FORM 10-K

Annual report pursuant to section 13 and 15(d)

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MEDSTONE INTERNATIONAL INC/
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SIC: **3845** Electromedical & electrotherapeutic apparatus

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 1998

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____________ to _____________

Commission File Number 0-16752

MEDSTONE INTERNATIONAL, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	66-0439440
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)

100 COLUMBIA, SUITE 100, ALISO VIEJO, CALIFORNIA 92656
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES) (ZIP CODE)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (949) 448-7700

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT: NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT:

COMMON STOCK, $.004 PAR VALUE
(TITLE OF CLASS)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form-K. [ ]

The number of shares of the Common Stock of the registrant outstanding as of March 1, 1999 was 5,064,905 The number of shares of voting and non-voting Common Stock held by non-affiliates on such date was 4,960,177 with an approximate aggregate market value of $40,301,438.

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TABLE OF CONTENTS

<TABLE>
<CAPTION>

PART I

ITEM 1. BUSINESS

INTRODUCTION

Medstone International, Inc., (the "Company" or "Medstone"), a Delaware corporation formed in October 1984, manufactures, markets and maintains lithotripters. The Company, as a manufacturer of capital medical devices, has vertically integrated by offering its medical devices directly to providers on a fee-per-procedure basis. Medstone currently offers lithotripsy services both in the United States and internationally on a fee-per-procedure basis in both the fixed and mobile environment. Medstone intends to expand efforts to grow this medical service side of its business. The Company's consolidated revenues during fiscal 1998 came primarily from Medstone's lithotripsy business.

In early 1996, the Company completed efforts to separate its operating business units and revenue streams into independent operations by spinning off two subsidiaries, Endocare, Inc. ("Endocare") and Urogen Corp. ("Urogen"), to the Company's stockholders of record at December 29, 1995. Endocare manufactures equipment and devices to treat urologic soft tissue diseases. Urogen is a development stage company in the business of developing pharmaceuticals to treat prostate cancer.

In June 1996 the Company purchased, for $1.35 million cash, a 60% interest in Northern Nevada Lithotripsy Associates, LLC ("Northern Nevada"), an operator of lithotripsy services. In March 1997, the Company purchased, for $2.3 million cash, a 60% interest in Southern Idaho Lithotripsy Associates, LLC ("Southern Idaho"), another operator of lithotripsy services. The Company consolidates the revenues of Northern Nevada and Southern Idaho and reflects minority interest expense for the portion of profits earned by the minority partners. These companies' revenues are derived from invoicing patients or insurers.

United Physicians Resources, Inc. ("UPR") was incorporated as a majority-owned subsidiary of the Company in June 1996, to expand the Company's service orientation to the urologist practitioners. UPR provides billing, practice management, and consulting services as an additional service line once the initial physician relationship has been established. UPR purchased the operations of Integrated Healthcare Systems, Inc. in July 1996 for $30,000. The operating results of UPR are included in the consolidated financial statements of the Company since its incorporation.

MARKETS

The Company currently operates in the kidney stone treatment market. In the United States, it is estimated that over 1,500,000 persons per year suffer from kidney stones and an estimated 375,000 patients per year are hospitalized with a primary kidney stone. Historically, approximately 180,000 of these patients have been treated with extra corporeal shockwave lithotripsy each year. With an estimated installed base of 380 lithotripters in the United States, there is a sufficient number of lithotripters to respond to this market.

Outside the United States the incidence of kidney stones varies from country to country. The installed base of extra corporeal shockwave lithotripters is not as extensive as in the United States. Medstone has sold systems into Japan, Egypt, Russia, Israel, Saudi Arabia, U.A.E., Hong Kong and China.

The share of its markets that the Company will obtain will be dependent on successful development of new products, obtaining appropriate regulatory agency approvals, market acceptance of the products, the Company's ability to market, the alternative sources of equivalent products and future developments.

PRODUCTS

Lithotripsy Equipment

The Medstone STS ("System") is presently being used to treat kidney stones, without invasive surgery, in the U.S. and foreign locations. The Company received a pre-market approval ("PMA") from the U.S. Food and Drug Administration ("FDA") in 1988 authorizing commercial use of the device for treating patients with kidney stones.

A series of shockwaves are created outside the patient's body and focused to travel through water-based fluids until they enter the body and disintegrate the stone. Each successive shockwave serves to further break apart the kidney stone into smaller particles until they are small enough to be passed in the patient's urine. A treatment typically requires 1200-1600 shockwaves in a procedure which lasts 45 to 60 minutes.

In addition to the shockwave generator, the Medstone STS's components include a customized X-ray table on which the patient lies horizontally with his or her kidney positioned above the shockwave generator, a computer, an X-ray system, an ultrasound system, and an electrocardiogram ("ECG") monitor. The computer generates information regarding the treatment and monitors the patient's condition. The X-ray/ultrasound system produces images that are converted and analyzed by the computer and then used by the physician for proper positioning and to determine when the kidney stone has been sufficiently disintegrated to terminate the treatment. The ECG monitor supplies the data that allows the computer to synchronize the shockwaves with phases of the patient's heartbeat.

The Company has developed and copyrighted all the software that controls the Medstone STS. This software, an integral part of the system and therefore subject to review by regulatory agencies, is licensed for use on a per procedure basis.

The Company also markets the Medstone STS-T ("STS-T"), its transportable lithotripter for treatment of kidney stones. The STS-T contains components similar to the STS, except for the ultrasound unit, with all components built to be modular, allowing the STS-T to be moved in and out of a hospital surgical suite. This "in operating room" technology allows hospitals and clinics to set up the lithotripter for patient treatment in existing surgical operating rooms and, once complete, the lithotripter can be moved to an equipment holding area or loaded on to a truck for transportation to another facility. This transportability allows hospitals and clinics the flexibility of full-time access to a lithotripter without dedication of a surgical suite to a fixed unit installation.

The Company received notification from the FDA on September 16, 1998 that its PMA supplement regarding the STS-T was accepted, authorizing the commercial use of the STS-T to treat patients with kidney stones. As of March 1, 1999, five units have been ordered and deposit checks have been received (see "Backlog"). The Company expects to commence shipments to customers by the end of the first quarter of 1999.

The Company also has developed and manufactures its own disposable components for use with the Medstone STS. Electrodes manufactured by the Company are used to produce electrical sparks in the shockwave generator part of the device. A disposable coupling bag containing fluid for transmission of the shockwave is placed between the shockwave generator and the patient's back or stomach during the treatment. One complete set of the supplies is normally used in each patient procedure.

The Company, as a vertically integrated manufacturer, also offers fee-for-service lithotripsy in the continental United States. It has placed its lithotripters in mobile trailers and contracts with hospitals, clinics, and ambulatory surgery centers to provide the equipment necessary to treat kidney stones, usually on an outpatient basis. This allows small and mid-size facilities in wide ranging geographic locations to access equipment and technology that otherwise would only be economically viable in larger population centers. There are currently over 90 sites in the United States that are active sites on the Company's mobile routes. The Company plans to continue to expand its customer base for lithotripsy services in future years.

Urotable

With its network of physicians and facilities that utilize lithotripsy products, the Company has begun using that same contact base to market a urological treatment table, the Medstone "UTS-Series". This urological table, which is used for various urological procedures, is used both as an in-office device for physicians and in-facility device in a hospital or clinic setting. The Company is an integrator of products available on the market and will use the "UTS-Series" for bundling of urological tables along with lithotripsy products, or sell the "UTS-Series" as a stand-alone product.

KIDNEY STONES AND TREATMENT

A kidney stone develops when the salt and mineral substances in urine form crystals that stick together and grow in size. In most cases, these crystals are removed from the body by the flow of urine, but they sometimes stick to the lining of the kidney or settle in places where the urine flow fails to carry them away. These crystals may gather and grow into a stone ranging in size from that of a grain of sand to a golf ball. Most stones start to form in the kidney. Some may travel to other parts of the urinary system, such as the ureter or bladder, and grow there.

Stones vary in size, composition, and the ease with which they can be dissolved. In some cases, certain medications may be used to lower the amount of acidity or alkalinity in the urine, thereby dissolving the stones. At present, stones that contain calcium cannot be dissolved. Most stones can be treated with conservative methods. This includes increased fluid intake, changes in diet, and medications. About 90 percent of stones that leave the kidney will pass through the ureter within three to six weeks. Stones that do not pass through the ureter may be removed with the aid of a grasping device (basket). The device is passed through a telescopic instrument (cystoscope) that the doctor inserts into the bladder or ureter (urethroscope). In some cases, the stones are removed whole, but sometimes they must be broken into smaller pieces with ultrasound before they can be removed with the basket.

The Medstone STS provides a non-invasive nonsurgical treatment for stones in the kidney and ureter called extra corporeal shockwave lithotripsy. In this method, X-rays are used to target the stone, and then high energy shockwaves are used to break down the stones into gravel which passes out with urine within a few weeks.

Although most stones can be treated with nonsurgical methods, certain stones still require conventional surgery, particularly when there is internal scarring and obstruction. With conventional surgery, an incision is made over the stone site. The hospital stay and recovery period are several weeks longer than when more conservative techniques are used. Therefore, stones are treated with non-invasive methods when possible.

PRODUCTION

Medstone manufactures, under FDA mandated Good Manufacturing Practice ("GMP") requirements, its devices at its plant in Aliso Viejo, California. The Company moved into its facility in March 1994. Subsequent to that move the Company was audited by the FDA and received notification from the FDA enabling it to manufacture and market devices in that facility. The Company has existing capacity to produce sufficient quantities of its shockwave lithotripters to support its commercial needs for the foreseeable future.

PRODUCT DEVELOPMENT

The Company has focused its research in 1998 on developments intended to improve performance and convenience, and also to reduce the size and costs, of its lithotripter systems. In 1998, the Company devoted a significant portion of its research and development expenditures on the Medstone STS-T, a smaller, movable lithotripsy system. This new product, which has been previewed at focus groups, was introduced in March 1999. The Company will continue to invest significantly in product enhancements and proprietary products. During the years ended December 31, 1996, 1997, and 1998, the Company's expenditures for research and development totaled $521,793, $1,021,349 and $1,078,792, respectively.

PRODUCT LIABILITY AND INSURANCE

The Company currently has in force commercial liability insurance, with coverage limits of $1 million per incident, and $2 million on an annual aggregate basis. It also has general umbrella liability insurance with coverage limits of $4 million per incident for a total aggregate amount of $5,000,000 per incident. The Company's directors and officers' insurance policies provide coverage on a claims-made basis and are all subject to annual renewals.

GOVERNMENT REGULATION

Governmental regulations in the United States and other countries are a significant factor affecting the research and development, manufacture and marketing of the Company's products. In the United States, the FDA has broad authority under the Federal Food, Drug and Cosmetic Act and the Public Health Service Act to regulate the distribution, manufacture and sale of drugs, including biologics, and medical devices. Foreign sales of drugs and medical devices are subject to foreign governmental regulation and restrictions which vary from country to country. DEVICES - Medical devices intended for human use in the United States are classified into three categories, depending upon the degree of regulatory control to which they will be subject. Such devices are classified by regulation into either class I (general controls), class II (performance standards) or class III (pre-market approval) depending upon the level of regulatory control required to provide reasonable assurance of the safety and effectiveness of the device. A class III product, such as the Medstone STS and STS-T, and class I and II devices for which a PMA is necessary generally require initial Investigational Device Exemption ("IDE") approval by the FDA. An IDE permits limited clinical evaluation of the product under controlled conditions. Extensive reporting and monitoring of patient treatments made pursuant to the IDE are required. After the PMA is obtained, the product may be marketed to an unrestricted number of users in the United States, but general medical device regulations regarding FDA inspection of facilities, Good Manufacturing Practices, labeling, maintenance of records and filings with the FDA continue to be applicable.

A subset of medical devices categorized as class I or II and classified as "old" devices, that is, commercially distributed before March 28, 1976 or substantially equivalent to a device that was in commercial distribution before that date, may be marketed after the acceptance of the premarket notification under a 510(k) exemption. The 510(k) section of the Federal Food, Drug and Cosmetic Act allows an exemption from the requirement of premarket notification. The Medstone UTS-Series is sold under a 510(k) exemption received by the original manufacturer of the components used in the equipment.

Medstone has obtained from the California Department of Health Services a license to manufacture medical devices and is subject to periodic inspections and other regulation by that agency.

Certificate of Need ("CON") laws and regulations are in effect in many states. Under such laws, a CON issued by a governmental agency is generally required before the introduction of certain new health care services or before a hospital or other provider can acquire certain new medical equipment or facilities having values exceeding specified amounts. Failure to obtain a required CON may prohibit the purchase of desired equipment or cause the denial of Medicare or other governmental reimbursements or payments for patient treatments. In recent years several states have repealed their CON laws and many other states have made or are considering possible amendments to the laws. Most of the revisions involve raising the thresholds for review, eliminating certain types of facilities or services from review or streamlining the review process.

On January 9, 1998, the Health Care Finance Administration (HCFA) published proposed Stark II regulations with the intent of seeking public comments regarding the proposal and its effects. Stark II proposes that lithotripsy would be defined as an "inpatient and outpatient hospital procedure" and this definition would put physician ownership of lithotripsy units in violation of HCFA regulations. This would apply to patients covered under Medicare, Medicaid and Champus health care.

With the completion of the comment period in the beginning of March 1998, no further information is currently available to the Company regarding the public comments. The regulations, if enacted as first published, could force physician partnerships to either divest ownership or find a "safe harbor" under which to operate lithotripsy partnerships.

PATENTS, COPYRIGHTS, TRADE SECRETS AND LICENSES

The Company's policy is to secure and protect intellectual property rights relating to its technology. While Medstone believes that the protection of patents or licenses is important to its business, it also relies on trade secrets, know-how and continuing technological innovation to maintain its competitive position. The Company has received or filed for certain patents or copyrights for its lithotripter operating systems.

The Company seeks to preserve the confidentiality of its technology by entering into confidentiality agreements with its employees, consultants, customers, and key vendors and by other means. No assurance can be given, however, that these measures will prevent the unauthorized disclosure or use of such technology.

COMPETITION

The Company's products currently marketed and under development will be competing with many existing products and therapies for market share. The

Company competes with fully integrated device companies, many of which have substantially more experience, financial and other resources and superior expertise in research and development, manufacturing, testing, obtaining regulatory approvals, marketing and distribution.

Future products of the Company are expected to address the urological market. The Company's competition will be determined in part by the particular urological disease to which the Company's potential products relate. An important factor in competition may be the timing of market introduction of its or competitive products. Accordingly, the relative speed with which Medstone can develop products, complete the clinical trials and approval processes and supply commercial quantities of the products to the market are expected to be important competitive factors. The Company expects that competition among products approved for sale will be based on, among other things, product efficacy, safety, reliability, availability, price, patent position and sales, marketing and distribution capabilities.

The Company's competitive position also depends upon its ability to attract and retain qualified personnel, obtain patent protection or otherwise develop proprietary products or processes and secure sufficient capital resources for the often substantial period between technological conception and commercial sales.

SHOCKWAVE LITHOTRIPTERS

The Company's two principal competitors in shockwave lithotripsy are Dornier, a subsidiary of a Singapore-based conglomerate, and Siemens GmbH, a German electronic company. In addition, a number of other companies, both in the U.S. and foreign countries, have PMAs to sell their lithotripters for the treatment of kidney stones in the U.S. or are conducting clinical studies on the use of lithotripters for the treatment of kidney stones.

The Company believes that, in addition to the obtaining of FDA and other governmental approvals, important competitive factors in the markets for shockwave lithotripters include the reliability, effectiveness in treating patients and pricing of particular systems. The Company believes the Medstone System compares favorably with other lithotripters presently being offered by competitors with respect to the precision of its imaging systems, its ease of patient handling, its simplicity of operation design, its safety features and its success rate in treating patients.

MOBILE LITHOTRIPSY SERVICES

In the fee-for-service business segment, the Company competes with a number of service oriented medical businesses, in a fragmented and highly competitive industry, both nationally and locally. Moreover, certain of the Company's current and potential competitors have substantially greater financial resources than the Company and may compete with the Company for acquisitions and development of operations in markets targeted by the Company. The Company has experienced competition in the acquisition of existing lithotripsy facilities and the development of relationships with treating physicians. The Company has experienced competition from hospitals or treating physicians who have opened their own lithotripsy facilities. Such competition could intensify in the event of a decrease in the purchase price of lithotripters or if the supply of new or used lithotripters increases over time.

The Company's main competitors in the fee-for-service business are Prime Medical Services, Inc., a Texas-based mobile lithotripsy provider, the lithotripsy business of Integrated Health Services, Inc., a Maryland based healthcare concern, of which one operating entity owns lithotripsy provider partnerships, and other smaller regional and local providers.

The Company's main competitors in the urological table business are Liebel Flarsheim Co., a private Ohio-based manufacturer of urology products, and OEC Medical Systems, Inc., a Utah based publicly-held provider of imaging and related products.

SALES AND MARKETING

The Company's current products and planned future products are targeted at the lithotripsy market. Medstone has a direct sales force covering the continental United States. Outside the United States, the Company uses a network of distributors.

The Company generates revenue from the sale of equipment, and also from the sale of software licenses, disposable supplies, procedure fees and service contracts to hospitals, physicians, and other health care providers.

The Company offers to hospitals, surgery centers and physician groups lithotripsy services on a fee basis. In the current cost conscious healthcare environment, many facilities do not have the patient flow to justify owning, or the available capital to purchase, a lithotripsy machine. These facilities are candidates for fee-for-service. In a fee-for-service arrangement the customer will sign a contract for a period of time, typically one to three years, and will pay a fixed fee for each patient treated on the lithotripter. Most often this service is provided by a lithotripter that is in a mobile van so a single machine can provide service over a wide geographic area. For facilities with adequate patient flow, fee-for-service can be provided with a fixed unit installed in that facility.

Marketing for the Company's products is accomplished through advertisement in medical journals, direct mail, direct physician contact, company participation in various associations, product exhibition and telephonic marketing.

BACKLOG - SHOCKWAVE LITHOTRIPSY

The Company's lithotripsy equipment sale backlog was $1,875,000 for the STS-T as of March 1, 1999 and $250,000 for the STS as of March 1, 1998. Due to the high per unit price of the Medstone Systems, equipment backlog can vary significantly from period to period based upon the number of systems on order. Backlog consists only of orders evidenced by signed contracts for equipment scheduled for delivery and installation within 12 months and does not include revenues for maintenance and per procedure charges, or management services contracts.

With the maturity of Medstone's lithotripsy business, recurring revenues from fee for service and procedure fees and maintenance services have become a major source of Medstone's revenue stream. Maintenance services are

generally provided under annual service contracts, and procedure and fee for service fees are earned based upon usage of the System.

HUMAN RESOURCES

As of February 28, 1999, Medstone had 82 employees. Of the 82 employees, 9 are engaged directly in research and development activities, 15 are engaged in manufacturing, 20 are engaged in mobile operations, 16 are engaged in field service, 11 are engaged in sales and marketing and 11 are employed in general and administrative positions.

Although Medstone conducts most of its research and development using its own employees, the Company has funded, and plans to continue to fund, research using consultants. Consultants provide services under written agreements and are paid based on the amount of time spent on Company matters. Under their consulting agreements, Medstone's consultants are required to disclose and assign to the Company any ideas, discoveries and inventions developed by them in the course of providing consulting services.

ITEM 2. PROPERTIES

In March 1994, the Company took occupancy of office, manufacturing, engineering, and warehouse space, and research and development laboratories, located in Aliso Viejo, California, under an operating lease with an initial term of two years. The Company negotiated an extension of its original lease with current monthly rent of $13,874 through February 1999, and starting in March 1999 through June 2000, a sixteen month period, the monthly rent is $14,410.

United Physicians Resources leases a 1,417 square foot office in Phoenix, Arizona with a monthly rental expense of $1,990 under an operating lease which expires in October 1999.

ITEM 3. LEGAL PROCEEDINGS

The Company carries director and officer liability insurance, and has indemnification agreements with its officers and directors.

The Company was a defendant in two related class action lawsuits filed by two shareholders of the Company alleging that adverse material information was not disclosed at the time of the initial public offering and in subsequent periods. On June 20, 1996 the defendants and plaintiffs reached an agreement whereby a $6 million, non-recapturable settlement fund was established in return for dismissal of all claims against the Company, its underwriter and current and former officers and directors. The Company recorded a one-time, $5.5 million expense in the second quarter of 1996 to cover its portion of the settlement fund, with the first half paid on July 9, 1996 and the second half paid on August 15, 1996. All funds for the settlement were remitted by the Company, with the co-defendants having paid their portions to the Company.

From time to time, the Company is subject to legal actions and claims for personal injuries or property damage related to patients who use its products. The Company has obtained a liability insurance policy providing coverage for product liability and other claims. Management does not believe that the resolution of any current proceedings will have a material financial impact on the Company or the consolidated financial statements.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Company's annual meeting of shareholders was held on June 10, 1998. At the meeting Frank R. Pope, David V. Radlinski, Donald Regan and Michael C. Tibbitts were elected directors of the Company.

EXECUTIVE OFFICERS OF THE REGISTRANT

Information regarding the Company's executive officers is included in Item 10 of Part III.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Prior to January 24, 1991, the Company's common stock was traded on the NASDAQ Stock Market under the symbol MSHK. On January 24, 1991, the Company changed its name to Cytocare, Inc. and began trading on the NASDAQ Stock Market under the symbol CYTI. On September 25, 1995, the Company changed its name to Medstone International, Inc. and began trading on the NASDAQ Stock Market under the symbol MEDS. The following table sets forth the high and low sales prices of the Company's common stock for the two years ended December 31, 1997 and December 31, 1998 as reported in the NASDAQ National Market System for the quarter indicated.

	HIGH	LOW
YEAR ENDED DECEMBER 31, 1998		
First quarter	$ 10-7/8	$ 8
Second quarter	11-1/2	8-1/4
Third quarter	9-3/8	5-15/16
Fourth quarter	8-1/4	5-1/4
YEAR ENDED DECEMBER 31, 1997		
First quarter	$ 9-5/8	$ 7-3/8
Second quarter	9-1/4	7-1/2
Third quarter	10-7/8	9-1/16
Fourth quarter	11-3/8	9-5/8

The stock markets have experienced extreme price and volume fluctuations during certain periods. These broad market fluctuations and other factors may adversely affect the market price of the Company's Common Stock. Any shortfall in revenue or earnings from levels expected by securities analysts could have an immediate and significant adverse effect on the trading price of the Company's common stock in any given period. Additionally, the Company may not learn of such shortfalls until late in the fiscal quarter, which could result in an even more immediate and adverse effect on the trading price of the Company's stock. Finally, the Company participates in a highly dynamic industry, which often results in significant volatility of the Company's common stock price.

At March 1, 1999, there were 289 stockholders of record and approximately 2,800 beneficial owners of the Company's Common Stock.

On February 9, 1996, the Company distributed two stock dividends, one common share of both Endocare and of Urogen for each common share of Medstone to holders of record at the close of business on December 29, 1995. The shares represent a distribution of all the assets of these two subsidiaries of the Company which became separate public companies upon distribution. Those companies operated as separate entities as of January 1, 1996. (See Note 6 to the Company's Consolidated Financial Statements.)

The Company has not paid any cash dividends during its two most recent fiscal years. The Company's board of directors does not presently anticipate that any cash dividends will be paid in the foreseeable future.

ITEM 6. SELECTED FINANCIAL DATA

CONSOLIDATED STATEMENTS OF OPERATIONS DATA:
(in thousands, except per share amounts)

<TABLE>
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	YEAR ENDED DECEMBER 31,				
	1998	1997	1996	1995	1994
<S>	<C>	<C>	<C>	<C>	<C>
Revenues:					
Net equipment sales	$ 2,144	$ 2,722	$ 2,420	$ 4,588	$ 3,125
Procedure, maintenance, and management fees	21,129	18,476	14,884	12,797	12,538
Interest and dividends	552	536	676	1,005	642
Total revenues	23,825	21,734	17,980	18,390	16,305
Costs and expenses:					
Cost of sales	11,000	9,503	8,009	7,633	6,004
Research and development	1,079	1,021	522	927	1,076
Selling	1,988	2,257	2,146	2,050	2,551
General and administrative	2,131	2,231	1,666	1,656	2,105
Lawsuit settlement cost	--	--	5,500	--	--
Legal and other (income)/expense	(61)	(39)	402	164	35
Total costs and expenses	16,137	14,973	18,245	12,430	11,771
Income (loss) before provision/(benefit) for income taxes	7,688	6,761	(265)	5,960	4,534
Minority interest in subsidiary income .	628	468	143	--	--
Provision (benefit) for income taxes ...	2,718	2,329	(170)	2,086	150
Net income (loss)	$ 4,342	$ 3,964	$ (238)	$ 3,874	$ 4,384
Net income (loss) per share:(1)					
Basic	$ .84	$ .74	$ (.04)	$ .74	$ .89
Diluted	$ .82	$ .72	$ (.04)	$ .70	$ .82

</TABLE>

CONSOLIDATED BALANCE SHEET DATA:
(in thousands)
<TABLE>
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	DECEMBER 31,				
	1998	1997	1996	1995	1994
<S>	<C>	<C>	<C>	<C>	<C>
Working capital	$18,432	$16,256	$14,983	$18,465	$16,658
Total assets	29,149	27,688	25,395	25,910	22,260
Total liabilities ..	3,216	3,567	4,230	3,753	2,809
Stockholders' equity	25,933	24,121	21,165	22,157	19,451

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(1) Restated in accordance of SFAS Statement No. 128 "Earnings Per Share".

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

Medstone manufactures, markets and maintains lithotripters, and continues to expand its Fee-for-Service Program to supply lithotripsy equipment to providers on a per procedure basis. The Company is also marketing a urology imaging and treatment table, used for various urological functions. To date, the Company's consolidated revenues have come primarily from Medstone's lithotripsy business.

As a manufacturer of medical devices, the Company has been vertically integrating by offering its medical devices directly to providers. It currently offers lithotripsy procedures using 15 mobile systems and two fixed sites in the

United States on a per procedure basis. With the ability to offer quality equipment at reasonable prices, Medstone intends to continue the growth of this manufacturer direct business.

In June 1996, the Company completed the acquisition of a 60% interest in Northern Nevada, a lithotripsy partnership which deals directly with patient and insurers, and also founded UPR as a majority-owned subsidiary of the Company, to expand the Company's service orientation to the urologist practitioner. Both entities signify the Company's emphasis on growth through expansion of relationships and acquisition. In March 1997, the Company completed the acquisition of a 60% interest in Southern Idaho Lithotripsy Associates LLC, another operator of "retail" lithotripsy operations in Southern Idaho, and operating results have been consolidated effective March 1, 1997.

The Company began the year with approximately $11 million in cash and marketable securities, no debt, inventories of $2.7 million, and total assets of $27.7 million. After purchase of $2.7 million of treasury stock, payment of income taxes of $2.6 million and recurring operating costs, the Company ended the year with approximately $11.6 million in cash and marketable securities, no debt, inventories of $3.6 million and total assets of $29.1 million.

Through its continuing research and development, management of the Company is putting in place the scientific and engineering base it believes is necessary to carry it through the next phases of its growth plans.

The Company was a defendant in two related class action lawsuits filed by two shareholders of the Company alleging that adverse material information was not disclosed at the time of the initial public offering and in subsequent periods. On June 20, 1996 the defendants and plaintiffs reached an agreement whereby a $6 million, non-recapturable settlement fund was established in return for dismissal of all claims against the Company, its underwriter and current and former officers and directors. The Company recorded and paid a one-time, $5.5 million expense in 1996 to cover its portion of the settlement fund. All funds for the settlement were remitted by the Company, with the co-defendants paying their portions to the Company. (See Item 3. Legal Proceedings).

From time to time, the Company is subject to legal actions and claims for personal injuries or property damage related to patients who use its products. The Company has obtained a liability insurance policy providing coverage for product liability and other claims. Management does not believe that the resolution of any current proceedings will have a material financial impact on the Company or the consolidated financial statements.

In 1996, the Company negotiated with Coram Healthcare ("Coram") for the right to purchase the lithotripsy related operations of Coram. In October 1996, negotiations ceased and, upon Coram's subsequent acquisition by Integrated Health Services, Inc., a breakup fee clause was enacted and the Company received reimbursement of $1.25 million of certain documented out-of-pocket expenses relating to the attempted acquisition and related financing. The Company received the $1.25 million in 10 installments during 1997.

RESULTS OF OPERATIONS

YEAR ENDED DECEMBER 31, 1998 COMPARED TO YEAR ENDED DECEMBER 31, 1997

Total revenue increased to $23.8 million, or by 10%, for the year ended December 31, 1998 when compared to the year ended December 31, 1997. Equipment revenues decreased by $578,000 in the current year when compared to the prior year, due to a decline in the number of unit shipments only partially offset by an increase in average unit selling prices. Also decreasing was revenue from equipment upgrades when compared to the year ended 1997.

Revenue from procedure, maintenance and management fees, increased by $2,652,000, or 14%, in the current year when compared to the prior year as the Company's fee-for-service revenues continue to increase as the number of patients treated in 1998 increased by 26% when compared to the number of patients treated in the fee-for-service, Northern Nevada and Southern Idaho operations in 1997. Higher patient counts in both Northern Nevada and Southern Idaho, the former due to higher activity and the latter due to full year results and increased activity, resulted in a 22% increase in revenue for those two operating entities, even though there was a slight decrease in the average per patient revenue. Pricing pressures on procedure revenue from third-party owned equipment resulted in a 7% decrease in the per procedure fee, even though the number of procedures increased by 5% when compared to 1997.

Interest income increased by 3% for the year ended December 31, 1998 when compared to the prior year as the Company's average invested cash balance increased slightly, partially offset by a decrease in average investment yield.

Cost of equipment sales decreased to $1,901,000 in 1998 compared to $2,040,000 in 1997 due to the decline in the number of unit shipments offset by an increase in the option content needed to complete sales, along with costs associated with a foreign installation, in the current year.

Cost on recurring revenues increased to $9,099,000 or 43% of revenues in 1998 compared to $7,463,000 or 40% in 1997, due to the addition of several new vans in new geographic areas in 1998 and the associated overhead needed for operations. Pricing pressure also contributed to the slight decline in the gross margins on recurring revenues.

Research and development costs increased in 1998 by $57,000, or 6%, when compared to the same period of 1997, due to slightly higher spending on payroll and related costs as the Company completed its development of its new transportable lithotripter, introduced into the marketplace in March 1999.

Selling expenses decreased $269,000, or 12%, in 1998 compared to 1997 due to lower payroll as the Company refocused its marketing effort and the associated lower travel expenses and lower bad debt expenses.

General and administrative expenses declined to $2,131,000 in 1998 compared to $2,231,000 in 1997 representing a 4% decrease. This decrease was due mainly to lower payroll as the United Physician Resources subsidiary was refined and lower bad debt in the Northern Nevada and Southern Idaho operations. This was partially offset by an increase in legal expenses.

Legal and other (income)/expense decreased by $22,000 in 1998 compared to 1997 due to the gain on investment in a joint venture only partially offset by increased goodwill amortization for a full year on the Southern Idaho acquisition.

Minority interest expenses of $628,000 in 1998 increased from $468,000 in 1997 due to both a full year's activity for Southern Idaho and increased activity in both Southern Idaho and Northern Nevada.

Provision (benefit) for income taxes increased in the current year compared to the prior year due to both an increase in taxable income and a higher effective tax rate in 1998.

YEAR ENDED DECEMBER 31, 1997 COMPARED TO YEAR ENDED DECEMBER 31, 1996

Total revenues increased to $21.7 million, or 21% for the year ended December 31, 1997 when compared to revenues of $18.0 million in the year ended December 31, 1996. The revenues from equipment sales increased by 12% as the number of units sold increased but the average unit selling price decreased due to competition. Decreasing was the revenue from equipment upgrades when compared to 1996 as fewer field upgrades are being performed.

Revenue from procedure and maintenance fees, or recurring revenue, increased by $3.4 million, or 23%, from 1996 levels due to the Company's continued revenue growth in its fee-for-service business, and the additional revenue from the Southern Idaho acquisition. Volume on company owned mobile lithotripsy units increased by 51% in 1997 when compared to 1996 with fees remaining constant. Procedure revenue on third-party owned equipment was flat in 1997 when compared to 1996 as patient volume increased slightly and per procedure fees decreased slightly. Revenues acquired with Southern Idaho, when combined with the previously acquired Northern Nevada, increased per procedure averages due to the higher fees for direct billings.

Interest income decreased by 21% in 1997 when compared to 1996 due to lower average invested cash balances which resulted from the payment of Coram expenses, acquisition costs and treasury stock repurchases.

Cost of equipment sales in 1997 increased by 57% in 1997 from 1996 levels due to the higher number of unit shipments in the year. Gross margins on equipment and equipment upgrades decreased due to the decrease in average unit selling prices.

Cost of recurring revenues increased by $752,000, or 11%, in 1997 when compared to 1996 due to increased activity in staffing costs and van movement costs for mobile services in correlation with higher patient volume. Gross margin, as percentage of recurring revenue, increased to 60% in 1997 from 55% due to higher utilization of existing equipment as fixed costs remain stable.

Research and development costs increased in 1997 by 96% when compared to 1996 levels due to increased spending on materials, staffing and consultants as the Company accelerated its development of a portable lithotripter.

Selling expenses increased by $111,000, or 5%, in 1997 when compared to 1996 due to higher commission expense in connection with revenue growth, the cost of a national ad campaign, and bad debt expenses.

General and administrative expenses increased by 34% or $565,000 from

1996 to 1997, due to higher staffing costs associated with a full year's operations of United Physicians Resources, increased legal expenses and increased billing service expense for the direct billings done on acquired entities.

Other income/expense, net decreased by $442,000 in 1997 when compared to 1996 due to the class action litigation preparation expenses incurred in 1996, partially offset by the gain on the sale of securities held for investment in 1996.

Lawsuit settlement costs decreased by $5.5 million due to the settlement of the class action lawsuit in 1996.

Minority interest expense of $468,000 represents the minority shareholder's interest in the results of operations of Northern Nevada and Southern Idaho.

Provision (benefit) for income taxes recognizes the tax expense of the current year's income compared to the operating loss incurred in 1996.

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 1998, the Company had cash and short-term investments of approximately $11.6 million. These funds were generated from operating activities.

The Company's long-term capital expenditure requirements will depend upon numerous factors, including the progress of the Company's research and development programs, the time required to obtain regulatory approvals, the resources that the Company devotes to the development of self-funded products, proprietary manufacturing methods and advanced technologies, the cost of acquisition and/or new revenue opportunities, the ability of the Company to obtain additional licensing arrangements and to manufacture products under those arrangements, the demand for its products if and when approved and possible acquisitions of products, technologies and companies.

The Company believes that its existing working capital and funds anticipated to be generated from operations will be sufficient to meet the cash needs for continuation of its present operations during 1999. See "Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995."

YEAR 2000

Impact of the Year 2000

The Year 2000 Issue exists because many computer systems and applications currently use two-digit date fields to designate a year. As the century date occurs, computer programs, computers and embedded microprocessors controlling equipment with date-sensitive systems may recognize Year 2000 as 1900 or not at all. This inability to recognize or properly treat Year 2000 may result in computer system failures or miscalculations of critical financial and operational information as well as failures of equipment controlling date-sensitive microprocessors. In addition, there are two other related issues, which could also lead to miscalculations or failures: (i) some older systems' programming assigns special meaning to certain dates, such as 9/9/99 and (ii) the Year 2000 is a leap year.

State of Readiness

The Company started to formulate a plan to address the Year 2000 Issue in 1997. To date, the Company's primary focus has been on its own internal information technology systems, along with date-sensitive subsystems of its products. The Company has developed a Year 2000 Plan to address all of its Year 2000 Issues. The Year 2000 Plan being developed will involve generally the following phrases: awareness, assessment, renovation, testing and implementation.

The Company has completed an assessment of approximately 95% of its internal information technology systems. The Company has already completed the renovation of approximately 50% of its information technology systems, including modifying and upgrading software and developing and purchasing new software, and continues to renovate the portions of such systems for which assessment is complete. The Company's goal is to complete testing and implementation phases by June 30, 1999.

The Company has recently begun to assess the potential for Year 2000 problems with the information systems of its customers and vendors. The Company is preparing questionnaires that it expects to send to its customers, vendors and other third parties with which the Company has a material relationship by March 31, 1999. The Company expects to complete the assessment with respect to such parties by June 30, 1999, subject to their ability to provide requested information. The Company does not have sufficient information to provide an estimated timetable for completion of renovation and testing that such parties with which the Company has a material relationship may undertake. The Company is unable to estimate the costs that it may incur to remedy the Year 2000 issues relating to such parties.

All of the mission critical date sensitive systems used in the Company's products have been evaluated for their compliance with Year 2000 issues. The findings of this evaluation are that, with an upgrade to the computer system of the equipment, along with an operating system upgrade, the system will be fully compliant with the Year 2000. The existing customer base of the Company has been notified of this, and where upgrades have been performed, compliance certificates have been issued. Customers have also been advised that if an upgrade is not purchased, a compliance certificate cannot be issued. Any other date related information contained in systems and software of the equipment that would not have any impact on the operation and safety of the Company's products will be addressed with vendors to the Company throughout 1999.

The Company has done an assessment of the potential for Year 2000 problems with the embedded microprocessors in its other equipment and facilities, including telecommunications systems, utilities, security systems and HVACs and expects no significant effect on the non-critical functions of the Company, provided major suppliers of mass consumption items, such as electricity, telephone and data transmission, gasoline, water, natural gas and waste disposal, meet their projections of Year 2000 compliance. The Company has already installed a new telephone system in 1998 to comply with Year 2000.

Costs to Address Year 2000 Issues

The Company estimates on a preliminary basis that the cost of assessment, renovation, testing and implementation of its internal systems will not be material to the overall operations of the Company. The major components of these costs are: consultants, programming, new software and hardware, software upgrades and travel expenses. The Company expects that such costs will be funded through operating cash flows. This estimate, based on currently available information, will be updated as the Company continues its assessment and proceeds with renovation, testing and implementation and may be adjusted upon receipt of more information from the Company's vendors, customers and other third parties and upon the design and implementation of the Company's contingency plan. In addition, the availability and cost of consultants and other personnel trained in this area and unanticipated acquisitions might materially affect the estimated costs.

Risks to the Company

The Company's Year 2000 Issue involves significant risks. There can be no assurance that the Company will succeed in implementing the Year 2000 Plan it is developing. The following describes the Company's most reasonably likely worse-case scenario, given current uncertainties. If the Company's renovated or replaced internal information technology systems fail the testing phase, or any software application or embedded microprocessors central to the Company's operations are overlooked in the assessment or implementing phases, significant problems including delays may be incurred in billing the Company's major customers for services performed. If its major customers' systems do not become year 2000 compliant on a timely basis, the Company will have problems and incur delays in receiving and processing correct reimbursement. If the systems on the diagnostic imaging equipment utilized by the Company are not Year 2000 Compliant, the Company may not be able to provide imaging services to patients.

If the Company's vendors or suppliers of the Company's necessary power, telecommunications, transportation and financial services, fail to provide the Company with equipment and services, the Company will be unable to provide services to its customers.

If any of these uncertainties were to occur, the Company's business, financial condition and results of operations would be adversely affected. The Company is unable to assess the likelihood of such events occurring or the extent of the effect on the Company.

Contingency Plan

The Company has not yet established a contingency plan to address unavoidable Year 2000 risks with internal information technology systems and with customers, vendors and other third parties, but it expects to create such a plan by June 30, 1999.

SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

Forward-looking statements in this report, including without limitation, statements relating to the Company's plans, strategies, objectives, expectations, intentions and adequacy of resources, are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Investors are cautioned that such forward-looking statements involve risks and uncertainties including without limitation the following: (i) the Company's plans, strategies, objectives, expectations and intentions are subject to change at any time at the discretion of the Company, (ii) the Company's plans and results of operations will be affected by the Company's ability to manage its growth; (iii) the Company's businesses are highly competitive and the entrance of new competitors into or the expansion of the operations by existing competitors in the Company's markets and other changes could adversely affect the Company's plans and results of operations; and (iv) other risks and uncertainties indicated from time to time in the Company's filings with the Securities and Exchange Commission.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company has no financial instruments which are subject to market risk. Although the Company's earnings and cash flows are subject to fluctuations due to changes in the interest rates on its investments, a hypothetical 10% adverse decrease in the interest rates would not have a material adverse effect on the results of operations because the majority of the Company's investments are short-term treasury bills. A 10% reduction in interest rates would reduce interest income by approximately $50,000 annually. Due to the short period to maturity, the Company believes that the impact of a 10% reduction in interest rates would not have a material effect on the carrying value of its available-for-sale securities.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

See Item 14. "Exhibits, Financial Statement Schedules, and Reports on Form 8-K."

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

DIRECTORS

The following are the directors of the Company:

NAME	AGE	PRINCIPAL OCCUPATION
David V. Radlinski	54	Chairman of the Board and Chief Executive Officer of the Company
Frank R. Pope	49	Managing Director Verdigris Capital
Donald John Regan	64	Vice President and General Counsel Kinsell, O'Neil, Newcomb & De Dios, Inc.
Michael C. Tibbitts	51	Officer and Vice President Gulf South Medical Supply, Inc.

Mr. Radlinski has been the Chairman of the Board and Chief Executive Officer of the Company since September 1995. He had been the President of the Company's subsidiary, Medstone International, Inc., and Chief Financial Officer and Secretary of the Company from January 1991 to September 1995. From July 1987 to January 1991, he was the Company's Executive Vice President of Finance, Chief Financial Officer and Secretary. From 1984 to 1987, he was Vice President of Finance and Chief Financial Officer of Printronix, Inc., a publicly-owned company which manufactured computer printers.

Mr. Pope is Managing Director of Verdigris Capital, a private merchant banking firm. From April 1981 to October 1996, Mr. Pope was a General Partner with Technology Funding, a venture capital investment firm. He was also the Executive Vice President, Chief Financial Officer and a director of Technology Funding Inc. Mr. Pope is also a director of Thermatrix, Inc. and a director and officer of Advanced BioCatalytics Corp. Mr. Pope is a C.P.A. and a member of the California Bar. He has been a director of the Company since January 1991.

Mr. Regan is currently the Vice President and General Counsel of Kinsell, O'Neal, Newcomb & De Dios, Inc., a municipal securities investment banking firm. Mr. Regan has practiced securities, municipal finance, nonprofit corporation, real estate, and business transactions law for over thirty years. He is a member of the National Association of Bond Lawyers, has published several articles on securities law and served as a lecturer for the Practicing Law Institute. He specializes in revenue and project finance bonds. He has been a director of the Company since September 1995.

Mr. Tibbitts, has been with Gulf South Medical Supply, Inc. since 1991 as a Vice President. Prior to joining that corporation, he was employed for 19 years by Johnson & Johnson in two divisions: Sterile Design (which manufactured and marketed kit packages) and Surgikos (which manufactured and marketed surgical supplies). He has been a director of the Company since May 1996.

EXECUTIVE OFFICERS

The names, ages and positions of all the executive officers of the Company as of March 1999 are listed below, followed by a brief account of their business experience during the past five years. Officers are normally appointed annually by the Board of Directors at a meeting of the directors immediately following the Annual Meeting of Shareholders. There are no family relationships among these officers nor any arrangements or understandings between any officer and any other person pursuant to which an officer was selected. None of these officers has been involved in any court or administrative proceeding within the past five years adversely reflecting on his or her ability or integrity.

<TABLE>
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NAME	AGE	POSITION
<S>	<C>	<C>
David V. Radlinski	54	Chief Executive Officer and Chairman of the Board
Mark Selawski	43	Vice President of Finance, Chief Financial Officer and Secretary
Eva Novotny	41	Executive Vice President of Sales and Marketing

</TABLE>

Mr. Radlinski has been the Chairman and Chief Executive Officer of the Company since September 1995. He had been the President of the Company's subsidiary, Medstone International, Inc., and Chief Financial Officer and Secretary of the Company from January 1991 to September 1995. From July 1987 to January 1991, he was the Company's Executive Vice President of Finance, Chief Financial Officer and Secretary. From 1984 to 1987, he was Vice President of Finance and Chief Financial Officer of Printronix, Inc., a publicly-owned company which manufactured computer printers.

Mr. Selawski has been the Chief Financial Officer, Vice President of Finance and Secretary of the Company since September 1995. He had previously served as the Company's Manager of Planning and Analysis since joining the Company in 1988. Prior to joining the Company he held various finance management positions with several high-tech manufacturing companies.

Ms. Novotny has been Executive Vice President of Sales and Marketing of the Company since October 1997. Prior to joining the Company, she was Director of Marketing for Imagyn Medical, formerly UroHealth, from June 1995 to October 1997. From 1985 to 1995, she was employed by Mentor Corporation as a Marketing Manager and later as Director of Marketing for Mentor Urology.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

The Company is not aware of any director, officer or 10% shareholder who during 1998 failed to file on a timely basis any report regarding the Company's securities required by Section 16(a) of the Securities Exchange Act of 1934.

ITEM 11. EXECUTIVE COMPENSATION

EXECUTIVE COMPENSATION

The following table sets forth certain information regarding compensation paid by the Company during each of the Company's last three fiscal years to the Company's Chief Executive Officer and to each of the Company's other executive officers during fiscal 1998.

SUMMARY OF COMPENSATION TABLE

<TABLE>
<CAPTION>

		ANNUAL COMPENSATION			LONG TERM COMPENSATION: AWARDS		LONG TERM COMPENSATION: PAYOUTS	
NAME AND PRINCIPAL POSITION	FISCAL YEAR	SALARY ($)(1)	BONUS ($)	OTHER ANNUAL COMPENSATION ($)	RESTRICTED STOCK AWARDS(S) ($)	SECURITIES UNDERLYING OPTIONS (#)(2)	LTIP PAYOUTS ($)	ALL OTHER COMPENSATION ($)
<S>	<C>	<C>	<C>	<C>	<C>	<C>	<C>	<C>
David V. Radlinski	1998	219,135	--	2,426	--	350,000	--	--
Chairman of the Board and	1997	200,300	--	--	--	100,000	--	--
Chief Executive Officer	1996	200,100	--	--	--	50,000	--	--
Mark Selawski	1998	99,038	300	--	--	80,000	--	--
Chief Financial Officer, Vice	1997	85,833	11,300	--	--	20,000	--	--
President of Finance	1996	85,600	--	--	--	20,000	--	--
and Secretary								
Eva Novotny(3)	1998	120,000	300	--	--	70,000	--	--
Executive Vice President of	1997	25,300	--	--	--	50,000	--	--
Sales and Marketing								

</TABLE>

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(1) In addition to the cash compensation shown in the table, executive officers of the Company may receive indirect compensation in the form of perquisites and other personal benefits. For each of the named executive officers, the amount of this indirect compensation in 1998, 1997 and 1996 did not exceed the lesser of $50,000 or 10% of the executive officer's total salary and bonus for that year.

(2) Options to acquire shares of Common Stock granted and repriced. (3) Ms. Novotny joined the Company as of October 15, 1997.

EMPLOYMENT AGREEMENTS

Mr. Radlinski - On August 13, 1998, the Company entered into an employment agreement with Mr. Radlinski to assure his continued service to the Company. The agreement runs for a term of five years, expiring on August 13, 2003. The agreement provides for a base salary of not less that $250,000 per year, subject to adjustments as authorized by the Board of Directors.

Mr. Radlinski is also eligible for bonuses based on performance of the Company's Common Stock. The Common Stock's closing price must attain and remain at or above various levels, ranging from $11 to $21, for a period of 90 consecutive days. If these breakpoint prices are achieved within a set number of months, the longest which is 48 months, from the commencement of the contract, a cash bonus will be paid following the achievement period. Each breakpoint bonus can be earned separately if achieved within the stated achievement period, but each bonus can only be awarded once.

Concurrent with the commencement of this agreement, the exercise prices of Mr. Radlinski's existing stock options to purchase up to 350,000 shares of the Company's Common Stock from $7.13 to $10.63 were reduced to equal $6.37 per share, the closing price per share of the Company's Common Stock on the commencement date as reported on the NASDAQ National Market System. Such option agreements were amended to provide that they shall become

fully exercisable, regardless of any otherwise applicable vesting requirements, i) concurrently with any termination of Mr. Radlinski's employment by the Company without "Good Cause" (as defined), or ii) if there is an acquisition of substantially all of the Company's assets or business while he is still employed by the Company and he does not immediately enter into an employment agreement with a buying or surviving party in the transaction (a "change in control")..

If he is terminated without "Good Cause" or a change of control occurs within the first three years of the agreement, a severance payment of five times his then current base salary will be due and payable. If he is terminated without "Good Cause" or such a change of control occurs within the fourth year of the agreement, a severance payment of four times his then current base salary will be due and payable. If he is terminated without "good cause" or a change of control occurs within the fifth year of the agreement, a severance payment of three times his then current base salary will be due and payable.

In addition to the preceding paragraph, if Mr. Radlinski is terminated without Good Cause in the first three years of this agreement, he will become a consultant to the Company for a period of five years following termination at a monthly compensation of $16,500 per month. If he is terminated without Good Cause or there is a change in control in the fourth year of this agreement, he will become a consultant to the Company for a period of four years following termination at the same monthly compensation. If he is terminated without Good Cause or there is a change of control in the fifth year of this agreement, he will become a consultant to the Company for a period of three years following termination at the same monthly compensation. The Company, during the consulting contract, shall provide term life insurance equivalent to the unpaid amount of the consulting fees as established above, payable to the beneficiary of his designation.

Mr. Selawski and Ms. Novotny - On August 13, 1998, the Company entered into employment agreements with both Mr. Selawski and Ms. Novotny to assure their continued service to the Company. The agreements run for a term of three years, expiring on August 13, 2001. The agreements provide for a base salary of not less that $100,000 per year for Mr. Selawski and $120,000 per year for Ms. Novotny, subject to adjustments as authorized by the Board of Directors.

Concurrent with the commencement of these agreements, the exercise prices of Mr. Selawski's existing stock options to purchase up to 80,000 shares of the Company's Common Stock at from $7.13 to $9.68 were reduced to equal $6.37 per share, the closing price per share of the Company's Common Stock on the commencement date as reported on the NASDAQ National Market System. Ms. Novotny's existing stock options to purchase up to 70,000 shares of the Company's Common Stock at from $9.68 to $10.68 were reduced to equal $6.37 per share, the closing price per share of the Company's Common Stock on the commencement date as reported on the NASDAQ National Market System. Each such option agreement was amended to provide that it shall become fully exercisable, regardless of any otherwise applicable vesting requirements, i) concurrently with any termination of the officer's employment by the Company without Good Cause, or ii) if there is an acquisition of substantially all of the Company's assets or business while such officer is still employed by the Company and he or she does not immediately enter into an employment agreement with a buying or surviving party in the transaction. If the officer is terminated without "Good Cause" or such a change of control occurs within the term of the agreement, a severance payment of two times his or her then current base salary will be due and payable.

STOCK OPTION GRANTS AND REPRICINGS DURING 1998

The following table provides information related to the stock options that in August 1998 were repriced to the current market value and new options granted in 1998.

<TABLE>
<CAPTION>

	INDIVIDUAL REPRICINGS AND GRANTS				POTENTIAL REALIZABLE VALUE AT ASSUMED ANNUAL RATES OF STOCK PRICE APPRECIATION FOR OPTION TERM	
NAME	SHARES UNDERLYING OPTIONS GRANTED OR REPRICED (#)(1)	% OF TOTAL EMPLOYEE OPTIONS GRANTED OR REPRICED IN FISCAL YEAR	EXERCISE PRICE ($/SHARE)(2)	EXPIRATION DATE	5%($)	10%($)
<S>	<C>	<C>	<C>	<C>	<C>	<C>
David V. Radlinski	50,000	5%	6.375	7/26/01	108,375	245,438
	100,000	10%	6.375	9/25/01	216,750	490,875
	50,000	5%	6.375	7/23/02	108,375	245,438
	50,000	5%	6.375	1/9/03	108,375	245,438
	50,000	5%	6.375	6/10/03	108,375	245,438
	50,000	5%	6.375	4/15/04	108,375	245,438
Mark Selawski	20,000	2%	6.375	7/26/01	43,350	98,175
	20,000	2%	6.375	7/23/02	43,350	98,175
	20,000	2%	6.375	6/10/03	43,350	98,175
	20,000	2%	6.375	4/15/04	43,350	98,175
Eva Novotny	50,000	5%	6.375	10/15/03	108,375	245,438
	20,000	2%	6.375	4/15/04	43,350	98,175

</TABLE>

(1) The options granted or repriced vest equally over a 60-month period commencing upon the original grant date. The first six months after a grant does not allow exercise of the option for the then vested shares.

The options are for a 6-year term, subject to earlier termination in certain events related to termination of employment. The Compensation Committee retains discretion, subject to the option plans' limits, to modify the terms of outstanding options.

2) Subject to certain conditions, the exercise price may be paid by delivery of already owned shares and the tax withholding obligations related to exercise may be paid by offset of the underlying shares.

STOCK OPTIONS HELD AT END OF FISCAL YEAR

The following table provides information related to options exercised during 1998 and options held by the named executive officers at December 31, 1998.

NAME	SHARES ACQUIRED ON EXERCISE(#)	VALUE REALIZED($)(1)	NUMBER OF SECURITIES UNDERLYING UNEXERCISED OPTIONS AT FY-END(#)		VALUE OF UNEXERCISED IN-THE-MONEY OPTIONS AT FY-END($)(2)	
			EXERCISABLE	UNEXERCISABLE	EXERCISABLE	UNEXERCISABLE
David V Radlinski	--	--	165,000	185,000	29,700	33,300
Mark Selawski	--	--	32,000	48,000	5,760	8,640
Eva Novotny	--	--	14,333	55,667	2,580	10,020

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(1) The value is calculated based on the difference between the option exercise price and the market price for the Company's Common Stock on the exercise date, multiplied by the number of shares purchased. For this purpose, the surrender or withholding of shares to pay the exercise price is not taken into account.

(2) The closing price for the Company's Common Stock as reported by the National Association of Securities Dealers (NASD) on December 31, 1998 was $6.56. Value is calculated on the basis of the difference between the option exercise price and $6.56, multiplied by the number of shares of Common Stock underlying the option.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

During 1998 Donald J. Regan and Frank R. Pope served as the members of the Company's Compensation Committee. Neither such individual is a current or former officer or employee of the Company or any of its subsidiaries. During 1998 there were no compensation committee interlocks between the Company and other entities involving Medstone executive officers serving as directors or members of compensation or similar committees of such other entities.

COMPENSATION OF DIRECTORS

The Company currently compensates Messrs. Regan, Tibbitts and Pope $1,000 per meeting for their services, in addition to reimbursement to all directors for expenses incurred by them in connection with the Company's business. In addition, the Company has compensated Messrs. Pope and Regan $11,000 each and Mr. Tibbitts $8,000, for their participation in a Special Committee of the Board of Directors.

Under the Nonemployee Director Stock Option Plan, each new nonemployee director is automatically granted an option to purchase up to 5,000 shares as of the effective date of his or her first appointment to the Board or first election to the Board by the shareholders, whichever is earlier. Subject to acceleration of the option exercises in the event of certain events specified in the plan, each such option becomes exercisable with respect to 1/60 of the shares issuable for each elapsed full month during the five-year period after its grant date, but will not be initially exercisable until six months after the grant date. The exercise price of each option will equal the fair market value of the underlying Common Stock on the date the option is granted. Each option will expire six years after its grant, except that the expiration will be extended until one year after the optionee's death if it occurs less than one year before the option's expiration date. An option granted under the plan is not transferrable during the grantee's lifetime and must be exercised within one year following his or her death, or within 90 days after the grantee ceases to be a member of the Board for any other reason, and will only be exercisable to the extent it is exercisable on the date the grantee leaves the Board. Under this plan, Mr. Regan was granted 5,000 shares in September 1995 at $11.88 and Mr. Tibbitts was granted 5,000 shares at $8.63 per share in May 1996. These options were repriced on August 13, 1998 to a price of $6.375.

As additional compensation, each current nonemployee director of the Company has received an option to purchase up to 15,000 shares of the Company's Common Stock. The options issued to Mssrs. Pope, Tibbitts and Regan were issued in November 1996 and have exercise prices of $6.375 after repricing of the options on August 13, 1998. The options are exercisable, after six months following their grant dates, in incremental amounts equal to 1/48 of the underlying shares for each elapsed calendar month during which the director remains on the Company's board. The terms of the options are five years, subject to earlier termination related to the director no longer serving on the board. Additionally, each director was granted options, on August 13, 1998, for 4,000 shares at an exercise price of $6.375. These options vest in incremental amounts equal to 1/36 of the underlying shares for each elapsed calendar month during which the Director remains on the Company's board. The term of the options are four years, subject to early termination related to the director no longer serving on the board.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth the number of shares of the Company's Common Stock known to the Company to be beneficially owned as of March 1, 1999 by each person who owns beneficially more than 5 percent of the outstanding shares of Common Stock, by each of the present directors and nominees for director, by each of the executive officers named in the Executive Compensation in Item 11 and by all executive officers and directors of the Company as a group, and the percentage of the total outstanding shares of Common Stock such shares represented as of March 1, 1999.

NAME AND ADDRESS OF BENEFICIAL OWNER	NUMBER OF SHARES BENEFICIALLY OWNED(1)	PERCENTAGE OF OWNERSHIP
FMR Corp. 82 Devonshire Street Boston, MA 02109	561,200	11.1%
The Kaufmann Fund 140 E. 45th Street, 43rd Floor New York, NY 10017	500,000	9.9%
Hathaway & Associates, Ltd. 119 Rowayton Avenue Rowayton, CT 06853	440,000	8.7%
David V. Radlinski(2)(3) 100 Columbia, Suite 100 Aliso Viejo, CA 92656	276,648	5.3%
Mark Selawski(3) 100 Columbia, Suite 100 Aliso Viejo, CA 92656	40,847(5)	(10)
Eva Novotny(3) 100 Columbia, Suite 100 Aliso Viejo, CA 92656	19,800	(10)
Donald J. Regan(2) 462 Stevens Avenue, Suite 308 Solana Beach, CA 92075	17,996(7)	(10)
Frank R. Pope(2) 25 Preston Road Woodside, CA 94062	10,590(8)	(10)
Michael C. Tibbitts(2) 27001 La Paz Road, Suite 448B Mission Viejo, CA 92691	8,757(9)	(10)
All executive officers and directors as a group (6 persons)(11)	374,638	7.02%

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(1) All such shares were held of record with sole voting and investment power, subject to applicable community property laws, by the named individual and/or by his wife, except as indicated in the following footnotes.

(2) Director of the Company. (3) Executive officer of the Company.

(4) Includes 187,500 shares issuable upon exercise of presently outstanding stock options.

(5) Includes 36,667 shares issuable upon exercise of presently outstanding stock options.

(6) Includes 19,000 shares issuable upon exercise of presently outstanding stock options.

(7) Includes 11,396 shares issuable upon exercise of presently outstanding stock options.

(8) Includes 8,590 shares issuable upon exercise of presently outstanding stock options.

(9) Includes 6,757 shares issuable upon exercise of presently outstanding stock options.

(10) Percentage information is omitted because the beneficially owned shares represent less than 1% of the outstanding shares of the Company's Common Stock

(11) Includes 269,910 shares issuable upon exercise of presently outstanding stock options.

ITEM 13. CERTAIN RELATIONSHIPS AND INVESTMENTS

CARDIAC SCIENCE, INC.

During 1991, the Company was a party to the formation of Cardiac Science, Inc., for which the Company purchased 5,353,031 (pre-split) shares of common stock, for a cash payment of $.0016 per share. This purchase represented 77.3% of the outstanding stock. As of July 8, 1991, the Company distributed, as a dividend to its shareholders of record on that date, one share of Cardiac Science, Inc. stock for each share of Medstone stock held. The Company retained 629,768 (pre-split) shares of common stock of Cardiac Science, Inc.

From 1991 through 1996, the Company performed various financings for Cardiac Science and received warrants to purchase Cardiac Science common stock. Due to exercise of warrants, common stock issued in lieu of interest and unsecured advances, the Company received 5,619,054 (pre-split) shares of Cardiac Science.

In April 1997, Cardiac Science effectuated a 1 for 11.42857143 reverse stock split, reducing the Company's holdings to 546,772 shares, which is the number of shares held at December 31, 1998. This investment is recorded at a cost of $750,054.

The Company also holds warrants to purchase 87,500 (post-split) shares at $.011 each, with an expiration date of September 2004.

DIGITAL IMAGING SYSTEMS, INC.

In 1998, the Company entered into a supply agreement with Digital Imaging Systems, Inc. ("DIS") for components integral in the Company's new transportable lithotripsy product. The Company has purchased $300,000, or 300,000 shares, of DIS preferred stock, which represents a 14% ownership interest. DIS has commenced shipments to the Company as of January 1999. The Company considers this investment to be temporary in nature.

K. BIOTECH

In 1998, the Company was made aware of an opportunity to invest in a developmental biotech drug company catering to the members of the International Centre for Genetic Engineering and Biotechnology ("ICGEB"), a United Nations sponsored institute. k. Biotech purchased license agreements for formulas, developed by the ICGEB, for commercialization purposes in the Indian sub-continent as its primary market. The Company has purchased $225,000 of preferred stock to assist k. Biotech in establishing itself as a viable business entity. Two of the Company's directors, Mssrs. Pope and Regan, are investors in k.Biotech and Mr. Regan serves as k. Biotech's President. Additional funding from international sources is currently being evaluated.

CHINESE JOINT VENTURE

The Company, along with Acuity International ("Acuity") and Phenix Optical Ltd ("Phenix"), a Chinese company, created a joint venture, in March 1998, to provide lithotripsy services to inland Chinese areas. Each entity was a

1/3 owner of the joint venture. The Company recognized a gain of $105,000 on its contribution of equipment to the joint venture in the first quarter of 1998, and recorded its investment of $92,000 as other assets. In November 1998, a purchase of the 2/3 ownership, not owned by Phenix, was proposed. In December 1998, documents were drawn to turn ownership over to Phenix in return for delivery of optical products to both Acuity and the Company. Subsequent to December 31, 1998, the Company received its optical products in release of its share in the joint venture and final release documents are being processed. The Company is carrying the value of the optical products at their estimated fair value, which is the same value as its investment established in the joint venture, with the intention of remarketing these products in 1999.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a) INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

(b) REPORTS ON FORM 8-K

There were no reports on Form 8-K filed with the Commission during the quarter ended December 31, 1998.

(c) EXHIBITS

EXHIBIT NO.	DESCRIPTION
3.1	Certificate of Incorporation of the Company, as amended(1)
3.2	Bylaws of the Company(1)
3.3	Amendment of ByLaws(2)
4.2	Specimen Certificate of the Company's Common Stock(3)
10.26	1989 Stock Incentive Plan(4)(5)
10.27	Non-employee Director Stock Option Plan(4)(5)
10.28	Facility Lease on 100 Columbia(6)
10.29	1997 Stock Incentive Plan(5)(7)
10.30	Employment Agreement with David Radlinski(5)
10.31	Employment Agreement with Mark Selawski(5)

10.32	Employment Agreement with Eva Novotny(5)
21	Subsidiaries
23.1	Consent of Independent Auditors
27	Financial Data Schedule
28.2	Form of Cytocare, Inc. Information Statement - Distribution to Shareholders of Stock of Cardiac Science, Inc.(8)
28.3	Form of Medstone International, Inc. Information Statement - Distribution to Shareholders of Stock of Endocare, Inc. and Urogen Corp.(9)

</TABLE>

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(1) Previously filed with the same exhibit number with the Company's Registration Statement on Form S-1 under the Securities Act of 1933, Reg. No 33-16340 and with the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1988, and incorporated herein by reference.

(2) Previously filed with the same exhibit number with the Company's Registration Statement on Form 10-Q for the quarter ended September 30, 1997, and incorporated herein by reference.

(3) Previously filed with the same exhibit number with the Company's Registration Statement on Form S-1 under the Securities Act of 1933, Reg. No. 33-16340 and incorporated herein by reference.

(4) Previously filed with the same exhibit number with the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1989, and incorporated herein by reference.

(5) Compensatory plan or arrangement.

(6) Previously filed with the same exhibit number with the Company's annual report on Form 10-K for the year ended December 31, 1993.

(7) Previously filed with the same exhibit number with the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1997.

(8) Previously filed with the same exhibit number with the Company's current report on Form 8-K dated June 26, 1991, and incorporated herein by reference.

(9) Previously filed with the Company's current report on Form 8-K dated February 9, 1996, and incorporated herein by reference.

The Company will furnish to a requesting beneficial owner of its securities a copy of any such exhibits upon payment of a fee equal to $.20 per exhibit page.

Report of Independent Auditors

Stockholders and Board of Directors
Medstone International, Inc.

We have audited the accompanying consolidated balance sheets of Medstone International, Inc. as of December 31, 1998 and 1997, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1998. Our audits also included the financial statement schedule listed in the Index at Item 14(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. 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, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Medstone International, Inc. at December 31, 1998 and 1997, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

ERNST & YOUNG LLP

Orange County, California
February 11, 1999

MEDSTONE INTERNATIONAL, INC.
CONSOLIDATED BALANCE SHEETS

<TABLE>
<CAPTION>

	DECEMBER 31, 1998	DECEMBER 31, 1997
<S>	<C>	<C>
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,128,463	$ 1,125,009
Short-term investments	10,494,075	9,900,909
Accounts receivable, less allowance for doubtful accounts of $602,564 and $534,918 in 1998 and 1997, respectively	3,535,581	3,120,787
Inventories	3,595,906	2,680,220
Deferred tax assets	1,139,903	891,507
Income taxes receivable	--	632,851
Prepaid expenses and other current assets	719,598	455,974
Total current assets	20,613,526	18,807,257
Property and equipment:		
Lithotripters	9,054,296	8,524,314
Equipment	1,077,352	815,585
Furniture and fixtures	788,457	821,565
Leasehold improvements	145,007	138,698
	11,065,112	10,300,162
Less accumulated depreciation and amortization	(6.362,955)	(4,721,618)
Net property and equipment	4,702,157	5,578,544
Goodwill, net	3,182,096	3,266,162
Other assets, net	651,494	36,425
	$ 29,149,273	$ 27,688,388
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 389,589	$ 887,740
Accrued expenses	485,108	210,421
Accrued income taxes	183,593	--
Accrued payroll expenses	303,687	239,504
Customer deposits	86,125	132,699
Deferred revenue	733,889	1,080,899
Total current liabilities	2,181,991	2,551,263
Deferred tax liabilities	714,737	649,524
Minority interest	319,868	366,654
Commitments and contingencies (Notes 8 and 9)		
Stockholders' equity:		
Common stock - $.004 par value, 20,000,000 shares authorized, 5,650,505 and 5,578,403 shares issued and outstanding at December 31, 1998 and 1997, respectively	22,602	22,539
Additional paid-in capital	19,076,104	18,998,260
Accumulated earnings	11,778,357	7,436,263
Stock purchase notes receivable	--	(134,800)
Accumulated other comprehensive loss	(1,177)	(579)
Treasury stock 587,100 shares at cost at December 31, 1998 and 268,800 shares at December 31, 1997	(4,943,209)	(2,200,736)

Total stockholders' equity	25,932,677	24,120,947
	$ 29,149,273	$ 27,688,388

</TABLE>

See accompanying notes

MEDSTONE INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

<TABLE>
<CAPTION>

	FOR THE YEAR ENDED DECEMBER 31,		
	1998	1997	1996
<S>	<C>	<C>	<C>
Revenues:			
Procedures and maintenance fees, and management fees	$ 21,128,586	$ 18,476,342	$ 14,883,598
Net equipment sales	2,144,500	2,722,360	2,420,000
Interest and dividend income	551,723	535,601	675,967
Total revenues	23,824,809	21,734,303	17,979,565
Costs and expenses:			
Costs related to procedures and maintenance fees	9,098,822	7,463,418	6,710,645
Cost of equipment sales	1,900,803	2,040,031	1,298,427
Research and development	1,078,792	1,021,349	521,793
Selling	1,988,331	2,256,933	2,145,759
General and administrative	2,131,373	2,231,006	1,666,164
Lawsuit settlement costs	--	--	5,500,000
Legal and other (income)/expense	(61,045)	(39,327)	402,673
Total costs and expenses	16,137,076	14,973,410	18,245,461
Income (loss) before provision/ (benefit) for income taxes	7,687,733	6,760,893	(265,896)
Minority interest in subsidiary income	627,639	467,595	142,575
Provision (benefit) for income taxes	2,718,000	2,329,000	(170,000)
Net income (loss)	$ 4,342,094	$ 3,964,298	$ (238,471)
Net income (loss) per share:			
Basic	$ .84	$ .74	$ (.04)
Diluted	.82	$ .72	$ (.04)
Number of shares used in the computation of net income (loss) per share:			
Basic	5,162,112	5,390,352	5,517,976
Diluted	5,286,967	5,510,668	5,517,976

</TABLE>

See accompanying notes

MEDSTONE INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

<TABLE>
<CAPTION>

	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	ACCUMULATED EARNINGS (DEFICIT)
	NUMBER OF SHARES	AMOUNT		
<S>	<C>	<C>	<C>	<C>

BALANCE AT DECEMBER 31, 1995	5,516,528	$22,066	$18,555,983	$ 3,710,436
Net loss	--	--	--	(238,471)
Other comprehensive income/(loss):				
Unrealized loss on short-term investments	--	--	--	--
Total Comprehensive income/(loss)				
Common stock options exercised	61,875	248	96,085	--
Income tax benefit from stock options	--	--	63,000	--
Treasury stock repurchased	(112,800)	--	--	--
BALANCE AT DECEMBER 31, 1996	5,465,603	22,314	18,715,068	3,471,965
Net income	--	--	--	3,964,298
Other comprehensive income/(loss):				
Unrealized gain on short-term investments	--	--	--	--
Total Comprehensive income/(loss)				
Common stock options exercised	56,385	225	283,192	--
Income tax benefit from stock options	--	--	--	--
Treasury stock repurchased	(156,000)	--	--	--
BALANCE AT DECEMBER 31, 1997	5,365,988	22,539	18,998,260	7,436,263
Net income	--	--	--	4,342,094
Other comprehensive income/(loss):				
Unrealized loss on short-term investments	--	--	--	--
Total Comprehensive income/(loss)				
Common stock options exercised	15,717	63	77,844	--
Repayment of stock purchase note	--	--	--	--
Treasury stock repurchased	(318,300)	--	--	--
BALANCE AT DECEMBER 31, 1998	5,063,405	$22,602	$19,076,104	$ 11,778,357

</TABLE>

<TABLE>
<CAPTION>

	STOCK PURCHASE NOTE RECEIVABLE	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)	TREASURY STOCK	TOTAL
<S>	<C>	<C>	<C>	<C>
BALANCE AT DECEMBER 31, 1995	$(134,800)	$ 3,543	$ --	$ 22,157,228
Net loss	--	--	--	(238,471)
Other comprehensive income/(loss):				
Unrealized loss on short-term investments	--	(4,711)	--	(4,711)
Total Comprehensive income/(loss)				(243,182)
Common stock options exercised	--	--	--	96,333
Income tax benefit from stock options	--	--	--	63,000
Treasury stock repurchased	--	--	(908,370)	(908,370)
BALANCE AT DECEMBER 31, 1996	(134,800)	(1,168)	(908,370)	21,165,009
Net income	--	--	--	3,964,298
Other comprehensive income/(loss):				
Unrealized gain on short-term investments	--	589	--	589
Total Comprehensive income/(loss)				3,964,887
Common stock options exercised	--	--	--	283,417
Income tax benefit from stock options	--	--	--	--

Treasury stock repurchased	--	--	(1,292,366)	(1,292,366)
BALANCE AT DECEMBER 31, 1997	(134,800)	(579)	(2,200,736)	24,120,947
Net income	--	--	--	4,342,094
Other comprehensive income/(loss):				
Unrealized loss on short-term investments	--	(598)	--	(598)
Total Comprehensive income/(loss)				4,341,496
Common stock options exercised	--	--	--	77,907
Repayment of stock purchase note	134,800	--	--	134,800
Treasury stock repurchased	--	--	(2,742,473)	(2,742,473)
BALANCE AT DECEMBER 31, 1998	$ --	$(1,177)	$(4,943,209)	$ 25,932,677

</TABLE>

See accompanying notes

MEDSTONE INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

<TABLE>
<CAPTION>

<S>	YEAR ENDED DECEMBER 31, 1998 <C>	1997 <C>	1996 <C>
Cash flows from operating activities:			
Net income (loss)	$ 4,342,094	$ 3,964,298	$ (238,471)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	1,946,746	1,613,385	1,244,840
Provision for doubtful accounts	130,000	251,000	60,000
Provision for excess inventories	--	--	(136,884)
Minority interest in partnership	627,639	467,595	142,575
Changes in operating assets and liabilities:			
Accounts receivable	(544,794)	(684,802)	(934,923)
Inventories	(915,686)	(220,441)	(777,557)
Deferred taxes	(183,183)	427,017	(94,000)
Note receivable	--	1,250,000	(1,250,000)
Prepaid expenses and other	(263,624)	(298,974)	355,207
Accounts payable	(498,151)	(873,182)	1,356,997
Accrued expenses	274,687	909	(25,753)
Accrued income taxes	816,444	(922,752)	251,608
Accrued payroll expenses	64,183	(98,957)	132,341
Deferred revenue	(347,010)	38,856	317,411
Customer deposits	(46,574)	132,699	--
Other, net	124,616	10,862	(211,912)
Net cash provided by operating activities	5,527,387	5,057,513	191,479
Cash flows from investing activities:			
Purchases of investments available for sale	(25,798,243)	(42,258,678)	(16,918,215)
Proceeds from sales of investments available for sale	25,205,077	39,460,528	24,306,051
Investments in non-public companies	(617,369)	--	--
Purchase of subsidiary	--	(2,300,000)	(1,350,000)
Investment by minority in partnership	--	193,179	(162,028)
Distribution of minority interest	(676,800)	(328,000)	(64,403)
Purchases of property and equipment	(1,106,832)	(1,597,545)	(3,392,627)
Net cash provided by (used in) investing activities	(2,994,167)	(6,830,516)	2,418,778
Cash flows from financing activities:			
Proceeds from issuance of common stock	77,907	283,417	96,333
Proceeds from stock purchase note	134,800	--	--
Purchase of treasury stock	(2,742,473)	(1,292,366)	(908,370)
Dividends paid	--	--	(1,000,000)

Net cash used in financing activities	(2,529,766)	(1,008,949)	(1,812,037)
Net increase (decrease) in cash and cash equivalents	3,454	(2,781,952)	798,220
Cash and equivalents at beginning of year	1,125,009	3,906,961	3,108,741
Cash and equivalents at end of year	$ 1,128,463	$ 1,125,009	$ 3,906,961
Supplemental cash flow disclosures:			
Cash paid during the year for:			
Income taxes	$ 2,588,819	$ 2,911,351	$ 554,136

</TABLE>

See accompanying notes

MEDSTONE INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 1998

1. ORGANIZATION AND OPERATIONS OF THE COMPANY

Medstone International, Inc. ("Medstone" or "the Company"), designs, manufactures and markets the Medstone STSTM Shockwave Therapy System (the "System") for the noninvasive disintegration of kidney stones in human patients. The Company also generates revenues from use of the System under procedure fees and fee for service arrangements and from repairs and maintenance. The Company operations occur mainly with customers located in the United States.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of consolidation

The consolidated financial statements include the accounts of the Company, United Physicians Resources, an 80% owned physicians practice management operation, incorporated in June 1996, Northern Nevada Lithotripsy Associates, LLC, a 60% owned Nevada Limited Liability Company, Southern Idaho Lithotripsy Associates, LLC, a California Limited Liability Company, also 60% owned, (See Note 3), and Medstone Sales Corporation, a 100% owned foreign sales corporation. All majority-owned subsidiaries are consolidated and all material intercompany accounts and transactions are eliminated. Investments in less than 20% owned affiliates are accounted for on the cost method, unless the Company is able to exercise significant influence over the affiliates operating and financial policies, in which case the investments are accounted for on the equity method.

Reclassifications

Certain prior year balances have been reclassified to conform with the December 31, 1998 presentation.

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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 revenue and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates made in preparing these financial statements include the allowance for doubtful accounts.

Statement of cash flows

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

The Company had net non-cash transfers of inventory into fixed assets of $0, $250,000 and $1,376,000 for the years ended December 31, 1998, 1997 and 1996, respectively.

The Company had net non-cash transfers of accounts receivable, inventory, prepaid expenses, fixed assets, accounts payable, accrued expenses and deferred revenue totaling $966,000 in 1996 in the form of a dividend as a result of the spinout of the Endocare, Inc. and Urogen, Inc. subsidiaries.

Short-term Investments

The Company applies the provisions of Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities" to its short-term investments. Under this statement, management determines the appropriate classification of such securities at the time of purchase and reevaluates such classification as of each balance sheet date. Based on its intent, the Company's investments are classified as available-for-sale and are carried at fair value, with unrealized gains and losses, net of tax, reported as a separate component of stockholders' equity. The investments are adjusted for amortization of premiums and discounts to maturity and such amortization is included in interest income. Realized gains and losses and declines in value judged to be other than temporary are determined based on the specific identification method and are reported in the consolidated statements of operations.

The Company invests primarily in U.S. government securities and corporate obligations. As of December 31, 1998 and December 31, 1997, investments are summarized as follows:

	COST	GROSS UNREALIZED LOSS	FAIR VALUE
1998 U.S. Treasury Bills	$10,496,037	$1,962	$10,494,075
1997 U.S. Treasury Bills	$ 9,901,828	$ 919	$ 9,900,909

No gains or losses were realized in 1998 and 1997.

The amortized cost and estimated fair value of investments at December 31, 1998 by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because the issuer of the securities may have the right to repurchase such securities.

	COST	FAIR VALUE
Due in one year or less	$10,496,037	$10,494,075

Comprehensive income

As of January 1, 1998, the Company adopted Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income (SFAS 130). SFAS No. 130 establishes new rules for the reporting and display of comprehensive income and its components; however, the adoption of this Statement had no impact on the Company's net income or stockholders' equity. SFAS No. 130 requires unrealized gains or losses on available-for-sale securities, which prior to adoption were reported separately in shareholders' equity, to be included in other comprehensive income. Prior financial statements have been reclassified to conform to the requirements of SFAS No. 130.

Concentrations of credit risk

Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, and short term investments, which are not federally insured, and accounts receivable. The Company's short term investments consist principally of U.S. Treasury Bills.

The Company sells its products primarily to hospitals worldwide. Credit is extended based on an evaluation of the customer's financial condition and collateral generally is not required. The Company's ten largest customers accounted for approximately 16% of accounts receivable at December 31, 1998.

Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market and consist of the following:

<TABLE>
<CAPTION>
DECEMBER 31,

<S>	1998 <C>	1997 <C>
Raw materials	$2,449,877	$1,645,902
Work in process	203,540	260,773
Finished goods	942,489	773,545
	$3,595,906	$2,680,220

</TABLE>

Property and equipment

Property and equipment are carried at cost. Depreciation and amortization are computed on the straight-line method over the following estimated useful lives:

<TABLE>

<S>	<C>
Lithotripters	5 years
Equipment	5 years
Furniture and fixtures	5 years
Leasehold improvements	Life of lease

</TABLE>

Depreciation expense for the years ended December 31, 1998, 1997 and 1996 was $1,863,000, $1,538,000 and $1,223,000, respectively.

Goodwill

The Company recorded goodwill resulting from the excess of the purchase prices of Northern Nevada and Southern Idaho over the fair market value of the net assets. Goodwill is being amortized over a period not to exceed forty years using the straight-line method. Accumulated amortization at December 31, 1998 and 1997 is $180,569 and $96,503, respectively.

Long-Lived Assets

Long-lived assets and certain identifiable intangibles held and used by the Company are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Based upon the Company's analysis, the Company believes no material impairment of the carrying value of its long-lived assets, inclusive of intangible assets, existed at December 31, 1998 and 1997. The Company's analysis was based on a comparison of the carrying amount of such assets to the Company's historical actual cash flows and to an estimate of future undiscounted cash flows.

Earnings (Loss) Per Share

The Company has adopted SFAS No. 128 "Earnings Per Share," and applied this pronouncement to all periods presented. This statement requires the presentation of both basic and diluted net income (loss) per share for financial statement purposes. Basic net income (loss) per share is computed by dividing income (loss) available to common stockholders by the weighted average number of common shares outstanding. Diluted net income (loss) per share includes the effect of the potential shares outstanding, including dilutive stock options and warrants using the treasury

stock method. Because the impact of options and warrants are antidilutive, there is no difference between the loss per share amount computed for basic and diluted purposes for 1996. All earnings (loss) per share amounts for all periods have been restated to conform with the SFAS No. 128 requirements.

The following table sets forth the computation of earnings (loss) per share:

<TABLE>
<CAPTION>

	YEAR ENDED DECEMBER 31,		
	1998	1997	1996
<S>	<C>	<C>	<C>
Numerator: Net income (loss)	$4,342,094	$ 3,964,298	$ (238,471)
Denominator for weighted average shares outstanding	5,162,112	5,390,352	5,517,976

Basic earnings (loss) per share	$ .84	$ .74	$ (.04)
	==========	===========	===========
Effect of dilutive securities:			
Weighted average shares outstanding	5,162,112	5,390,352	5,517,976
Stock options	124,855	120,316	--
	----------	-----------	-----------
Denominator for diluted earnings per share	5,286,967	5,510,668	5,517,976
	==========	===========	===========
Diluted earnings (loss) per share	$ .82	$ .72	$ (.04)
	==========	===========	===========

</TABLE>

Stock Compensation

The Company has elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related Interpretations in accounting for its employee stock options because, as discussed below, the alternative fair value accounting provided for under FASB Statement No. 123, Accounting for Stock-Based Compensation, requires the use of option valuation models that were not developed for use in valuing employee stock options. Under APB 25, because the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized.

To calculate the pro forma information required by Statement 123, the Company uses the Black-Scholes option pricing model. The Black-Scholes model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of 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 a reliable single measure of the fair value of its employee stock options.

Revenue recognition

Revenues are recognized in accordance with the underlying contractual terms of each sale. Typically, revenue recognition requires the transfer of title upon shipment, customer acceptance, receipt of specified down payments and performance of all significant contractual obligations. All foreign sales contracts are negotiated with payment terms in U.S. dollars so the Company has no exposure to foreign currency price fluctuations.

Service and maintenance contract revenues are deferred and amortized over the terms of the related contracts.

Advertising

The Company expenses advertising costs including promotional literature, brochures and trade shows as incurred. Advertising expense was $135,000, $126,000 and $107,000 for the years ended December 31, 1998, 1997 and 1996, respectively.

Business Segments

Effective January 1, 1998, the Company adopted Statement of Financial Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information (SFAS 131), which superseded Statement of Financial Accounting Standards No. 14, Financial Reporting of Segments of a Business Enterprise. SFAS No. 131 also establishes standards for related disclosures about products and services, geographic areas and major customers. The adoption of SFAS 131 did not affect results of operations or financial position, but did affect the following disclosure of segment information.

The Company operates in two business segments, equipment sales and fees for procedures, maintenance and management. The equipment sales segment is not significant. The fees for procedures, maintenance and management segment represents recurring revenue from procedure fees and fee for service arrangements for use and the maintenance of lithotripter equipment. The accounting policies of these segments are the same as those described in the summary of significant accounting policies except that certain expenses, such as amortization of certain intangibles and certain corporate expenses, are not allocated to the segments and costs related to the class action lawsuit settled in 1996 are not included. Asset categories used for allocation to segment reporting include net accounts receivable, net inventory, net property and equipment and net goodwill.

Selected financial information for the Company's reportable segments as of and for the years ended December 31, 1998, 1997 and 1996 follows (in thousands):

<TABLE>
<CAPTION>

	1998	1997	1996
<S>	<C>	<C>	<C>
Revenues for reportable segment	$ 21,129	$18,476	$14,884
Operating income (loss)			
Reportable segment	$ 7,751	$ 6,121	$ 4,572
Nonreportable segment	(63)	640	1,431
	$ 7,688	$ 6,761	$ 6,003
Assets			
Reportable segment	$ 13,252	$13,117	$10,448
Nonreportable segment	1,764	1,529	1,340
	$ 15,016	$14,646	$11,788
Depreciation and amortization			
Reportable segment	$ 1,798	$ 1,517	$ 1,159
Nonreportable segment	149	96	86
	$ 1,947	$ 1,613	$ 1,245
Expenditures for long-lived assets			
Reportable segment	$ 864	$ 2,934	$ 3,823
Nonreportable segment	199	963	920
	$ 1,063	$ 3,897	$ 4,743

</TABLE>

3. ACQUISITIONS AND INVESTMENTS IN JOINT VENTURES

Purchase of Northern Nevada

The Company acquired, in the second quarter of 1996, a 60% interest in Northern Nevada, an operator of a "retail" lithotripsy operation which bills patients or insurers for their services. The assets acquired, accounted for on the purchase method, consisted of the accounts receivable and contracts to provide service to insurers. The Company acquired this 60% interest for $1.35 million cash. The operating results of Northern Nevada are included in the consolidated financial statements of the Company since April 1, 1996.

Purchase of Southern Idaho

On March 18, 1997, the Company completed the acquisition of a 60% interest in Southern Idaho Lithotripsy Associates, LLC, an operator of a "retail" lithotripsy operation in southern Idaho, for a purchase price of $2.3 million in cash. The assets acquired, accounted for on the purchase method, consisted of the accounts receivable and contracts to provide services to insurers. The operating results of Southern Idaho are included in the consolidated financial statements of the Company since March 1, 1997.

Digital Imaging Systems, Inc.

In 1998, the Company entered into a supply agreement with Digital Imaging Systems, Inc. ("DIS") for components integral in the Company's new transportable lithotripsy product. DIS commenced shipments of that product to the Company in January 1999. The Company has purchased 300,000 shares of DIS preferred stock for $300,000, which represents a 14% ownership interest, which is accounted for under the cost method. The value is recorded in other assets, and the Company considers this investment to be temporary in nature.

k. Biotech

In 1998, the Company was made aware of an opportunity to invest in a developmental biotech drug company catering to the members of the International Centre for Genetic Engineering and Biotechnology ("ICGEB"), a United Nations sponsored institute. k. Biotech purchased license agreements for formulas, developed by the ICGEB, for commercialization purposes in the Indian sub-continent as its primary market. The Company has purchased $225,000 of preferred stock, which represents a 15.3% ownership interest, to assist k. Biotech in establishing itself as a viable business entity. The investment in k. Biotech is accounted for under the equity method because the Company has the ability to exercise significant influence over k.Biotech and is included in other assets. k. Biotech is seeking additional funding from international sources to finance its required investment in plant and equipment.

Chinese Joint Venture

The Company, along with Acuity International ("Acuity") and Phenix Optical Ltd ("Phenix"), a Chinese company, created a joint venture in March 1998 to provide lithotripsy services to inland Chinese areas. Each entity was a 1/3 owner of the joint venture. The Company recorded its investment of $92,000 as other assets. In November 1998, a purchase of the 2/3 ownership, not owned by Phenix, was proposed. In December 1998, documents were drawn to turn ownership over to Phenix in return for delivery of optical products to both Acuity and the Company. Subsequent to December 31, 1998, the Company received its optical products in release of its share in the joint venture and final release documents are being processed. The Company estimates the resale value of the optical products approximates the value of the investment established in the joint venture. The Company intends to sell these products in 1999.

4. INCOME TAXES

The Company provides for income taxes under the liability method. Accordingly, deferred income tax assets and liabilities are computed for differences between the financial statement and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to amounts which are more likely than not to be realized.

The provision (benefit) for income taxes consists of the following:

	YEAR ENDED DECEMBER 31, 1998	YEAR ENDED DECEMBER 31, 1997	YEAR ENDED DECEMBER 31, 1996
Current:			
Federal	$ 2,270,000	$ 1,454,000	$ (34,000)
State	631,000	448,000	(42,000)
Total current	2,901,000	1,902,000	(76,000)
Deferred:			
Federal	$ (153,000)	338,000	(129,000)
State	(30,000)	89,000	35,000
Total deferred	(183,000)	427,000	(94,000)
Provision (benefit) for income taxes	$ 2,718,000	$ 2,329,000	$ (170,000)

The following is a reconciliation of the provision (benefit) for income taxes at the federal statutory rate compared to the Company's effective tax rate:

	YEAR ENDED DECEMBER 31, 1998	YEAR ENDED DECEMBER 31, 1997	YEAR ENDED DECEMBER 31, 1996
Income tax (benefit) at the statutory rate	$ 2,400,000	$ 2,140,000	$ (139,000)
State income taxes (net of federal benefit)	398,000	354,000	(48,000)
Other	(80,000)	(165,000)	17,000
Provision (benefit) for			

income taxes	$ 2,718,000	$ 2,329,000	$ (170,000)

</TABLE>

The tax effect of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are as follows:

<TABLE>
<CAPTION>

<S>	DECEMBER 31, 1998	DECEMBER 31, 1997
DEFERRED TAX ASSETS (LIABILITIES):		
State taxes	$ 199,000	$ 150,000
Cardiac investment reserve	321,000	321,000
Inventory reserve	145,000	134,000
Bad debt reserve	204,000	223,000
Accruals not currently deductible for tax	74,000	63,000
Inventory adjustment	55,000	--
Product reserves	141,000	--
Deferred tax assets	1,139,000	891,000
Depreciation and amortization	(714,000)	(649,000)
Deferred tax liabilities	(714,000)	(649,000)
Net deferred tax assets (liabilities)	$ 425,000	$ 242,000

</TABLE>

5. STOCK OPTIONS

In 1987, the Company adopted the 1987 Stock Option Plan (1987 Plan) under which options could be granted to key employees or directors of the Company by a committee appointed by the Company's Board of Directors (the Committee) to purchase up to 476,323 shares of the Company's common stock. The exercise price for options granted under the 1987 Plan were equal to the fair market value of the common stock on the date of grant. During 1988 and 1989, the Committee granted options which generally become exercisable with respect to 1/60th of the issuable shares for each elapsed month during the five-year period commencing with dates determined by the Committee. All options granted in 1988 and 1989 terminated one year after the end of the five-year period. In June 1989, the Company terminated the 1987 Plan as to the granting of additional options. In April 1996, the remaining options outstanding under this Plan were exercised and the Plan is now terminated.

In June 1989, the Company's stockholders approved the 1989 Stock Incentive Plan which provides for the granting of a variety of stock-related securities, including shares of common stock, stock options and stock appreciation rights to employees and other selected individuals. In May 1991, the Company's stockholders amended the Plan to increase the number of shares issuable to 1,593,783 and eliminated the provision for an automatic increase in the number of shares issuable on January 1 of each year by one percent of the then outstanding shares. In May 1997 the Company terminated the 1989 Plan as to the granting of additional options. As of December 31, 1998, 610,052 options for shares of common stock had been granted and remain outstanding under this plan.

In June 1989, the Company's stockholders also approved the Nonemployee Director Stock Option Plan. This plan provides for the issuance of up to 50,000 shares of the Company's common stock upon exercise of options granted under the plan. As of December 31, 1998, 15,000 options for shares of common stock had been granted under this plan and 5,000 shares have been exercised. In addition, three outside directors have each been granted separate options to purchase 15,000 shares.

In May 1997, the Company's stockholders approved the 1997 Stock Incentive Plan which provides for the granting of a variety of stock-related securities, including shares of common stock, stock options and stock appreciation rights to employees and other selected individuals. The Plan allows for the issuance of up to 800,000 shares, with increases each January 1 that the Plan is in effect by a number of shares equal to one percent of the total number of outstanding shares of Common Stock on that date. As of January 1, 1998 the number of shares authorized by the plan increased to 853,660. As of December 31, 1998, 417,850 options for shares of common stock had been granted and are outstanding under this plan.

Effective August 13, 1998, the Company repriced all outstanding options granted under all plans with exercise prices exceeding the closing market value of the stock on that date. Accordingly, the exercise price of these options was reduced to $6.375 per share.

A summary of the Company's stock option plans as of the end of 1998 and 1997 and changes during the years is presented below:

<TABLE>
<CAPTION>

	DECEMBER 31, 1998		DECEMBER 31, 1997		DECEMBER 31, 1996	
	SHARES	WEIGHTED-AVE. EXERCISE PRICE	SHARES	WEIGHTED-AVE. EXERCISE PRICE	SHARES	WEIGHTED-AVE. EXERCISE PRICE
<S>	<C>	<C>	<C>	<C>	<C>	<C>
Outstanding, beginning of year	970,803	$8.34	743,926	$8.22	683,748	$7.76
Granted	230,000	6.52	422,000	8.08	212,000	8.12
Exercised	(15,717)	4.95	(56,385)	5.03	(61,875)	4.15
Canceled	(102,184)	7.90	(138,738)	8.23	(89,947)	7.29
Outstanding, end of year	1,082,902	$6.39	970,803	$8.34	743,926	$8.22
Available for future grants	470,810		593,000		152,04	
Exercisable at end of year	474,446		316,899		216,179	
Weighted-average fair value of options granted during the year		$6.52		$8.02		$4.59

</TABLE>

The following table summarizes information about stock options outstanding at December 31, 1998:

<TABLE>
<CAPTION>

		OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
	RANGE OF EXERCISE PRICES	NUMBER OUTSTANDING AT 12/31/98	WEIGHTED-AVERAGE EXERCISE PRICE	WEIGHTED-AVERAGE REMAINING TERM	NUMBER EXERCISABLE AT 12/31/98	WEIGHTED-AVERAGE EXERCISE PRICE
<S>	<C>	<C>	<C>	<C>	<C>	<C>
	$ 0 to $5.47	15,035	$5.47	1.9 years	8,615	$5.47
	$5.50 to $7.50	1,067,284	$6.40	3.8 years	465,248	$6.37
	$8.50 to $9.50	583	$8.50	2.6 years	583	$8.50
	$1.31 to $9.50	1,082,902	$6.39	3.8 years	474,446	$6.65

</TABLE>

In calculating pro forma information regarding net income and net income per share, as required by Financial Accounting Standards Board Statement No. 123, Accounting for Stock-Based Compensation, the fair value was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions for the options on the Company's common stock for the years ended December 31, 1998, 1997, and 1996, respectively: risk free interest rates of 6%, 6%, and 6.5%; dividend yields of 0% for all periods; volatility of the expected market prices of the Company's common stock of .542, .316 and .543; and expected life of the options of 5.5 years for all periods.

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 proforma information for the years ended December 31, 1998, 1997 and 1996 follows (in thousands, except per share information):

<TABLE>
<CAPTION>

	YEAR ENDED DECEMBER 31,		
	1998	1997	1996
<S>	<C>	<C>	<C>
Pro forma net income (loss)	$4,077	$3,381	$ (571)
Pro forma diluted net income (loss) per share	$ .77	$ .61	$ (.10)

</TABLE>

These pro forma amounts reflect only the cumulative effect of the expense of options granted during the years ended December 31, 1998, 1997 and 1996, and does not give effect to options granted prior to January 1, 1995.

6. DISTRIBUTION TO SHAREHOLDERS

On February 9, 1996, the Company distributed two stock dividends, payable to stockholders of record on the close of trading on December 29, 1995. The two dividends represent distribution of all the assets and operations of the Endocare and Urogen divisions of the Company. Effective with the start of business on January 1, 1996 these two companies were no longer a part of the Medstone operations, as Medstone distributed to its shareholders all outstanding common stock of each company, retaining only 100,000 shares of each company. These two companies are separate, publicly-held companies.

Medstone, as part of the distribution of Endocare, forgave intercompany debt of $2,831,364 and contributed $500,000 in cash and net other assets of $803,133 to Endocare. As part of the distribution of Urogen, Medstone forgave intercompany debt of $3,888,875 and contributed $500,000 in cash and net other assets of $163,082 to Urogen.

In October 1996, the Company liquidated its position in Endocare. The average sales price was $5.53 per share, net of commissions, for the 100,000 shares that were owned by the Company. A $553,372 gain was recognized in the fourth quarter of 1996.

7. STOCK REPURCHASE PLAN

On March 29, 1996, the Company announced a Stock Repurchase Program of up to 500,000 shares of its Common Stock. In August 1998, the Company announced an additional stock purchase plan for up to 100,000 shares of its common stock. Both programs were fulfilled by November 1998. For the year ended December 31, 1998, the Company had repurchased a total of 318,300 shares at a total cost of $2,742, 473 under the two repurchase programs. For the year ended December 31, 1997, the Company repurchased a total of 156,000 shares at a cost of $1,292,366. For the year ended December 31, 1996, the Company repurchased a total of 112,800 shares at a cost of $908,370. The Company has repurchased 587,100 shares at a total cost of $4,943,209 since the inception of the repurchase programs with all amounts recorded as treasury stock. The Company does not have any active repurchase programs in place as of December 31, 1998.

8. COMMITMENTS

In March 1994, the Company took occupancy of office, manufacturing, engineering, warehouse space, and research and development laboratories under an operating lease with an initial term of two years. Under lease extensions, the monthly lease rate was $13,360 through February 1998 and $13,874 through February 1999. The Company has negotiated an extension for a sixteen month period from March 1999 to June 2000, at a monthly rate of $14,410.

The future minimum lease payments under all operating leases are as follows:

	Minimum Rental
1999	$197,000
2000	$ 91,000
2001	$ 5,000
2002	$ 3,000

Total net rent expense under all operating leases for the years ended December 31, 1998, 1997 and 1996 was $194,000, $182,000 and $156,000, respectively.

9. CONTINGENCIES

In June 1996, the Company negotiated a settlement of the two related class action lawsuits filed by two shareholders of the Company. The settlement in the third quarter of 1996 totaled $6.0 million, with $500,000 paid by the Company's underwriter and $5.5 million paid by the Company. The $5.5 million was charged against earnings in the second quarter of 1996.

From time to time, the Company is subject to legal actions and claims for personal injuries or property damage related to patients who use its products. The Company has obtained a liability insurance policy providing coverage for product liability and other claims. Management does not believe that the resolution of any current proceedings will have a material financial impact on the Company or the consolidated financial statements.

10. RELATED PARTY TRANSACTIONS

CARDIAC SCIENCE, INC.

During 1991, the Company was a party to the formation of Cardiac Science, Inc., for which the Company purchased 5,353,031 (pre-split) shares of common stock, for a cash payment of $.0016 per share. This purchase represented 77.3% of the outstanding stock. As of July 8, 1991, the Company distributed, as a dividend to its shareholders of record on that date, one share of Cardiac Science, Inc. stock for each share of Medstone stock held. The Company retained 629,768 (pre-split) shares of common stock of Cardiac Science, Inc. This investment has been recorded at a net investment value of $0 due to Cardiac Science's historical financial performance.

From 1991 through 1996, the Company performed various financings for Cardiac Science and received warrants to purchase Cardiac Science common stock. Due to exercise of warrants, common stock issued in lieu of interest and unsecured advances the Company received 5,619,054 (pre-split) shares of Cardiac Science.

In April 1997, Cardiac Science effectuated a 1 for 11.42857143 reverse stock split, reducing the Company's holdings to 546,772 shares, which is the number of shares held at December 31, 1998. This investment has been recorded at a net investment value $0 due to Cardiac Science's historical financial performance.

The Company also holds warrants to purchase 87,500 (post-split) shares of Cardiac Science at $.011 each, with an expiration date of September 2004.

K. BIOTECH

During the year, the Company obtained a 15.3% ownership interest in k.Biotech, Inc. for $225.000. Two members of the Board of Directors of the Company are also shareholders of k.Biotech, Inc. and one member is the President of k.Biotech.

DIGITAL IMAGING SYSTEMS

During the year, the Company obtained a 14% ownership interest in Digital Imaging Systems, Inc. ("DIS") for $300,000 and entered into a supplier agreement whereby the Company will purchase equipment up to $1.1 million from DIS.

11. EMPLOYEE BENEFIT PLAN

In January 1990, the Company established a defined contribution profit sharing 401(k) plan for all eligible employees. The plan provides for the deferral of up to 15% of an employee's qualifying compensation under Section 401(k) of the Internal Revenue Code. Contributions by the Company may be made to the plan at the discretion of the

Board of Directors. During 1997, the Company's Board of Directors elected to match employee contributions $.25 on a dollar, up to a maximum company contribution of $2,000. In 1998 and 1997, the Company's contribution totaled $44,430 and $37,991, respectively. No such contributions were made to the plan during the year ended December 31, 1996.

12. MAJOR CUSTOMERS AND FOREIGN SALES

During the 12 months ended December 31, 1998 no single customer accounted for 10% or more of total revenues and the Company derived 4% of its total revenues from sales to foreign customers. During the year ended December 31, 1997 no single customer accounted for 10% or more of total revenues and the Company derived 2% of its total revenues from sales to foreign customers. During the year ended December 31, 1996, no single customer accounted for 10% of total revenues of the Company and the Company derived 11% of its total revenues from sales to foreign customers.

13. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

The tables below set forth selected quarterly financial information for 1998 and 1997 (in thousands, except per share amounts).

<TABLE>

1998	1ST QUARTER	2ND QUARTER	3RD QUARTER	4TH QUARTER
<S>	<C>	<C>	<C>	<C>
Net sales	$5,852	$6,268	$6,263	$5,442

Gross profit	2,964	3,441	3,425	2,995
Net income	956	1,195	1,273	918
Basic earnings per share	$ .18	$ .23	$ .25	$ .18

</TABLE>

<TABLE>
<CAPTION>

1997	1ST QUARTER	2ND QUARTER	3RD QUARTER	4TH QUARTER
<S>	<C>	<C>	<C>	<C>
Net sales	$4,962	$5,665	$5,655	$5,452
Gross profit	2,692	3,329	3,353	2,857
Net income	860	1,022	1,150	932
Basic earnings per share	$ .16	$ .19	$ .21	$ .17

</TABLE>

14. SUBSEQUENT EVENTS

On February 17, 1999, the Company announced that it had retained J.P. Morgan Securities, Inc. to advise the Company with respect to strategic alternatives to the Company's current business plan. These strategic plans include, but are not limited to, acquisitions, partnerships, or sale of all or part of the Company's assets or operations. Any or all of these plans could have a material effect on the financial position, results of operations, or cash flows of the Company in future operating periods.

MEDSTONE INTERNATIONAL, INC.
SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS

<TABLE>
<CAPTION>

		ADDITIONS			
DESCRIPTION	BALANCE AT BEGINNING OF YEAR	CHARGED TO COSTS AND EXPENSES	CHARGED TO OTHER ACCOUNTS	DEDUCTIONS	BALANCE AT END OF YEAR
<S>	<C>	<C>	<C>	<C>	<C>
FOR THE YEAR ENDED DECEMBER 31, 1998:					
Allowance for doubtful accounts	$534,918	$ 130,000	$	$ 62,354(c)	$ 602,564
Allowance for inventory obsolescence	$337,437	$ --	$ --	$ --	$ 337,437
Allowance for related party loan	$ 0	$ --	$ --	$ --	$ 0
Allowance for investment in related party	$750,054	$ --	$ --	$ --	$ 750,054
FOR THE YEAR ENDED DECEMBER 31, 1997:					
Allowance for doubtful accounts	$220,312	$ 251,000	$ 66,606	$ 3,000(c)	$ 534,918
Allowance for inventory obsolescence	$440,000	$ --	$ --	$ 102,563(b)	$ 337,437
Allowance for related party loan	$ 0	$ --	$ --	$ --	$ 0
Allowance for investment in related party	$750,054	$ --	$ --	$ --	$ 750,054
FOR THE YEAR ENDED DECEMBER 31, 1996:					
Allowance for					

doubtful accounts	$207,260	$ 60,000	$ --	$ 46,948(a)	$ 220,312
Allowance for inventory obsolescence	$576,884	$ (136,884)	$ --	$ --	$ 440,000
Allowance for related party loan	$109,672	$ --	$ --	$ 109,672(d)	$ 0
Allowance for investment in related party	$643,000	$ --	$ --	$(107,054)(d)	$ 750,054

</TABLE>

(a) Reserve transferred to Endocare with the spinout.

(b) Write-off of inventory

(c) Write-off of bad debt

(d) Reserve transferred from loan provision to investment provision due to restructuring.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

MEDSTONE INTERNATIONAL, INC.

By: DAVID V. RADLINSKI

David V. Radlinski
Chief Executive Officer

Dated: March 26, 1999

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 26, 1999.

<TABLE>
<CAPTION>

SIGNATURE	TITLE
<S>	<C>
DAVID V. RADLINSKI ----------------------------- David V. Radlinski	Chairman of the Board, Chief Executive Officer and Director (Principal Executive Officer)
MARK SELAWSKI ----------------------------- Mark Selawski	Chief Financial Officer (Principal Financial and Accounting Officer)
DONALD J. REGAN ----------------------------- Donald J. Regan	Director
FRANK R. POPE ----------------------------- Frank R. Pope	Director
MICHAEL C. TIBBITTS ----------------------------- Michael C. Tibbitts	Director

</TABLE>

EXHIBIT INDEX

<TABLE>

<CAPTION>

EXHIBIT NUMBER	DESCRIPTION
<S>	<C>
10.30	Employment Agreement with David Radlinski
10.31	Employment Agreement with Mark Selawski
10.32	Employment Agreement with Eva Novotny
21	Subsidiaries
23.1	Consent of Independent Auditors
27	Financial Data Schedule

</TABLE>

EXHIBIT 10.30

MEDSTONE INTERNATIONAL, INC.
EMPLOYMENT AGREEMENT
CHIEF EXECUTIVE OFFICER
(David V. Radlinski)

This Employment Agreement is entered, effective August 13, 1998 (the "Commencement Date"), by and between Medstone International, Inc., a Delaware Corporation ("Medstone"), and David V. Radlinski ("Employee") in order to secure his services in the future and in recognition of his past services.

1. EMPLOYMENT

Employee shall be employed as Medstone's Chief Executive Officer. If his title or responsibilities are materially diminished without Employee's consent, such act shall be considered a termination of this Agreement by Medstone.

2. DEVOTION OF TIME

Employee shall devote his full working time and energy to his responsibilities as Chief Executive Officer and shall fulfill those responsibilities in good faith and in accordance with the terms of this Agreement.

3. TERM

Unless earlier terminated in accordance with Section 9, the term of Employee's employment by Medstone under this Agreement shall commence on the date set forth in the first paragraph and shall continue for five (5) full years thereafter.

4. BASE SALARY

The Employee's base salary shall be a minimum of $250,000 per year unless increased from time to time during the term of this Agreement by Medstone's Board of Directors.

5. STOCK OPTIONS

Effective the Commencement Date, the exercise prices of the Employee's existing stock options to purchase up to 350,000 shares of Medstone's Common Stock at from $7.13 to $10.63 per share are reduced to equal $6.37 per share, the closing price per share of Medstone's Common Stock on the Commencement Date as reported on the NASDAQ National Market System. In addition, such options are amended to provide that they shall become fully exercisable, regardless of any otherwise applicable vesting requirements, (a) concurrently with any termination of Employee's employment by the Company without Good Cause (as defined in Section 9) or (b) if there is an Asset Acquisition (as defined in Section 9) while Employee continues to be employed by Medstone and Employee does not immediately enter into an employment agreement with a buying or surviving party in the Asset Acquisition. In all other respects, the options shall remain unchanged.

6. BONUS

Employee shall receive a one-time bonus according to the schedule below if the NASDAQ closing stock price of Medstone's Common Stock remains at or above the price (for all business days) in accordance with the following schedule for 90 consecutive days. The stock price must be reached to begin such a consecutive 90-day period during the first number of months of this Agreement as indicated below and before the termination of Employee's employment, but the entire 90 days do not have to be in such first number of months.

<TABLE>
<CAPTION>

STOCK PRICE	BONUS	THE FIRST ( ) MONTHS OF THIS AGREEMENT
<S>	<C>	<C>
$ 11	$ 50,000	18 months
$ 13	$ 75,000	24 months
$ 15	$100,000	30 months
$ 17	$125,000	36 months
$ 18	$150,000	42 months
$ 21	$175,000	48 months

</TABLE>

For example, if the Common Stock price remained at $13 per share for 90 consecutive days, both the $11 and $13 bonus shall be awarded to Employee. Once the bonus is awarded at a particular stock price level, it cannot be awarded a second time at that stock price level. For example, if the bonus is awarded at the $13 level, the $13 level cannot be awarded a second time but the $15 level shall be awarded when earned.

7. OTHER BENEFITS

Employee shall receive such other employee benefits as are generally available to other employees of Medstone such as group health and dental insurance, extended long-term disability insurance, etc. Employee shall be reimbursed for reasonable business related expenses.

8. ADDITIONAL COVENANTS OF EMPLOYEE

(a) Employee agrees that, during the term of his retention as an employee or consultant under this Agreement and thereafter, except as otherwise authorized by Medstone's Board of Directors, he shall continue to abide by the terms of the Employee Confidentiality and Invention Agreement dated as of July 29, 1994 between Employee and Medstone.

(b) Employee agrees that, during the term of his retention as an employee or consultant under this Agreement by Medstone or a Purchasing Party (as defined in Section 9) (the "Company"), he will not, unless consented to by the Board of Directors of the Company: (i) engage or have an interest, directly or indirectly, in any other business or venture which would interfere with the performance of his duties under this Agreement or which then competes with any part of the lithotripter-related or lithotripsy-related business, comparable or similar to that now engaged in by Medstone (the "Business"), that is then conducted by the Company in any state or country outside the United States in which Medstone during the term of this Agreement conducts such business; (ii) induce or influence, or seek to induce or influence, any individual who is then employed by Medstone or the Purchasing Party to terminate such employment; or (iii) for himself or for any other person, firm or entity, divert or take away, or solicit or attempt to divert or take away, as such customers of Medstone or the Purchasing Party any persons or entities which were lithotripter-related or lithotripsy-related customers of Medstone during the term of Employee's employment by Medstone. This paragraph shall not prevent Employee from passively owning or investing in any shares or other assets which he owns on the date of this Agreement and are listed on an exhibit or supplement to this

Agreement, any real property or interest in a partnership or other entity which engages solely in the ownership or operation of real property or less than one percent (1%) of the outstanding shares of an entity which are publicly traded. In addition, if Employee during the term of his consulting agreement is employed by an entity that is not controlled by him and that entity subsequently acquires an ownership interest in an entity that is engaged in the Business or assets for the conduct of the Business from an unaffiliated entity, such acquisition and continued engagement of the acquired entity in the Business or continued conduct of the Business using such acquired assets shall not be a breach of item (i) of this paragraph, provided that Employee has no personal role or involvement, directly or indirectly, in such acquisition or continued conduct or engagement.

(c) Employee agrees that the breach by him of his agreements set forth in this Section 8 could not reasonably or adequately be compensated in damages in an action at law and that Medstone shall be entitled to injunctive relief for such a breach. Such relief may include, but shall not be limited to, an injunction restraining Employee from rendering any service or engaging in any activity which breaches or would violate these agreements. However, no remedy conferred by any of the provisions of this Agreement is intended to be exclusive of any other remedy, and each and every remedy shall be cumulative and shall be in addition to every other remedy existing at law or in equity. The election of any one or more remedies by Medstone shall not constitute a waiver of its rights to pursue other available remedies. Employee agrees that the covenants contained in this Section 8 shall be regarded as divisible and shall be operative to the extent, both as to time and area covered, that they may be applicable. If any of the covenants or any part thereof shall be declared invalid or unenforceable, or the applicability thereof to any person, area or circumstances is held to be invalid, the validity and enforceability of the remainder of such covenants and the applicability of such covenants to other persons, areas or circumstances shall not be affected thereby and such covenants shall be enforced to the fullest extent permitted under applicable laws.

9. TERMINATION

(a) Employee's employment under this Agreement shall automatically terminate upon Employee's death, which shall not be deemed to be a termination without Good Cause.

(b) Medstone may at any time terminate Employee's employment by Medstone under this Agreement by giving notice of such termination to the other party. If such termination is without Good Cause, Employee shall be entitled to the remedies and benefits set forth in this Section 9 and in Section 5 of this Agreement. Such remedies and benefits shall be in lieu of any other damages or payments, and shall be deemed to be agreed liquidated damages, for such a termination. "Good Cause" for Medstone to terminate Employee's employment shall mean (i) willful and habitual breach of Employee's duties or obligations under the terms of this Agreement, (ii) habitual gross neglect of his duties or obligations, (iii) his commission of fraud, embezzlement or misappropriation, or other willful acts of dishonesty or willful misconduct, or commission of a crime of moral turpitude whether or not a criminal or civil charge is filed in connection therewith, (iv) his willful unauthorized disclosure of Medstone's confidential information, (v) his material breach of his covenants set forth in Section 8, or (vi) his failure, due to physical or mental disability, to effectively perform his duties for a period of ninety (90) days during any consecutive period of twelve (12) months.

(c) If during the term of Employee's employment hereunder either (i) Employee's employment is terminated by Medstone without Good Cause or (ii) there is an Asset Acquisition while Employee continues to be employed by Medstone and Employee does not immediately enter into an employment agreement with a buying or surviving party in the Asset Acquisition, in addition to his other rights under this Section 9 and Section 5, Employee shall receive the severance payment specified in this paragraph. If the termination or Asset Acquisition occurs during the first three (3) years of the term of this Agreement, the severance payment shall equal five (5) times the amount of Employee's then current annual base salary. If the termination or Asset Acquisition occurs during the fourth (4th) year of the term of this Agreement, the severance payment shall equal four (4) times the amount of Employee's then current annual base salary. If the termination or Asset Acquisition occurs during the fifth (5th) year of the term of this Agreement, the severance payment shall equal three (3) times the amount of Employee's then current annual base salary. Any such severance payment shall be paid fully in cash to Employee on the date of the termination or closing of the Asset Acquisition, as the case may be. As used in this paragraph, an "Asset Acquisition" means the sale, transfer or other disposition in one or in a series of transactions, including (without limitation) a merger or consolidation of Medstone in which it is not the surviving party, of all or substantially all of the assets or business of Medstone to another person or entity or to persons or entities which are affiliated or acting in concert with respect to such sale, transfer or other disposition, other than the sale of Medstone's products in the ordinary course of its business or a contribution of its assets to a partnership, limited liability company or other entity which is controlled by Medstone.

(d) In the event that Employee's employment by Medstone is terminated without Good Cause, unless otherwise mutually agreed upon by Employee and Medstone in writing, Employee shall continue after such termination to serve and be retained as a consultant to Medstone. If the termination occurs during the first three (3) years of the term of this Agreement, Employee shall be a consultant for five (5) years after the termination. If the termination occurs during the fourth (4th) year of the term of this Agreement, Employee shall be a consultant for four (4) years after the termination. If the termination occurs during the fifth (5th) year of the term of this Agreement, Employee shall be a consultant for three (3) years after the termination. As such consultant, Employee shall provide up to thirty (30) hours per month of advice and information to Medstone regarding Medstone's operations, affairs and history as Medstone shall reasonably request and shall continue to be subject to the covenants set forth in Section 8. In consideration of his agreeing to provide such consulting services, Medstone shall pay Employee a monthly fee of $16,500, shall continue to reimburse him for expenses in accordance with Section 7 and shall continue during such term insurance coverage and other benefits reasonably comparable to those provided for in Section 7. Employee's retention as a consultant to Medstone shall automatically terminate upon his death. In connection with any such termination without Good Cause, Medstone shall purchase term life insurance on Employee's life, with employee's designated beneficiary, in declining amounts of coverage at least equal at any time to the total amount of fees remaining to be paid under Employee's consulting arrangement; provided, however, that such coverage is reasonably available at an annual premium not exceeding $100 per $1,000 of coverage.

(e) In the event that there is an Asset Acquisition while Employee continues to be employed by Medstone and Employee does not immediately enter into an employment agreement with a buying party in the Asset Acquisition, Employee shall continue after such Asset Acquisition to serve and be retained as a consultant to the principal buying party in the Asset Acquisition (the "Purchasing Party"). If the Asset Acquisition occurs during the first three (3) years of the term of this Agreement, Employee shall be a consultant for five (5) years after the Asset Acquisition. If the Asset Acquisition occurs during the fourth (4th) year of the term of this Agreement, Employee shall be a consultant for four (4) years after the Asset Acquisition. If the Asset Acquisition occurs during the fifth (5th) year of the term of this Agreement, Employee shall be a consultant for three (3) years after the Asset Acquisition. In connection with the Asset Acquisition, Medstone shall cause the Purchasing Party to so retain Employee as a consultant in accordance with this paragraph. As such consultant, Employee shall provide up to thirty (30) hours per month of advice and information to the Purchasing Party regarding the business and assets acquired from Medstone, as the Purchasing Party shall reasonably request, and shall continue to be subject to the covenants set forth in Section 8. In consideration of his agreeing to provide such consulting services, the Purchasing Party shall pay Employee a monthly fee of $16,500, shall continue to reimburse him for expenses in accordance with Section 7 and shall continue during such term to provide Employee with benefits that are reasonably comparable to those

provided for in Section 7. Employee's retention as a consultant to Medstone shall automatically terminate upon his death. In connection with any such Asset Acquisition, Medstone or the purchasing party shall purchase term life insurance on Employee's life, with employee's designated beneficiary, in declining amounts of coverage at least equal at any time to the total amount of fees remaining to be paid under Employee=s consulting arrangement; provided, however, that such coverage is reasonably available at an annual premium not exceeding $100 per $1,000 of coverage.

(f) The termination of Employee's employment pursuant to this Section 9 shall not release either party from any accrued obligation to pay any sum to the other party (whether then or thereafter payable) or operate to discharge any liability incurred prior to the termination date. In addition, the obligations under Sections 5-17 shall survive the termination of Employee's employment under this Agreement.

(g) If (i) Medstone terminates Employee=s employment and claims that such termination is for Good Cause, and (ii) an arbitrator or court determines that such termination was without Good Cause, upon such determination Medstone shall pay to Employee, in addition to amounts otherwise payable under this Agreement, a special additional payment equal to the severance payment otherwise payable to Employee on account of such termination under Section 9(c).

10. WAIVER

No waiver by either of the parties of any failure by the other party to keep or perform any provision, covenant or condition of this Agreement shall be deemed to be a waiver of any preceding or succeeding breach of the same, or of any provision, covenant or condition. All rights and remedies herein granted or referred to are cumulative; resort to one shall not preclude resort to any other or any other right or remedy provided by the law.

11. ARBITRATION

Any controversy or claim arising out of or relating to this Agreement or the breach hereof shall be settled by arbitration before a single arbitrator in Orange County, California. The arbitration shall be administered by and held in accordance with the Commercial Arbitration Rules of the American Arbitration Association. Judgment upon the award rendered by the arbitrator may be entered in any court having jurisdiction thereof. The costs of the arbitration, including any AAA administration fee, the arbitrator's fee, and costs for the use of facilities during the hearings, shall initially be borne equally by the parties to the arbitration. However, reimbursement for such fees and costs and such party's attorneys' fees shall be awarded to the prevailing or most prevailing party by the arbitrator.

12. ENFORCEABILITY

The invalidity or enforceability of any term or provision hereof shall not affect the validity or enforceability of any other term or provision.

13. ATTORNEYS FEES

In any arbitration or other legal proceeding to enforce or interpret the terms of this Agreement, the prevailing party shall be entitled to reasonable attorneys' fees and costs in addition to any other relief to which it or he may be entitled.

14. CHOICE OF LAW

This Agreement shall be construed and governed by the laws of the State of California.

15. ENTIRE AGREEMENT

This Agreement may be executed in counterparts and the counterparts read together, together with the agreements referred to in Sections 5 and 8(a), shall constitute the complete and entire agreement between the parties regarding the subject matter hereof, superseding all prior agreements, representations, proposals and negotiations, either oral or in writing, between the parties with respect to the subject matter hereof.

16. MODIFICATIONS

This Agreement shall not be modified or amended except by a written document executed by both parties to this Agreement.

17. SUCCESSORS

This Agreement will be binding upon the heirs, executors, administrators, successors, assignees, and other legal representatives of the parties to this Agreement.

18. DRAFTING

This Agreement has been negotiated at arm's length and between persons sophisticated and knowledgeable in the matters dealt with and represented by their own counsel. Accordingly, any rule of law (including California Code of Civil Procedure Section 1654) or legal decision that would require interpretation against the drafter of this Agreement is not applicable and is waived.

The parties have entered into this Agreement as of the date set forth in the first paragraph above.

Medstone International, Inc., a Delaware corporation	Employee
By: -------------------------------- Signature	--------------------------------------- David V. Radlinski
-------------------------------- Printed Name	
-------------------------------- Title	

Exhibit 10.31

MEDSTONE INTERNATIONAL, INC.
EMPLOYMENT AGREEMENT
CHIEF FINANCIAL OFFICER
(Mark Selawski)

This Employment Agreement is entered, effective August 13, 1998 (the Commencement Date), by and between Medstone International, Inc., a Delaware Corporation (Medstone), and Mark Selawski (Employee) in order to secure his [her] services in the future and in recognition of his [her] past services.

1. EMPLOYMENT

Employee shall be employed as Medstone's Chief Financial Officer for the term of this Agreement. If his [her] title or responsibilities are materially diminished without Employee's consent, such act shall be considered a termination of this Agreement by Medstone.

2. DEVOTION OF TIME

Employee shall devote his [her] full working time and energy to his [her] responsibilities as Chief Financial Officer and shall fulfill those responsibilities in good faith and in accordance with the terms of this Agreement.

3. TERM

Unless earlier terminated in accordance with Section 7, the term of Employee's employment by Medstone under this Agreement shall commence on the date set forth in the first paragraph and shall continue for three (3) full years thereafter.

4. BASE SALARY

The Employee's base salary shall be a minimum of $ 100,000 per year unless increased from time to time during the term of this Agreement by Medstone's Board of Directors.

5. STOCK OPTIONS

Effective the Commencement Date, the exercise prices of the Employee's existing stock options to purchase up to 80,000 shares of Medstone's Common Stock at from $ 7.13 to $ 9.68 per share are reduced to equal $ 6.37 per share, the closing price per share of Medstone's Common Stock on the Commencement Date as reported on the NASDAQ National Market System. In addition, such options are amended to provide that they shall become fully exercisable, regardless of any otherwise applicable vesting requirements, (a) concurrently with any termination of Employee's employment by the Company without Good Cause (as defined in Section 7) or (b) if there is an Asset Acquisition (as defined in Section 7) while Employee continues to be employed by Medstone and Employee does not immediately enter into an employment agreement with a buying or surviving party in the Asset Acquisition. In all other respects, the options shall remain unchanged.

6. OTHER BENEFITS

Employee shall receive such other employee benefits as are generally available to other employees of Medstone such as group health and dental insurance, extended long-term disability insurance, etc. Employee shall be reimbursed for reasonable business related expenses.

7. TERMINATION

(a) Employee's employment under this Agreement shall automatically terminate upon Employee's death, which shall not be deemed to be a termination without Good Cause.

(b) Medstone may at any time terminate Employee's employment by Medstone under this Agreement by giving notice of such termination to the other party. If such termination is without Good Cause, Employee shall be entitled to the remedies and benefits set forth in this Section 7 and in Section 5 of this Agreement. Such remedies and benefits shall be in lieu of any other damages or payments, and shall be deemed to be agreed liquidated damages, for such a termination. "Good Cause" for Medstone to terminate Employee's employment shall mean (i) willful and habitual breach of Employee's duties or obligations under the terms of this Agreement, (ii) habitual gross neglect of his [her] duties or obligations, (iii) his [her] commission of fraud, embezzlement or misappropriation, or other willful acts of dishonesty or willful misconduct, or commission of a crime of moral turpitude whether or not a criminal or civil charge is filed in connection therewith, (iv) his [her] willful unauthorized disclosure of Medstone's confidential information, or (v) his [her] failure, due to physical or mental disability, to effectively perform his [her] duties for a period of ninety (90) days during any consecutive period of twelve (12) months.

(c) If during the term of Employee's employment hereunder either (i) Employee's employment is terminated by Medstone without Good Cause or (ii) there is an Asset Acquisition while Employee continues to be employed by Medstone and Employee does not immediately enter into an employment agreement with a buying or surviving party in the Asset Acquisition, Employee shall receive a severance payment equal to two (2) times the amount of Employee's then current annual base salary. Any such severance payment shall be paid fully in cash to Employee on the date of the termination or closing of the Asset Acquisition, as the case may be. As used in this paragraph, an "Asset Acquisition" means the sale, transfer or other disposition in one or in a series of transactions, including (without limitation) a merger or consolidation of Medstone in which it is not the surviving party, of all or substantially all of the assets or business of Medstone to another person or entity or to persons or entities which are affiliated or acting in concert with respect to such sale, transfer or other disposition, other than the sale of Medstone's products in the ordinary course of its business or a contribution of its assets to a partnership, limited liability company or other entity which is controlled by Medstone.

(d) The termination of Employee's employment pursuant to this Section 7 shall not release either party from any accrued obligation to pay any sum to the other party (whether then or thereafter payable) or operate to discharge any liability incurred prior to the termination date.

(e) If (i) Medstone terminates Employee's employment and claims that such termination is for Good Cause, and (ii) an arbitrator or court determines that such termination was without Good Cause, upon such determination Medstone shall pay to Employee, in addition to amounts otherwise payable under this Agreement, a special additional payment equal to the severance payment otherwise payable to Employee on account of such termination under Section 7(c).

8. WAIVER

No waiver by either of the parties of any failure by the other party to keep or perform any provision, covenant or condition of this Agreement shall be deemed to be a waiver of any preceding or succeeding breach of the same, or of any provision, covenant or condition. All rights and remedies herein granted or referred to are cumulative; resort to one shall not preclude resort to any other or any other right or remedy provided by the law.

9. ARBITRATION

Any controversy or claim arising out of or relating to this Agreement or the breach hereof shall be settled by arbitration before a single arbitrator in Orange County, California. The arbitration shall be administered by and held in accordance with the Commercial Arbitration Rules of the American Arbitration Association. Judgment upon the award rendered by the arbitrator may be entered in any court having jurisdiction thereof. The costs of the arbitration, including any AAA administration fee, the arbitrator's fee, and costs for the use of facilities during the hearings, shall initially be borne equally by the parties to the arbitration. However, reimbursement for such fees and costs and such party's attorneys' fees shall be awarded to the prevailing or most prevailing party by the arbitrator.

10. ENFORCEABILITY

The invalidity or enforceability of any term or provision hereof shall not affect the validity or enforceability of any other term or provision.

11. ATTORNEYS FEES

In any arbitration or other legal proceeding to enforce or interpret the terms of this Agreement, the prevailing party shall be entitled to reasonable attorneys' fees and costs in addition to any other relief to which it or he may be entitled.

12. CHOICE OF LAW

This Agreement shall be construed and governed by the laws of the State of California.

13. ENTIRE AGREEMENT

This Agreement may be executed in counterparts and the counterparts read together, together with the option agreements referred to in Section 5, shall constitute the complete and entire agreement between the parties regarding the subject matter hereof, superseding all prior agreements, representations, proposals and negotiations, either oral or in writing, between the parties with respect to the subject matter hereof.

14. MODIFICATIONS

This Agreement shall not be modified or amended except by a written document executed by both parties to this Agreement.

15. SUCCESSORS

This Agreement will be binding upon the heirs, executors, administrators, successors, assignees, and other legal representatives of the parties to this Agreement.

16. DRAFTING

This Agreement has been negotiated at arm's length and between persons sophisticated and knowledgeable in the matters dealt with. Accordingly, any rule of law (including California Code of Civil Procedure Section 1654) or legal decision that would require interpretation against the drafter of this Agreement is not applicable and is waived.

The parties have entered into this Agreement as of the date set forth in the first paragraph above.

Medstone International, Inc., Employee

a Delaware corporation

By:

--------------------------------	---------------------------------------
David V. Radlinski, Chairman and CEO	Mark Selawski

EXHIBIT 10.32

MEDSTONE INTERNATIONAL, INC.
EMPLOYMENT AGREEMENT
EXECUTIVE VICE PRESIDENT OF SALES AND MARKETING
(Eva Novotny)

This Employment Agreement is entered, effective August 13, 1998 (the Commencement Date), by and between Medstone International, Inc., a Delaware Corporation (Medstone), and Eva Novotny (Employee) in order to secure his [her] services in the future and in recognition of his [her] past services.

1. EMPLOYMENT

Employee shall be employed as Medstone's Executive Vice President of Sales and Marketing for the term of this Agreement. If his [her] title or responsibilities are materially diminished without Employee's consent, such act shall be considered a termination of this Agreement by Medstone.

2. DEVOTION OF TIME

Employee shall devote his [her] full working time and energy to his [her] responsibilities as and shall fulfill those responsibilities in good faith and in accordance with the terms of this Agreement.

3. TERM

Unless earlier terminated in accordance with Section 7, the term of Employee's employment by Medstone under this Agreement shall commence on the date set forth in the first paragraph and shall continue for three (3) full years thereafter.

4. BASE SALARY

The Employee's base salary shall be a minimum of $ 120,000 per year unless increased from time to time during the term of this Agreement by Medstone's Board of Directors.

5. STOCK OPTIONS

Effective the Commencement Date, the exercise prices of the Employee's existing stock options to purchase up to 70,000 shares of Medstone's Common Stock at from $ 9.68 to $ 10.38 per share are reduced to equal $ 6.37 per share, the closing price per share of Medstone's Common Stock on the Commencement Date as reported on the NASDAQ National Market System. In addition, such options are amended to provide that they shall become fully exercisable, regardless of any otherwise applicable vesting requirements, (a) concurrently with any termination of Employee's employment by the Company without Good Cause (as defined in

Section 7) or (b) if there is an Asset Acquisition (as defined in Section 7) while Employee continues to be employed by Medstone and Employee does not immediately enter into an employment agreement with a buying or surviving party in the Asset Acquisition. In all other respects, the options shall remain unchanged.

6. OTHER BENEFITS

Employee shall receive such other employee benefits as are generally available to other employees of Medstone such as group health and dental insurance, extended long-term disability insurance, etc. Employee shall be reimbursed for reasonable business related expenses.

7. TERMINATION

(a) Employee's employment under this Agreement shall automatically terminate upon Employee's death, which shall not be deemed to be a termination without Good Cause.

(b) Medstone may at any time terminate Employee's employment by Medstone under this Agreement by giving notice of such termination to the other party. If such termination is without Good Cause, Employee shall be entitled to the remedies and benefits set forth in this Section 7 and in Section 5 of this Agreement. Such remedies and benefits shall be in lieu of any other damages or payments, and shall be deemed to be agreed liquidated damages, for such a termination. "Good Cause" for Medstone to terminate Employee's employment shall mean (i) willful and habitual breach of Employee's duties or obligations under the terms of this Agreement, (ii) habitual gross neglect of his [her] duties or obligations, (iii) his [her] commission of fraud, embezzlement or misappropriation, or other willful acts of dishonesty or willful misconduct, or commission of a crime of moral turpitude whether or not a criminal or civil charge is filed in connection therewith, (iv) his [her] willful unauthorized disclosure of Medstone's confidential information, or (v) his [her] failure, due to physical or mental disability, to effectively perform his [her] duties for a period of ninety (90) days during any consecutive period of twelve (12) months.

(c) If during the term of Employee's employment hereunder either (i) Employee's employment is terminated by Medstone without Good Cause or (ii) there is an Asset Acquisition while Employee continues to be employed by Medstone and Employee does not immediately enter into an employment agreement with a buying or surviving party in the Asset Acquisition, Employee shall receive a severance payment equal to two (2) times the amount of Employee's then current annual base salary. Any such severance payment shall be paid fully in cash to Employee on the date of the termination or closing of the Asset Acquisition, as the case may be. As used in this paragraph, an "Asset Acquisition" means the sale, transfer or other disposition in one or in a series of transactions, including (without limitation) a merger or consolidation of Medstone in which it is not the surviving party, of all or substantially all of the assets or business of Medstone to another person or entity or to persons or entities which are affiliated or acting in concert with respect to such sale, transfer or other disposition, other than the sale of Medstone's products in the ordinary course of its business or a contribution of its assets to a partnership, limited liability company or other entity which is controlled by Medstone.

(d) The termination of Employee's employment pursuant to this Section 7 shall not release either party from any accrued obligation to pay any sum to the other party (whether then or thereafter payable) or operate to discharge any liability incurred prior to the termination date.

(e) If (i) Medstone terminates Employee's employment and claims that such termination is for Good Cause, and (ii) an arbitrator or court determines that such termination was without Good Cause, upon such determination Medstone shall pay to Employee, in addition to amounts otherwise payable under this Agreement, a special additional payment equal to the severance payment otherwise payable to Employee on account of such termination under Section 7(c).

8. WAIVER

No waiver by either of the parties of any failure by the other party to keep or perform any provision, covenant or condition of this Agreement shall be deemed to be a waiver of any preceding or succeeding breach of the same, or of any provision, covenant or condition. All rights and remedies herein granted or referred to are cumulative; resort to one shall not preclude resort to any other or any other right or remedy provided by the law.

9. ARBITRATION

Any controversy or claim arising out of or relating to this Agreement or the breach hereof shall be settled by arbitration before a single arbitrator in Orange County, California. The arbitration shall be administered by and held in accordance with the Commercial Arbitration Rules of the American Arbitration Association. Judgment upon the award rendered by the arbitrator may be entered in any court having jurisdiction thereof. The costs of the arbitration, including any AAA administration fee, the arbitrator's fee, and costs for the use of facilities during the hearings, shall initially be borne equally by the parties to the arbitration. However, reimbursement for such fees and costs and such party's attorneys' fees shall be awarded to the prevailing or most prevailing party by the arbitrator.

10. ENFORCEABILITY

The invalidity or enforceability of any term or provision hereof shall not affect the validity or enforceability of any other term or provision.

11. ATTORNEYS FEES

In any arbitration or other legal proceeding to enforce or interpret the terms of this Agreement, the prevailing party shall be entitled to reasonable attorneys' fees and costs in addition to any other relief to which it or he may be entitled.

12. CHOICE OF LAW

This Agreement shall be construed and governed by the laws of the State of California.

13. ENTIRE AGREEMENT

This Agreement may be executed in counterparts and the counterparts read together, together with the option agreements referred to in Section 5, shall constitute the complete and entire agreement between the parties regarding the subject matter hereof, superseding all prior agreements, representations, proposals and negotiations, either oral or in writing, between the parties with respect to the subject matter hereof.

14. MODIFICATIONS

This Agreement shall not be modified or amended except by a written document executed by both parties to this Agreement.

15. SUCCESSORS

This Agreement will be binding upon the heirs, executors, administrators, successors, assignees, and other legal representatives of the parties to this Agreement.

16. DRAFTING

This Agreement has been negotiated at arm's length and between persons sophisticated and knowledgeable in the matters dealt with. Accordingly, any rule of law (including California Code of Civil Procedure Section 1654) or legal decision that would require interpretation against the drafter of this Agreement is not applicable and is waived.

The parties have entered into this Agreement as of the date set forth in the first paragraph above.

Medstone International, Inc., Employee
a Delaware corporation

By:

-------------------------------- --

David V. Radlinski, Eva Novotny

Chairman and CEO

EXHIBIT 21

MEDSTONE INTERNATIONAL, INC.

SUBSIDIARIES

<TABLE>
<CAPTION>

NAME	JURISDICTION
<S>	<C>
United Physicians Resources, Inc.	Delaware
Northern Nevada Lithotripsy Associates, LLC	Nevada
Southern Idaho Lithotrispy Associates, LLC	California

</TABLE>

EXHIBIT 23.1

CONSENT OF INDEPENDENT AUDITORS

We consent to the incorporation by reference in the Registration Statements (Form S-8 Nos. 33-32891, 33-45470, 33-32892 and 33-36707) pertaining to the 1989 Stock Incentive Plan (as amended), the Nonemployee Director Stock Option Plan and the 1997 Stock Incentive Plan of Medstone International, Inc. of our report dated February 11, 1999, with respect to the consolidated financial statements and schedule of Medstone International, Inc. included in this Annual Report (Form 10-K) for the year ended December 31, 1998.

/s/ ERNST & YOUNG LLP

Orange County, California
March 22, 1999

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