power supplies and other engineered components and software. By leveraging our expertise and experience in engineering and integrating our internally developed products with Sun, Intel, AMD and other vendors’ technologies, we are able to offer product solutions with minimal product design and engineering costs to our customers.

Our end-of-life product management service allows our customers to maximize their investment in technology by providing continued support for products no longer in production or supported by the original manufacturer. This allows our customers to eliminate or delay the engineering, software development and re-certification charges required to integrate new technology into their products. For example, when a computer board manufacturer stops manufacturing a particular board, its OEM customers are left with few alternative sources for the boards they need to continue building or repairing their products. We can provide the boards, purchased from a number of available sources, either new or refurbished, or we can redesign a new board with the same form, fit and function with components that are readily available at the time.

We are a SunSoft Master Distributor authorized to provide our customers with the right to use Solaris, Sun Microsystem’s UNIX operating system. We are an authorized Intel Product Dealer and have earned Intel Premier Provider status for our distinct level of competency with Intel technologies. We are an authorized AMD Solution Provider. We are the North American reseller of Agilent remote diagnostic solutions, selected for our engineering and design capabilities. We are an authorized HP Business Development Partner. We are also licensed by Microsoft to distribute embedded Microsoft operating systems.

Service

We offer complete service and support for several OEMs’ products, as well as our own, including testing, repair, inventory and logistics management services. Depot repair and testing services are provided for advanced technology systems, printed circuit board assemblies, and other computer peripherals and components, where the suspect non-functioning equipment is sent to our designated depot location for testing and repair, if required. We also manage “advanced-exchange” repair programs. Our highest volume testing and repair is performed on complex printed circuit boards and electro-mechanical data storage devices for Sun, Hewlett-Packard Company and Silicon Graphics, Inc., and on standard PC configurations for a large home-based computer learning program. For our largest OEM customers, we maintain and share online information management systems that seamlessly connect our companies.

We consider our Product and Service segments to be complementary. New product development keeps our engineers and service technicians on the forefront of technologies being sold that generate new service opportunities. Our services provide a competitive advantage in selling our products since the entire infrastructure is already in place to provide high quality service and support before and after the sale.

FIVE YEAR SELECTED FINANCIAL INFORMATION
(in thousands, except earnings per share)

		2004	2003	2002	2001	2000
FINANCIAL RESULTS						
Sales	Total	\$ 34,397	\$ 22,884	\$ 15,674	\$ 22,672	\$ 25,316
	Products	28,351	15,595	8,367	18,261	21,048
	Services	6,046	7,289	7,307	4,411	4,268
Gross profit	Total	\$ 8,015	\$ 6,038	\$ 4,609	\$ 4,420	\$ 6,388
	Products	5,698	3,594	1,610	3,419	4,603
	Services	2,317	2,444	2,999	1,001	1,785
Gross profit margin %	Total	23.3%	26.4%	29.4%	19.5%	25.2%
	Products	20.1%	23.0%	19.2%	18.7%	21.9%
	Services	38.3%	33.5%	41.0%	22.7%	41.8%
Operating expenses		\$ 6,616	\$ 5,147	\$ 4,500	\$ 5,191	\$ 4,541
Income (loss) from operations		\$ 1,399	\$ 891	\$ 109	\$ (771)	\$ 1,847
Interest expense		\$ 113	\$ 85	\$ 128	\$ 351	\$ 229
Net income (loss)		\$ 884	\$ 473	\$ (19)	\$ (690)	\$ 1,014
Basic earnings (loss) per share		\$ 0.16	\$ 0.09	\$ (-)	\$ (0.13)	\$ 0.20
Diluted earnings (loss) per share		\$ 0.14	\$ 0.08	\$ (-)	\$ (0.13)	\$ 0.18
FINANCIAL POSITION						
Current assets		\$ 9,381	\$ 7,787	\$ 5,683	\$ 7,709	\$ 14,280
Net fixed assets		\$ 971	\$ 1,086	\$ 1,334	\$ 1,446	\$ 1,174
Current liabilities		\$ 5,219	\$ 4,813	\$ 3,418	\$ 5,564	\$ 11,141
Long-term liabilities		\$ 101	\$ 55	\$ 93	\$ 98	\$ 208
Stockholders' equity		\$ 5,055	\$ 4,036	\$ 3,552	\$ 3,546	\$ 4,124
Current ratio		1.8	1.6	1.7	1.4	1.3
Long-term debt to equity ratio		0.0	0.0	0.0	0.1	0.1
Return on equity		19.4%	12.5%	(0.5)%	(18.0)%	31.0%

MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

The following discussion should be read in conjunction with the Financial Statements and Notes contained herein.

This annual report, including the following sections, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. The words "believe," "expect," "anticipate," "estimate," "project," "should," and similar expressions identify forward-looking statements that speak only as of the date thereof. Investors are cautioned that such statements involve risks and uncertainties that could cause actual results to differ materially from historical or anticipated results due to many factors. Such factors include, but are not limited to, adverse changes in general economic conditions, including adverse changes in the specific markets for our products and services, adverse business conditions, decreased or lack of growth in the computing industry, adverse changes in customer order patterns, including any decline or change in product orders from large customers like the four customers that made up approximately 52% of our revenue during 2004, increased competition, any adverse change in our business or our relationship with major technology partners, around whose computing platforms large portions of our business are based, lack of acceptance of new products, pricing pressures, lack of adequate financing to take advantage of business opportunities that may arise, lack of success in technological advancements, risks associated with our new business practices, processes and information systems, and other factors, including those discussed under "Risk Factors" on page 11 of this report.

OVERVIEW

Pinnacle Data Systems, Inc. ("PDSi" or the "Company") provides product lifecycle service solutions to Original Equipment Manufacturers ("OEMs") in the medical, telecommunications, defense, imaging and computer equipment industries, among others. We offer a full range of computer and computer-related product development and manufacturing services to increase product speed to market and engineered product life, and to support units in the field through comprehensive product lifecycle management programs encompassing depot repair, advanced exchange, contact center support and end-of-life control.

As an outsourced service provider, we manage the extended product lifecycle required by OEMs in these industries to satisfy a major market need that exists in the computer industry.

Major developers of computer technology and products, like Sun Microsystems, Inc., Intel, Advanced Micro Devices, Hewlett Packard, among others, have a business model in which the primary target market consists of corporate IT data centers and large scale users of corporate worker desktop or laptop workstations. To capture the next capital dollar spent by this market, the computer manufacturers must offer the latest technologies and performance features. To do this economically and competitively, the manufacturer must maintain economies of scale and, as such, limit their product offerings by generally discontinuing older products that have been in the market 18-36 months.

Contrast that to the model employed by OEMs in the medical, telecommunications, defense and imaging equipment industries that embed computer products into their own marketable solutions. Their model involves extensive research and development investment to develop unique intellectual property, with extensive validation and testing to ensure their products' effectiveness and safety, and significant product launches to develop significant market demand. New product development and time to market can span two to eight years. To financially justify this level of investment, OEMs need to market and sell their products for at least five to ten years, and their customers will want that product to be supported for eight to ten years beyond the time of purchase to recover their investment. The computers that are embedded in these types of very sophisticated OEM equipment are mission critical, serving as the controller or user interface to the system, but they do not contain the intellectual property or the competitive advantage of the product. When the computer manufacturer revises their product eight to ten times over the life of the OEM's product life, the OEM must either update the technology in their equipment incurring significant redesign, product and process engineering, and recertification costs for each revision just to keep up, or they must be able to supply the original technology with only one to two revisions over the life of their product. In the case of medical equipment manufacturers, updating their product for every revision of the embedded computer is all but impossible to justify over the life of their product; a life that may span up to twenty years.

To solve this problem, major OEMs have historically maintained aggressive control of their supply chain and after-market support by performing much of the work themselves. This involved designing and manufacturing their own computers, and managing their own inventory, returns and repairs of them.

Over the past decade, the trend has continued to move away from this model. At first, the OEMs continued to do the design and manage the customer-interfacing activities, only outsourcing the manufacturing to others. Later, they used suppliers to outsource the design and moved toward the customization of off-the-shelf products, while continuing to manage the logistics and the customer contact. Now, OEMs look to outsource almost any and all functions other than those directly involved with the development of intellectual property.

We have taken advantage of this trend by developing a business model that supports both the OEMs and the computer manufacturers that serve them. Over the years, we have developed a portfolio of technological competencies, services, selling strategies and program management processes that have allowed it to offer a strong value proposition to the markets it serves.

Our strategy is to focus on Fortune Global 500 companies, take advantage of the trend toward business process outsourcing, and broaden our scope of service offerings. This has given us a strong foundation and ability to convert significant opportunities. We compete in the contract manufacturing industry and the value-added computer reseller market, as well as with independent engineering and repair organizations. The combined markets for these services exceeds \$200 billion and the competition ranges from \$10 billion multinational organizations to small local businesses. We compete by offering services of these different industries in combination with sophisticated and customized program management systems and processes.

We increased sales 50% in 2004 after growing sales 46% in 2003. Earnings grew 87% in 2004, after achieving our second most profitable year in our history in 2003. In 2004, we earned new business from world-leading medical, telecommunications and imaging equipment OEMs. We achieved ISO13485 and TL9000 registration further qualifying us for outsourcing in the medical and telecommunications equipment markets. We won the repair and logistics programs of a world-leading OEM of high-performance computing, visualization and storage equipment, Silicon Graphics, Inc., and a home-based computer learning program, as well as earning Sun Microsystems 2004 Best in Class Award for outstanding performance in repair and logistics support. We also forged new partnerships that expand our marketing, technological and geographical capabilities.

We believe we can refine and execute this business model and sustain an average annual sales growth rate of approximately 25% over the next five years, achieving an annual sales level exceeding \$100 million and, with additional leverage, significant earnings growth as well. Towards that goal in 2005, we expect sales to increase 20-25% and for the year to be profitable, as we continue to build our market presence and improve the scalability of our organization.

The following discussions and analyses are for the year ended December 31, 2004 compared to the year ended December 31, 2003.

SALES

Sales for 2004 and 2003 were as follows:

	<u>Year</u>		<u>%</u>
	<u>2004</u>	<u>2003</u>	<u>Change</u>
	(\$ thousands)		
Total company	\$34,397	\$22,884	50%
Product	28,351	15,595	82%
Service	6,046	7,289	(17%)

The increase in product sales for 2004 was due to increased shipments to medical, telecommunications and imaging customers, which more than offset lower shipments to defense and industrial control customers. Service sales decreased and were less than projected because sales to two of our larger repair customers declined in 2004 and certain projected service sales are being reported as product sales due to changes in the customers' actual versus projected programs. Services sales in the second half of 2004 were bolstered by the startup of a new OEM repair customer and a new hardware management program.

For 2004, we had three customers that generated revenues of approximately \$5,694,000, \$5,688,000, and \$3,877,000 or 17%, 17%, and 11% respectively, of total revenue. In the statements of operations, approximately \$405,000 of the revenues from these customers is included in service sales and \$14,853,000 is included in product sales. In addition, these customers represented 15%, 10%, and 3%, respectively, of accounts receivable at December 31, 2004.

GROSS PROFIT

Gross profits for 2004 and 2003 were as follows:

	<u>Year</u>		<u>%</u>
	<u>2004</u>	<u>2003</u>	<u>Change</u>
	(\$ thousands)		
Total company	\$8,015	\$6,038	33%
Product	5,698	3,594	59%
Service	2,317	2,444	(5%)

The gross profits margin percentage for 2004 and 2003 were as follows:

	<u>Year</u>	
	<u>2004</u>	<u>2003</u>
Total company	23%	26%
Product	20%	23%
Service	38%	34%

While the increase in product sales volume resulted in the increase in gross profit dollars on product sales, product sales to newer customers generally were lower value-added sales and, therefore, had lower margins than the product sales in older customer programs.

The increase in the gross profit margin percentage for service sales was due to a change in the mix of service programs and partially offset the volume loss effect on gross profit dollars on service sales.

OPERATING AND INTEREST EXPENSES

Operating expenses include selling, general and administrative (SG&A) expenses. Operating and interest expenses for 2004 and 2003 were as follows:

	<u>Year</u>		<u>%</u>
	<u>2004</u>	<u>2003</u>	<u>Change</u>
	(\$ thousands)		
SG&A expense	\$6,616	\$5,147	29%
Interest expense	113	85	33%
Total expense	<u>\$6,729</u>	<u>\$5,232</u>	29%

We increased sales and marketing expenses in the second half of 2004 consistent with our targeted growth strategy. As a result, operating expenses rose from 2003 levels, as planned. The 29% increase in operating expenses was significantly less than the 50% increase in sales. Operating expenses were 19% of sales in 2004, down from 22% in 2003.

In 2004, an increased use of the credit line due to higher levels of receivables and inventory to support the higher sales volume combined with higher interest rates resulted in higher interest expense compared to 2003. The average daily balance on the line of credit increased to \$2.6 million in 2004 from \$1.9 million in 2003. Interest rates paid on the line of credit ranged from 4.00% to 5.25% in 2004, and from 4.00% to 4.50% in 2003.

INCOME TAXES AND NET INCOME

The effective tax rate used for 2004 was 31%, compared to 41% in 2003, reflecting an increase in foreign sales and the use of the extra-territorial income tax incentive.

Income before taxes, income taxes and net income for 2004 and 2003 were as follows:

	<u>Year</u>	
	<u>2004</u>	<u>2003</u>
	(\$ thousands)	
Income before		
income taxes	\$1,286	\$806
Income tax expense	402	333
Net income	<u>\$884</u>	<u>\$473</u>

Earnings per share for 2004 and 2003 were as follows:

	<u>Year</u>	
	<u>2004</u>	<u>2003</u>
EPS:		
Basic	\$0.16	\$0.09
Fully diluted	\$0.14	\$0.08
Weighted average number of shares outstanding:		
Basic	5,572,811	5,526,978
Fully diluted	6,121,675	5,834,551

The improvement to net income in 2004 reflected the 50% increase in sales and the resulting increase in gross profit from additional operating leverage, which exceeded the planned increase in selling, general and administrative expenses.

LIQUIDITY AND CAPITAL RESOURCES

A summary of changes in current assets for 2004 and 2003 follows:

	<u>12/31/04</u>	<u>12/31/03</u>	<u>% Change</u>
	(\$ thousands)		
Accounts receivable	\$4,398	\$5,127	-14%
Inventory	4,080	2,023	102%
Other current assets	903	637	42%
Total	<u>\$9,381</u>	<u>\$7,787</u>	20%

A summary of changes in current liabilities for 2004 and 2003 follows:

	<u>12/31/04</u>	<u>12/31/03</u>	<u>% Change</u>
	(\$ thousands)		
Line of credit	\$2,525	\$2,487	2%
Accounts payable	2,177	1,866	17%
Other current liab.	517	460	12%
Total	<u>\$5,219</u>	<u>\$4,813</u>	8%

During 2004, \$94,000 of cash was used by operating activities. Net income before depreciation and amortization, provision for doubtful accounts, inventory reserves, and provision for deferred taxes was \$1,707,000. Additional cash was generated by reductions in accounts receivable of \$728,000 and a combined increase in accrued expenses and unearned revenue of \$51,000. The amount of cash otherwise generated by operating activities was more than offset by an increase in inventory of \$2.4 million, and a combined increase in prepaid expense and other current assets of \$174,000. The increase in inventory was primarily attributable to two new multi-year customer programs that required a substantial investment in inventory in order to conduct those programs. In both programs, agreements minimize our risk of inventory loss and our revenue includes charges for carrying the extra inventory. Without those two programs, our increase in total inventory over 2004 would have been significantly less than the increase in total revenue.

In 2004, we used \$344,000 of cash to purchase equipment, including computers and software, primarily to support new product customers and a new OEM service program. The 50% increase in sales, the planned increases in operating expenses, and the investment in new inventory and fixed assets were mostly financed by our own operations, with only a \$38,000 increase to our line of credit balance, representing a 2% increase in the line balance over 2003. We also converted \$76,000 of inventory to computer equipment in 2004.

The line of credit, which is our primary source of operational and non-operational funding, is maintained with KeyBank National Association and is payable on demand and collateralized by a "Blanket Lien" on all of our assets. The amount available under the line of credit is subject to borrowing base restrictions and other financial covenants as outlined in the agreement.

The aforementioned borrowing base on the line of credit is calculated as 85% of eligible accounts receivable and 50% of inventory value, net of reserves. The line has an overall limit of \$6,000,000 as well as a sub-limit of \$3,000,000 that can be collateralized by inventory. That calculation represents the maximum amount that can be drawn on the line of credit. The balance on the line of credit at December 31, 2004 was \$2,525,000. The borrowing base calculation on that date was \$5,776,000, resulting in an unused capacity of \$3,251,000. We are not currently, and do not expect at this time to be, constrained by our credit limits. We were in compliance with all covenants of the line for the entire year of 2004.

On December 28, 2004, the line of credit was renewed until May 15, 2006. The maximum limit of the line was increased to \$6,000,000 from \$5,000,000, with the variable interest rate continuing at prime. As the line of credit is our primary source of financing, it is critical to our short-term liquidity. To maintain a sufficient borrowing base to meet our needs and meet the covenant requirements of the line, we must maintain sales and gross profit levels with minimum inventory on hand, and effectively manage cash flow from collections to payments. Significant delays or loss of customer orders, or delayed customer payments, could impact our ability to meet our short-term financial obligations. Inventory reductions also reduce our borrowing base, thereby limiting our capacity for short-term borrowing. This would include reductions in inventory due to changes in the valuation of our inventory and the setting of appropriate inventory reserves to reflect changes in technology or reduced customer requirements.

Additional financing may be needed to support the future growth plans of the Company. The Company is evaluating an acquisition strategy that may be financed by the issuance of additional common or preferred stock that has already been authorized by the shareholders. Those shares may be issued by approval of the Board of Directors. Acquisitions being evaluated provide services similar to those of the Company that are, or can be made, accretive in a short period of time; that bring large OEM customer relationships with potential additional business for the combined company (that neither company would get on their own); and that bring resources, in terms of people, processes and systems, that increase the scalability of the combined businesses.

OFF-BALANCE SHEET ARRANGEMENTS

We have no off-balance sheet arrangements with any obligation under a guarantee contract, or a retained or contingent interest in assets or similar arrangement that serves as credit, liquidity or market risk support for such assets, or any other obligation, including a contingent obligation, under a contract that would be accounted for as a derivative instrument.

At any given point in time in the normal course of business, we have numerous outstanding purchase orders with our vendors to purchase inventory for use in the products that we sell to our customers or to use in performing repair services for our customers. Such orders are not recorded as liabilities in our balance sheet until the material is physically received from the vendors. We have no minimum purchase quantity requirements with any of our vendors.

We lease our operating facility under an operating lease in which we have an obligation to pay rent through 2009. See Note 6 to the financial statements contained in our Form 10-KSB for the year ended December 31, 2004. Except for that operating lease, we have not entered into any off-balance sheet transactions in 2004 and 2003.

Total rent charged to operations for operating leases and other month-to-month rental obligations for the years ended December 31, 2004 and 2003 amounted to \$689,576 and \$616,230, respectively.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make judgments, assumptions and estimates that affect the amounts reported in the Financial Statements and accompanying notes. Note 1 to the Financial Statements in the Annual Report on our Form 10-KSB for the year ended December 31, 2004 describes the significant accounting policies and methods used in the preparation of the Financial Statements. Estimates are used for, but not limited to, the accounting for allowance for doubtful accounts and inventory reserves. Actual results could differ from these estimates. The following critical accounting policies are impacted significantly by judgments, assumptions and estimates used in the preparation of the Financial Statements.

For product sales, we recognize revenue upon transference of the title to the products to the customer. For repair sales, we recognize revenue upon completion of the repair work and either shipment of the item back to the customer or, in the programs in which we also manage the customer's inventory on our site, when we return the repaired item to the customer's finished goods inventory. For some repair and maintenance programs, the customer pays a flat fee that covers multiple fiscal periods. In those instances, we recognize revenue over the fiscal periods covered by the billing on a pro-rata basis. Our inventory and logistics management programs are billed monthly, with revenue recognized upon billing. For non-recurring engineering projects, we recognize revenue on a percentage-of-completion basis.

The allowance for doubtful accounts is based on our assessment of the collectibility of specific customer accounts and the aging of the accounts receivable. If there is a deterioration of a major customer's credit worthiness or actual defaults are higher than our historical experience, our estimates of the recoverability of amounts due to us could be adversely affected.

Inventory purchases and commitments are based upon future demand forecasts. If there is a sudden and significant decrease in demand for our products or there is a higher risk of inventory obsolescence because of rapidly changing technology and customer requirements, we may be required to increase our inventory allowances and our gross margin would be adversely affected.

RISK FACTORS

If we are unable to compete effectively with existing or new competitors, the loss of our competitive position could result in price reductions, fewer customer orders, reduced revenues, reduced margins, reduced levels of profitability, and loss of market share. If we are unable to manage our inventory, will not be able to satisfy customer demand. Our reliance on one or a few suppliers for inventory components could delay shipments and increase our costs. Our future operating results depend on our ability to purchase a sufficient amount of components to meet the demands of our customers. Since we may order components from suppliers in advance of receipt of customer orders for our products that include these components, we could face a material inventory risk. Our products may have quality issues that could adversely affect our sales and reputation. We are dependent on significant customers, as noted in the “SALES” section above.

We depend on key employees and face competition in hiring and retaining qualified employees. Recent and proposed regulations related to equity compensation could adversely affect our ability to attract and retain key personnel.

We expect our quarterly revenues, cash flows and operating results to fluctuate due to the fact that our quarterly sales have historically reflected a pattern in which a disproportionate percentage of such quarter’s total sales occur in the last month and weeks and days of the quarter. This pattern makes prediction of revenues, earnings and working capital for each financial period especially difficult and uncertain and increases the risk of unanticipated variations in quarterly results and financial condition.

Business interruptions could adversely affect our business. Environmental regulations and costs could result in significant liabilities for us. Our credit rating is subject to downgrade. Our business may suffer if it is alleged or found that we have infringed the intellectual property rights of others.

Our stock price, like that of other technology companies, can be volatile. Our stock price can be affected by many factors such as quarterly increases or decreases in our earnings, speculation in the investment community about our financial condition or results of operations, technological developments, or the loss of key management or technical personnel. In addition, general macroeconomic and market conditions unrelated to our financial performance may also affect our stock price.

PINNACLE DATA SYSTEMS, INC.
(DBA PDSi)

BALANCE SHEETS

December 31, 2004 and 2003

<u>ASSETS</u>	<u>2004</u>	<u>2003</u>
CURRENT ASSETS		
Cash	\$ 15,068	\$ 11,997
Accounts receivable, net of allowance for doubtful accounts of \$20,000	4,398,251	5,126,632
Inventory	4,080,202	2,023,434
Prepaid expenses	239,720	197,270
Refundable income taxes	171,248	-
Deferred income taxes	477,000	428,000
	<u>9,381,489</u>	<u>7,787,333</u>
 PROPERTY AND EQUIPMENT		
Leasehold improvements	309,920	226,693
Furniture and fixtures	382,935	331,991
Computer equipment and related software	2,481,919	2,264,719
Shop equipment	568,223	494,857
	<u>3,742,997</u>	<u>3,318,260</u>
Less accumulated depreciation and amortization	2,772,203	2,232,379
	<u>970,794</u>	<u>1,085,881</u>
 OTHER ASSETS		
Deposits	22,166	20,385
License agreement, less accumulated amortization of \$41,800 and \$32,595, respectively	400	9,606
	<u>22,566</u>	<u>29,991</u>
	<u>\$ 10,374,849</u>	<u>\$ 8,903,205</u>

The accompanying notes are an integral part of these financial statements.

**PINNACLE DATA SYSTEMS, INC.
(DBA PDSi)**

BALANCE SHEETS

December 31, 2004 and 2003

<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>	<u>2004</u>	<u>2003</u>
CURRENT LIABILITIES		
Line of credit	\$ 2,525,020	\$ 2,486,566
Accounts payable	2,176,746	1,865,699
Accrued expenses:		
Wages, payroll taxes and benefits	295,681	351,778
Income taxes	-	7,379
Unearned revenue	13,822	-
Other	207,398	100,953
	<u>5,218,667</u>	<u>4,812,375</u>
 LONG-TERM LIABILITIES		
Deferred income taxes	<u>101,000</u>	<u>55,000</u>
	<u>5,319,667</u>	<u>4,867,375</u>
 COMMITMENTS AND CONTINGENCIES		
	<u>-</u>	<u>-</u>
 STOCKHOLDERS' EQUITY		
Preferred stock; no par value; 4,000,000 shares authorized; no shares issued or outstanding	-	-
Common stock; no par value; 25,000,000 shares authorized; 5,628,806 and 5,539,796 shares issued and outstanding, respectively	2,266,482	2,172,281
Additional paid-in capital	543,095	502,095
Retained earnings	2,245,605	1,361,454
	<u>5,055,182</u>	<u>4,035,830</u>
	<u>\$ 10,374,849</u>	<u>\$ 8,903,205</u>

The accompanying notes are an integral part of these financial statements.

PINNACLE DATA SYSTEMS, INC.
(DBA PDSi)

STATEMENTS OF INCOME

Years Ended December 31, 2004 and 2003

	<u>2004</u>	<u>2003</u>
SALES		
Product sales	\$ 28,351,007	\$ 15,595,152
Service sales	<u>6,046,483</u>	<u>7,288,866</u>
	<u>34,397,490</u>	<u>22,884,018</u>
COST OF SALES		
Product sales	22,652,817	12,000,903
Service sales	<u>3,730,144</u>	<u>4,845,075</u>
	<u>26,382,961</u>	<u>16,845,978</u>
GROSS PROFIT	8,014,529	6,038,040
OPERATING EXPENSES	<u>6,615,741</u>	<u>5,147,325</u>
INCOME FROM OPERATIONS	<u>1,398,788</u>	<u>890,715</u>
OTHER EXPENSE		
Interest expense	<u>112,637</u>	<u>85,177</u>
INCOME BEFORE INCOME TAXES	1,286,151	805,538
INCOME TAX EXPENSE	<u>402,000</u>	<u>333,000</u>
NET INCOME	<u>\$ 884,151</u>	<u>\$ 472,538</u>
BASIC EARNINGS PER COMMON SHARE	<u>\$ 0.16</u>	<u>\$ 0.09</u>
DILUTED EARNINGS PER COMMON SHARE	<u>\$ 0.14</u>	<u>\$ 0.08</u>

The accompanying notes are an integral part of these financial statements.

PINNACLE DATA SYSTEMS, INC.
(DBA PDSi)

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

Years Ended December 31, 2004 and 2003

	<u>Common Stock</u>		<u>Additional Paid-In Capital</u>	<u>Retained Earnings</u>	<u>Total Stockholders' Equity</u>
	<u>Outstanding Shares</u>	<u>Amount</u>			
BALANCE - December 31, 2002	\$ 5,518,870	\$ 2,161,656	\$ 501,506	\$ 888,916	\$ 3,552,078
Options and warrants exercised	32,000	10,625	-	-	10,625
Treasury stock redeemed	(11,074)	-	-	-	-
Other proceeds from shareholders	-	-	589	-	589
Net income	-	-	-	472,538	472,538
BALANCE - December 31, 2003	<u>5,539,796</u>	<u>2,172,281</u>	<u>502,095</u>	<u>1,361,454</u>	<u>4,035,830</u>
Options and warrants exercised	93,000	94,201	-	-	94,201
Treasury stock redeemed	(3,990)	-	-	-	-
Tax benefits from employee stock option plan	-	-	41,000	-	41,000
Net income	-	-	-	884,151	884,151
BALANCE - December 31, 2004	<u>\$ 5,628,806</u>	<u>\$ 2,266,482</u>	<u>\$ 543,095</u>	<u>\$ 2,245,605</u>	<u>\$ 5,055,182</u>

The accompanying notes are an integral part of these financial statements.

PINNACLE DATA SYSTEMS, INC.
(DBA PDSi)

STATEMENTS OF CASH FLOWS

Years Ended December 31, 2004 and 2003

	<u>2004</u>	<u>2003</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 884,151	\$ 472,538
Adjustments to reconcile net income to net cash provided by/(used in) operating activities:		
Depreciation and amortization	554,226	575,173
Provision for doubtful accounts	-	5,000
Inventory reserves	271,610	264,221
Provision for deferred taxes	(3,000)	48,000
Loss on disposal of property and equipment	1,620	2,296
(Increase)/decrease in assets:		
Accounts receivable	728,381	(3,043,940)
Inventory	(2,404,650)	272,858
Prepaid expenses and other assets	(44,231)	124,930
Refundable income taxes	(130,248)	-
Increase/(decrease) in liabilities:		
Accounts payable	(3,467)	1,151,099
Accrued expenses and taxes	37,440	(46,136)
Unearned revenues	13,822	-
Total adjustments	<u>(978,497)</u>	<u>(646,499)</u>
Net cash used in operating activities	<u>(94,346)</u>	<u>(173,961)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property and equipment	(344,465)	(152,244)
Proceeds from sale of property and equipment	<u>165</u>	<u>27,000</u>
Net cash used in investing activities	<u>(344,300)</u>	<u>(125,244)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Net change in line of credit	38,454	384,697
Outstanding checks in excess of funds on deposit	314,514	(39,322)
Principal payments on long-term debt	-	(33,333)
Principal payments on capital lease obligation	(5,452)	(22,759)
Proceeds from stock options exercised	94,201	10,625
Other proceeds from shareholders	-	589
Net cash provided by financing activities	<u>441,717</u>	<u>300,497</u>

The accompanying notes are an integral part of these financial statements.

PINNACLE DATA SYSTEMS, INC.
(DBA PDSi)

STATEMENTS OF CASH FLOWS (CONTINUED)

Years Ended December 31, 2004 and 2003

	<u>2004</u>	<u>2003</u>
INCREASE IN CASH	3,071	1,292
CASH - Beginning of year	<u>11,997</u>	<u>10,705</u>
CASH - End of year	<u>\$ 15,068</u>	<u>\$ 11,997</u>
 SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Interest paid	<u>\$ 104,151</u>	<u>\$ 81,880</u>
Income taxes paid, net of refunds	<u>\$ 481,438</u>	<u>\$ 355,063</u>
 SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING TRANSACTIONS		
Inventory capitalized as computer equipment.	<u>\$ 76,272</u>	<u>\$ 189,545</u>
Equipment acquired through capital lease.	<u>\$ 10,981</u>	
Income tax benefit from employee stock option plan credited to Additional paid-in-capital	<u>\$ 41,000</u>	

The accompanying notes are an integral part of these financial statements.

NOTES TO FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

- A. Nature of Business - Pinnacle Data Systems, Inc. (dba PDSi) (the Company) provides product lifecycle service solutions to Original Equipment Manufacturers (OEMs) in the medical, telecommunications, defense, imaging and computer equipment markets, among others. PDSi offer a full range of computer and computer-related product development and manufacturing services to increase product speed to market and engineered product life, and to provide service and support to units in the field through comprehensive product lifecycle management programs encompassing depot repair, advanced exchange, contact center support and end-of-life control.
- B. Use of Estimates - The preparation of 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 at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.
- C. Concentration of Credit Risk – Financial instruments, which potentially subject the Company to a concentration of credit risk, principally consist of accounts receivable. The Company grants credit to its customers, which are varied in terms of size, geographic location and financial strength. Customer balances are continually monitored to minimize the risk of loss.

For 2004, the Company had three customers that generated revenues of approximately \$5,694,000, \$5,688,000, and \$3,877,000 or 17%, 17%, and 11% respectively, of total revenue. In the statements of income, approximately \$405,000 of the revenues from these customers is included in service sales and \$14,853,000 is included in product sales. In addition, these customers represented 15%, 10%, and 3%, respectively, of accounts receivable at December 31, 2004.

For 2003, the Company had four customers that generated revenues of approximately \$5,986,000, \$3,048,000, \$2,337,000 and \$2,242,000 or 26%, 13%, 10% and 10%, respectively, of total revenue. In the statements of income, approximately \$4,531,000 of the revenues from these customers is included in service sales and \$9,082,000 is included in product sales. In addition, these customers represented 11%, 23%, 16%, and 24%, respectively, of accounts receivable at December 31, 2003.

- D. Revenue Recognition – For product sales, we recognize revenue upon transference of the title to the products to the customer. For repair sales, we recognize revenue upon completion of the repair work and either shipment of the item back to the customer or, in the programs in which we also manage the customer's inventory on our site, when we return the repaired item to the customer's finished goods inventory. For some repair and maintenance programs, the customer pays a flat fee that covers multiple fiscal periods. In those instances, we recognize revenue over the fiscal periods covered by the billing on a pro-rata basis. Our inventory and logistics management programs are billed monthly, with revenue recognized upon billing. For non-recurring engineering projects, we recognize revenue on a percentage-of-completion basis.
- E. Inventories - Inventories are valued at average cost, not in excess of market.

Inventory at December 31, 2004 and 2003 was comprised of the following (net of inventory reserves):

	<u>2004</u>	<u>2003</u>
Component parts (raw materials)	\$ 3,362,924	\$ 1,501,213
Work-in-process	369,937	129,088
Finished goods	347,341	393,133
	<u>\$ 4,080,202</u>	<u>\$ 2,023,434</u>

The carrying values of component parts and finished goods represent average cost or management's estimate of its net realizable value. Such value is based on forecasts of product orders and repair/trade-in activity in the ensuing years. Such forecasts are based on historical information, known contracts, and management's expertise in computer hardware life cycles. Should demand for the Company's products and repair/trade-in hardware prove to be significantly less than anticipated, the ultimate realizable value of such products could be substantially less than the amount shown in the balance sheet. At December 31, 2004 and 2003, the Company provided reserves of approximately \$1,027,000 and \$799,000, respectively, to reduce the carrying value of inventory.

- F. Statement of Cash Flows – For purposes of the statement of cash flows, the Company considers all short-term instruments purchased with a maturity of three months or less to be cash equivalents. There were no cash equivalents at December 31, 2004 or 2003.
- G. Property and Equipment - Property and equipment are recorded at cost. Depreciation and amortization are provided on the straight-line method for financial reporting purposes over the estimated useful lives of the respective assets. Expenditures for maintenance and repairs are charged to operations as incurred, while expenditures for additions and improvements are capitalized. Furniture and fixtures, computer equipment and related software, and shop equipment are depreciated over useful lives ranging from 3 to 7 years. Leasehold improvements are being amortized over the shorter of useful life or remaining lease term. Technology licenses are amortized over their terms of three years. Depreciation and amortization expense amounted to \$554,226 and \$575,173 for the years ended December 31, 2004 and 2003, respectively.

Annually, or more frequently if events or circumstances change, a determination is made by management to ascertain whether property and equipment have been impaired based on the sum of expected future undiscounted cash flows from operating activities. If the estimated net cash flows are less than the carrying amount of such assets, the Company will recognize an impairment loss in an amount necessary to write down the assets to a fair value.

- H. Advertising - All of the Company's advertising costs are of the nondirect-response type. The Company expenses all advertising costs as incurred or at the time the advertising takes place. The Company incurred approximately \$83,000 and \$14,000 in advertising costs in 2004 and 2003, respectively.
- I. Life Insurance - The Company has purchased, and is the beneficiary, of three term life insurance policies on key employees of the Company. The total amount of coverage at December 31, 2004 was \$11,500,000.
- J. Stock-Based Compensation - The Company has implemented Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation". This standard encourages the adoption of the fair value-based method of accounting for employee stock options or similar equity instruments, but continues to allow the Company to measure compensation cost for those equity instruments using the intrinsic value-based method of accounting prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." Under the fair value-based method, compensation cost is measured at the grant date based on the estimated fair value of the award. Under the intrinsic value-based method, compensation cost is the excess, if any, of the quoted market price of the stock at the grant date or other measurement date over the amount the employee must pay to acquire the stock. The Company intends to continue the use of the intrinsic value-based method until required to change to the fair value-based method as required by SFAS No 123(R) issued in December 2004 (see Note 1.L.).

Pro forma information regarding net income and earnings per share is required by SFAS No. 123, and has been determined as if the Company had accounted for its employee stock options under the fair value method of that Statement. The Company is continuing to utilize the intrinsic value-based method for accounting for employee stock options or similar equity instruments; therefore, the Company has not recorded any compensation cost in the statements of income for stock-based employee compensation awards.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. The Company's pro forma income and earnings per share are as follows for the year ended:

	<u>2004</u>	<u>2003</u>
Net income - as reported	\$ 884,151	\$ 472,538
Stock-based employee compensaton expense - pro forma	<u>337,311</u>	<u>112,020</u>
Net income - pro forma	\$ 546,840	\$ 360,518
Basic earnings per common share-as reported	\$.16	\$.09
Diluted earnings per common share-as reported	.14	.08
Basic earnings per common share-pro forma	\$.10	\$.07
Diluted earnings per common share-pro forma	.09	.06
Weighted-average fair value of options granted during the year	\$ 1.97	\$ 1.85

- K. Research and Development – Research and development costs are charged to operations when incurred. The amounts of research and development expense were \$23,823 and \$205,842 for 2004 and 2003, respectively.
- L. Product Warranty Policy – The Company provides a limited warranty for defects in material or workmanship on its products and its repair services. The warranty periods currently in effect range from one to two years. The warranty involves repairing or replacing any defective component returned within the warranty period. The warranty is limited to the original customer. The historical warranty cost of material has been nominal, as most components used in the Company's products are warranted by the component supplier. In 2003, the Company experienced higher warranty costs than the historical levels, due to defects in components used in one customer product for a limited period of time. Engineering changes eliminated the problem for units built and sold after the changes. A limited number of units with those known defects remained under warranty at December 31, 2004.

The following summarizes the Company's warranty liability for 2004:

Beginning balance	\$ 21,293
Additions to balance	10,000
Reductions to balance	<u>(12,742)</u>
Ending balance	\$ <u>18,551</u>

- M. RECENTLY ISSUED FINANCIAL ACCOUNTING STANDARDS--SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances), many of which were previously classified as equity. SFAS No. 150 is effective for interim periods beginning after June 15, 2003. In its October 2003 meeting, the FASB decided to defer the effective date of certain provisions of SFAS No. 150. Management does not expect the adoption of this accounting pronouncement will have a material impact on the Company's consolidated financial statements.

In November 2002, the FASB issued FASB Interpretation ("FIN") No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57 and 107 and Rescission of FASB Interpretation No. 34. FIN 45 clarifies the requirements of SFAS No. 5, Accounting for Contingencies, relating to the guarantor's accounting for, and disclosure of, the issuance of certain types of guarantees. FIN 45 is effective for guarantees issued or modified starting January 1, 2003 and requires the additional disclosures for the periods ended after December 15, 2002. The adoption of FIN 45 did not have a material impact on the Company's financial condition or results of operations.

In December 2003, the FASB issued FIN 46 (Revised), Consolidation of Variable Interest Entities. FIN 46 clarifies the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements, to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without

additional subordinated financial support from other parties. FIN 46 requires a variable interest entity to be consolidated by a company, if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. FIN 46 also requires disclosures about variable interest entities that a company is not required to consolidate but in which it has a significant variable interest. The consolidation requirements of FIN 46 apply in the first fiscal year or interim period ending after December 15, 2004. The adoption of FIN 46 is not expected to have a material impact on the Company's consolidated financial statements.

In December 2004, the FASB issued SFAS No. 123 (Revised), Shared Based Payment. SFAS No. 123(R) replaces SFAS No. 123, Accounting for Stock Based Compensation, and supercedes APB Opinion No. 25, Accounting for Stock Issued to Employees. SFAS No. 123(R) requires compensation costs related to share-based payment transactions to be recognized in the financial statements. Compensation costs will be recognized over the vesting period of the award. SFAS No. 123 is effective as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. The impact of SFAS No. 123(R) is to record the additional compensation expenses on the financial statements that is currently disclosed in Note 1.J.

N. Reclassifications – Certain insignificant amounts for the year 2003 have been reclassified to conform with the 2004 presentation.

Note 2. Line of Credit

At December 31, 2004, the Company had a bank line of credit with a limit of \$6,000,000 and monthly interest payments at prime. The effective rate was 5.25%. The Company was obligated for funds drawn against this line of credit in the amount of \$2,525,020 and \$2,486,566 at December 31, 2004 and 2003, respectively.

The line is payable on demand and is collateralized by a "Blanket Lien" on all assets of the Company. The amount available under the line of credit is subject to borrowing base restrictions as outlined in the agreement. On December 28, 2004, the terms of the bank line of credit with KeyBank were amended to reflect the Company's near term borrowing needs and the Company's credit risk as rated by KeyBank. The amount available under the line was increased to \$6,000,000 from \$5,000,000 and is due and renewable by May 15, 2006. The unused capacity at December 31, 2004 was approximately \$3,251,000.

Note 3. Stock Options and Warrants

The Company adopted the Pinnacle Data Systems, Inc., 1995 Stock Option Plan (the Plan) on December 19, 1995. Any employee who is granted a discretionary option upon vesting, may purchase Company common stock over a ten-year period, at the fair market value at time of grant. (If the grantee owns more than 10% of the Company's stock at the time of the grant, the purchase price shall be at least 110% of the fair market value and the options expire five years from the date of grant.) The aggregate number of common shares of the Company, which could have been granted under the plan, was 1,200,000 shares. Incentive options available under the plan must be granted by December 19, 2005. On February 16, 2000, the Board of Directors amended the Pinnacle Data Systems, Inc., 1995 Stock Option Plan, which was subsequently approved by the shareholders on June 24, 2000, to increase the number of shares reserved for issuance pursuant to options to 2,400,000 common shares. Under the 1995 Stock Option Plan, 388,250 shares were reserved for future grants at December 31, 2004.

On March 22, 2000, the Company adopted the Pinnacle Data Systems, Inc., 2000 Director Stock Option Plan (Director Plan), which was subsequently approved by the shareholders on June 24, 2000. Under the Director Plan, 500,000 shares are reserved for issuance to Directors who are not employees of the Company (Outside Director). Any Outside Director who has been granted a discretionary option may upon vesting, purchase Company common stock over a ten-year period, at the fair market value at time of grant. Before the adoption of the Director Plan, previous issuance of stock options to Outside Directors was made by entering into individual stock option agreements. Under the 2000 Director Stock Option Plan, 324,000 shares were reserved for future grants at December 31, 2004.

Although the Board of Directors has the authority to set other terms, the options are generally exercisable one year from the date of grant.

The following table is a summary of option activity:

<u>Stock Option Plan</u>	<u>2004</u>		<u>2003</u>	
	Number	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
<u>Employee Stock Option</u>				
<u>Agreements</u>	of Options	Price	of Options	Price
Outstanding, beginning of year	1,170,500	\$ 1.92	1,038,650	\$ 1.84
Granted	211,500	2.28	178,000	2.26
Exercised	73,000	0.90	32,000	0.85
Forfeited	52,050	2.24	14,150	2.83
Outstanding, end of year	<u>1,256,950</u>	<u>\$ 2.02</u>	<u>1,170,500</u>	<u>\$ 1.92</u>
Exercise price range of options outstanding	\$0.63 to \$5.25		\$0.63 to \$5.25	
<u>Director Stock Option</u>				
<u>Agreements</u>				
Outstanding, beginning of year	290,000	\$ 1.88	230,000	\$ 1.81
Granted	20,000	2.63	60,000	2.11
Exercised	20,000	2.35	-	-
Forfeited	20,000	1.82	-	-
Outstanding, end of year	<u>270,000</u>	<u>\$ 1.90</u>	<u>290,000</u>	<u>\$ 1.88</u>
Exercise price range of options outstanding	\$0.75 to \$3.88		\$0.75 to \$3.88	

The following table summarizes information concerning outstanding and exercisable options at December 31, 2004:

Range of Exercise Price	<u>Options Outstanding</u>		
	Number Outstanding	Weighted-average Remaining Contractual Life (in years)	Weighted-average Exercise Price Per Share
\$0.63 - 0.83	386,200	2.85	\$ 0.75
\$0.97 - 1.38	159,550	4.49	1.03
\$1.82 - 2.63	758,100	7.54	2.28
\$3.07 - 4.26	220,100	5.24	3.89
\$4.69 - 5.25	3,000	5.79	4.88
Total	<u>1,526,950</u>	<u>5.70</u>	<u>\$ 2.00</u>
Range of Exercise Price	<u>Options Exercisable</u>		
	Number Exercisable	Weighted-average Exercise Price Per Share	
\$0.63 - 0.83	386,200	\$ 0.75	
\$0.97 - 1.38	159,550	1.03	
\$1.82 - 2.63	550,600	2.29	
\$3.07 - 4.26	220,100	3.89	
\$4.69 - 5.25	3,000	4.88	
Total	<u>1,319,450</u>	<u>\$ 1.96</u>	

At December 31, 2003, 1,197,500 outstanding options were exercisable. The weighted-average exercise price for outstanding options was \$1.85 at December 31, 2003.

The options outstanding at December 31, 2004 are exercisable through periods ranging from January 2005 through November 2014.

The fair value of each option grant disclosed in Note 1.J. is estimated on the grant date using the Black-Scholes option pricing model with the following weighted average assumptions for the year ended:

	<u>2004</u>	<u>2003</u>
Risk-free interest rate	4.3%	4.5%
Dividend yield	0%	0%
Volatility factor	88.61%	84.29%
Weighted average expected life in years	9	9

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option pricing models require input of highly subjective assumptions including the expected stock price volatility. The Company uses projected volatility rates that are based upon historical volatility rates trended into the future. Because the Company's stock options have characteristics significantly different from those traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide an accurate measure of the fair value of the Company's options.

Note 4. Operating Leases

The Company leases its operating facility under an operating lease that expires in 2009. The Company has an option to extend the lease for an additional five years beyond the expiration date in 2009.

Minimum future lease payments under the operating lease as of December 31, 2004 are as follows:

2005	\$	589,216
2006		589,216
2007		589,216
2008		589,216
2009		196,406
	\$	<u><u>2,553,270</u></u>

Total rent charged to operations for operating leases and other month-to-month rental obligations for the years ended December 31, 2004 and 2003 amounted to \$689,576 and \$616,230, respectively. The ten-year operating lease on the facilities at 6600 Port Road, Groveport, Ohio, contains annual escalators intended to cover inflationary costs over the life of the lease.

Note 5. Profit Sharing and 401(k) Savings Plan

The Company maintains a qualified cash or deferred compensation plan under section 401(k) of the Internal Revenue Code. The plan covers all employees age 21 or over with three months of service. Under the plan, employees may elect to defer a portion of their salary, subject to Internal Revenue Code limits.

The Company, at its discretion, may match up to 15% of employee contributions up to 6% of wages deferred with an annual maximum contribution of \$1,950 per employee. The Company made matching contributions of \$32,045 in 2004. The Company elected not to make a matching contribution for 2003.

Note 6. Income Taxes

Deferred income taxes arise from temporary differences resulting from income and expense items reported for financial accounting and tax reporting purposes in different periods. Deferred taxes are classified as current or long-term, depending on the classification of the assets and liabilities to which they relate. Deferred taxes arising from temporary differences that are not related to an asset or liability are classified as current or long-term depending on the periods in which the temporary differences are expected to reverse.

Net deferred tax assets in the accompanying balance sheets include the following components:

	<u>2004</u>	<u>2003</u>
Assets		
Inventory reserves	\$ 411,000	\$ 316,000
Allowance for doubtful accounts	8,000	8,000
Uniform capitalization	51,000	32,000
Bonus accrual	-	72,000
Warranty accrual	7,000	-
	<u>\$ 477,000</u>	<u>\$ 428,000</u>
Liabilities		
Depreciation	<u>\$ 101,000</u>	<u>\$ 55,000</u>
	<u>\$ 101,000</u>	<u>\$ 55,000</u>

The components of the tax expense for the year ended December 31, were as follows:

	<u>2004</u>	<u>2003</u>
Current:		
Federal	\$ 341,000	\$ 254,000
State and local	<u>64,000</u>	<u>31,000</u>
	<u>405,000</u>	<u>285,000</u>
Deferred:		
Federal	-	30,000
State and local	<u>(3,000)</u>	<u>18,000</u>
	<u>(3,000)</u>	<u>48,000</u>
Total	<u>\$ 402,000</u>	<u>\$ 333,000</u>

The following sets forth the differences between the provision for income taxes computed at the federal statutory rate of 34% and that reported for financial statement purposes:

	<u>2004</u>	<u>2003</u>
Income tax provision at statutory rate	\$ 437,000	\$ 274,000
Add:		
Tax effect of permanent differences	(49,000)	10,000
State income taxes, net of federal income tax provision	40,000	49,000
Other	<u>(26,000)</u>	<u>0</u>
Total income tax provision	<u>\$ 402,000</u>	<u>\$ 333,000</u>

Note 7. Earnings Per Common and Common Equivalent Share

Earnings per common and common equivalent share were computed by dividing net earnings by the weighted average number of shares of common stock outstanding during the year.

	For the Year Ended 2004		
	<u>Income</u>	<u>Shares</u>	<u>Per-Share</u>
	<u>(Numerator)</u>	<u>(Denominator)</u>	<u>Amount</u>
Basic EPS			
Income available to common stockholders	\$ 884,151	5,572,811	\$ 0.16
Effect of Dilutive Securities			
Options	<u>0</u>	<u>548,864</u>	
Diluted EPS			
Income available to common stockholders and assumed conversions	\$ <u>884,151</u>	<u>6,121,675</u>	\$ <u>0.14</u>

	For the Year Ended 2003		
	<u>Income</u>	<u>Shares</u>	<u>Per-Share</u>
	<u>(Numerator)</u>	<u>(Denominator)</u>	<u>Amount</u>
Basic EPS			
Income available to common stockholders	\$ 472,538	5,526,978	\$ 0.09
Effect of Dilutive Securities			
Options	<u>0</u>	<u>307,573</u>	
Diluted EPS			
Income available to common stockholders and assumed conversions	\$ <u>472,538</u>	<u>5,834,551</u>	\$ <u>0.08</u>

The number of anti-dilutive options for December 31, 2004 and 2003 were 223,100 and 823,750, respectively.

Note 8. Operating Segments

The Company's reportable segments are Product and Service and are described in Item 1 of the Company's form 10KSB, including a discussion of principle markets and distribution. The "Other" column listed below reflects working groups of the Company that are not allocated to segments, such as engineering, finance, human resources, quality systems, and executive management. These items primarily represent assets and expenses for various administrative functions within the Company. The Company evaluates performance based on operating earnings of the product and service segments and its coverage of the other administrative expenses of the Company.

Segment information for the years ended December 31, 2004 and 2003, was as follows:

	2004			
	Product	Service	Other	Total
Sales	\$ 28,351,007	\$ 6,046,483	\$ -	\$ 34,397,490
Gross profit	5,698,190	2,316,339	-	8,014,529
Operating earnings (loss)	2,759,841	1,336,882	(2,697,935)	1,398,788
Depreciation and amortization	261,570	126,722	165,934	554,226
Interest expense	-	-	112,637	112,637
Total assets	6,311,306	1,928,303	2,135,240	10,374,849
Capital expenditures	171,832	211,468	37,437	420,737

	2003			
	Product	Service	Other	Total
Sales	\$ 15,595,152	\$ 7,288,866	\$ -	\$ 22,884,018
Gross profit	3,594,249	2,443,791	-	6,038,040
Operating earnings (loss)	1,653,883	1,274,128	(2,037,296)	890,715
Depreciation and amortization	260,479	121,813	192,881	575,173
Interest expense	-	-	85,177	85,177
Total assets	5,723,996	1,123,461	2,055,748	8,903,205
Capital expenditures	255,840	66,588	19,361	341,789

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders
Pinnacle Data Systems, Inc. (dba PDSi)
Groveport, Ohio

We have audited the accompanying balance sheets of Pinnacle Data Systems, Inc. (the “Company”) as of December 31, 2004 and 2003, and the related statements of income, stockholders’ equity, 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 the financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also 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, 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 financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2004 and 2003, 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. Also, in our opinion, such financial statement schedules, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

/s/ DELOITTE & TOUCHE LLP

Columbus, Ohio
February 15, 2005

MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

- (a) *Market Information.* Since September 7, 2000, our common stock has traded on the American Stock Exchange under the stock symbol “PNS.” Set forth below is the range of high and low sales prices of the common shares on the American Stock Exchange during 2004 and 2003.

	<u>Range of Sales Prices</u>	
	<u>High</u>	<u>Low</u>
Fiscal Year 2004		
Fourth quarter (ended December 31)	\$3.50	\$1.90
Third quarter (ended September 30)	4.54	2.00
Second quarter (ended June 30)	5.00	2.21
First quarter (ended March 31)	3.23	1.85
Fiscal Year 2003		
Fourth quarter (ended December 31)	\$3.16	\$1.75
Third quarter (ended September 30)	2.55	1.02
Second quarter (ended June 30)	1.30	1.00
First quarter (ended March 31)	1.70	0.95

- (b) *Holder.* On February 11, 2005, there were 86 holders of record of the Shares. Most of the Shares not held by officers and directors are held in street name.
- (c) *Dividends.* During the past five years, we have not paid cash dividends. Payments of dividends are within the discretion of our board of directors.

CORPORATE INFORMATION

Corporate Officers

John D. Bair
Chairman and Chief Executive
Officer

Christopher L. Winslow
President and Chief Operating
Officer

Michael R. Sayre
Executive Vice President, Chief
Financial Officer and Treasurer

Laura A. Palko
Secretary

Thomas J. Carr
Controller

Corporate Office

Pinnacle Data Systems, Inc.
6600 Port Road
Groveport, OH 43125
Tel: 800.882.8282
Tel: 614.748.1150
Fax: 614.748.1209
www.pinnacle.com

Board of Directors

John D. Bair
Chairman and Chief Executive
Officer
Pinnacle Data Systems, Inc.

Carl J. Aschinger, Jr.
Chairman and Chief Executive
Officer
Columbus Show Case Company

Hugh C. Cathey
Principal
Columbus Capital Partners

Paul H. Lambert
Chief Technology Officer
ImageArray Ltd.

Thomas M. O'Leary
Director of Manufacturing
Development
Lucent Technologies (retired)

Robert V. R. Ostrander
Chairman
Manex Financial Management

Michael R. Sayre
Executive Vice President, Chief
Financial Officer and Treasurer
Pinnacle Data Systems, Inc.

Christopher L. Winslow
President and Chief Operating
Officer
Pinnacle Data Systems, Inc.

Stock Symbol

PNS
Listed on the American Stock
Exchange

Transfer Agent and Registrar

Computershare Investor Services
Shareholder Services
2 North LaSalle Street
Chicago, IL 60602

Independent Registered Public Accounting Firm

Deloitte & Touche LLP
155 East Broad Street
Columbus, OH 43215-3611

Legal Counsel

Schottenstein Zox & Dunn, Co. L.P.A.
250 West Street
Columbus, OH 43215

Shareholders may receive a copy of the Company's 2004 Annual Report on Form 10-KSB without charge by writing to:

**Investor Relations
Pinnacle Data Systems, Inc.
6600 Port Road
Groveport, OH 43125**



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