

---

---

# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-QSB

**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**for the quarterly period ended March 31, 2003**

**Or**

**Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

Commission file number: 000-32925

### **AVATAR SYSTEMS, INC.**

(Exact name of Registrant as specified in its charter)

**Texas**

(State or other jurisdiction of incorporation or organization)

**75-2796037**

(IRS Employer Identification Number)

**5728 LBJ Freeway, Suite 270, Dallas, Texas 75240**

(Address of principal executive offices and zip code)

**(972) 720-1800**

(Registrant's telephone number, including area code)

#### **APPLICABLE ONLY TO CORPORATE ISSUERS**

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

Class	Number of shares outstanding at March 31, 2003
Common stock, \$0.001 par value	8,695,652

---

---

**INDEX**

<b>PART I. FINANCIAL INFORMATION.....</b>	<b>1</b>
Item 1. Financial Statements and Notes to Condensed Financial Statements.....	1
Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations .....	4
Item 3. Controls and Procedures.....	5
<b>PART II. OTHER.....</b>	<b>6</b>
<b>INFORMATION .....</b>	<b>6</b>
Item 1. Legal Proceedings .....	6
Item 2. Changes in Securities .....	6
Item 3. Defaults Upon Senior Securities .....	6
Item 4. Submission of Matters to a Vote of Security Holders .....	6
Item 5. Other Information.....	6
Item 6. Exhibits And Reports On Form 8-K.....	6
Signatures .....	7
Certifications .....	8
Exhibit 99.3 .....	9
Statement Furnished Pursuant To Section 906 Of The Sarbanes-Oxley Act Of 2002, 18 U.S.C. Section 1350 .....	9

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements and Notes to Condensed Financial Statements**

**AVATAR SYSTEMS, INC.  
BALANCE SHEETS**

	<b>March</b>	<b>December 31,</b>
	<b>2003</b>	<b>2002</b>
	<b>(unaudited)</b>	
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 408,488	\$ 395,256
Accounts receivable, net	144,284	199,102
Prepaid Expense	6,817	7,603
Deferred income taxes	10,319	10,319
Total current assets	569,908	612,280
Property and Equipment – at cost, net	143,018	134,280
Purchased Software, net	265,099	293,060
Software Development Costs, net	1,597,293	1,562,141
Total assets	\$ 2,575,318	\$ 2,601,761
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current liabilities:</b>		
Current maturities of long-term debt	\$ 7,218	\$ 13,433
Accounts payable	60,307	75,937
Accrued expense	43,270	51,642
Deferred revenues	235,016	235,016
Total current liabilities	345,811	376,028
Deferred income taxes	149,788	148,504
Total liabilities	495,599	524,532
<b>Stockholders' equity:</b>		
Common stock, \$0.001 par value; 30,000,000 shares authorized; 8,695,652 shares, issued and outstanding	8,696	8,696
Additional paid-in capital	1,768,345	1,768,345
Retained earnings	302,678	300,188
Total stockholders' equity	2,079,719	2,077,229
Total liabilities and stockholders' equity	\$ 2,575,318	\$ 2,601,761

The accompanying notes are an integral part of these financial statements

**AVATAR SYSTEMS, INC.**  
**CONDENSED STATEMENTS OF INCOME**

	<b>Three Months Ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
	<b>(unaudited)</b>	
<b>Revenues:</b>		
Software	\$ 73,558	\$ 76,330
Maintenance	285,764	287,954
Professional services	33,353	87,637
Hardware	28,225	13,940
Net revenues	420,900	465,861
<b>Cost of revenues:</b>		
Software	16,279	18,972
Maintenance	39,846	76,879
Professional services	12,186	18,362
Hardware	25,285	13,120
Total cost of revenues	93,596	127,333
Gross profit	327,304	338,528
<b>Operating expenses:</b>		
Sales and marketing	88,180	63,614
General and administrative	135,195	137,363
Amortization of intangibles	88,809	74,007
Depreciation	12,134	16,487
Total operating expenses	324,318	291,471
Operating income	2,986	47,057
Interest income	788	3,418
Interest expense	-	481
Income from operations before income taxes	3,774	49,994
Deferred income tax expense	1,284	14,958
Net Income	\$ 2,490	\$ 35,036
<b>Earnings per share:</b>		
<b>Basic</b>		
Net income	\$ *	\$ *
Shares used in per share calculations	8,695,652	8,695,65
<b>Diluted</b>		
Net income	\$ *	\$ *
Shares used in per share calculations	8,695,652	11,590,036

\* Less than \$0.01 per share.

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

**AVATAR SYSTEMS, INC.**  
**STATEMENTS OF CASH FLOWS**

	<b>Three Months Ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
	<b>(unaudited)</b>	
<b>Cash flows from operating activities:</b>		
Net income	\$ 2,490	\$ 35,036
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of intangibles	88,809	74,007
Depreciation	12,134	16,487
Deferred income taxes	1,284	14,958
Changes in operating assets and liabilities:		
Accounts receivable	54,818	(4,123)
Prepaid expense	786	8,125
Accounts payable and accrued expense	(24,002)	(25,181)
Deferred revenue	-	-
Net cash provided by operating activities	<u>136,319</u>	<u>119,309</u>
<b>Cash flows from investing activities:</b>		
Property and Equipment	(20,872)	(2,215)
Capitalized software development costs	(96,000)	(96,000)
Payments received on note receivable	-	9,052
Other	-	141
Net cash used in investing activities	<u>(116,872)</u>	<u>(89,022)</u>
<b>Cash flows from financing activities:</b>		
Payments on note payable and capital lease obligation	(6,215)	(47,707)
Net cash used in financing activities	<u>(6,215)</u>	<u>(47,707)</u>
Net increase (decrease) in cash and cash equivalents	13,232	(17,420)
Cash and cash equivalents at beginning of period	395,256	397,362
Cash and cash equivalents at end of period	<u>\$ 408,488</u>	<u>\$ 379,942</u>
<b>Supplemental disclosure of cash paid for:</b>		
Interest	<u>\$ -</u>	<u>\$ 481</u>
<b>Supplemental disclosure of noncash investing and financing activities:</b>		
Equipment acquired through foreclosure of note receivable	<u>\$ -</u>	<u>\$ 42,070</u>

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

# AVATAR SYSTEMS, INC.

## NOTES TO THE CONDENSED FINANCIAL STATEMENTS (Unaudited)

### 1. Basis of Presentation

We prepared the condensed financial statements in accordance with the rules and regulations of the Securities and Exchange Commission (“SEC”) applicable to interim financial information. Certain information and footnote disclosures included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted in these interim statements pursuant to such SEC rules and regulations. We recommend that these interim financial statements be read in conjunction with the audited financial statements and related notes included in our 2002 Annual Report on Form 10-KSB filed with the SEC. Interim results are not necessarily indicative of the results to be expected for the full year.

In our opinion, the condensed financial statements include all adjustments necessary to present the financial position and results of operations for each interim period shown.

Certain items in the March 31, 2002 financial statements have been reclassified to conform with subsequent presentations.

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

#### SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

You should read the following discussion in conjunction with our financial statements and related notes. Except for historical information, the following discussion contains forward-looking statements within the meaning of Section 27a of the Securities Act of 1933 and Section 21e of the Securities Exchange Act of 1934. These forward-looking statements involve risks and uncertainties, including, among other things, statements about our gross margins and operating costs and expenses. Our actual results may differ significantly from those projected in the forward-looking statements. Factors that might cause future results to differ materially from those discussed in the forward-looking statements include, but are not limited to, those discussed in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere in this document as well as other information set forth in our 2002 Annual Report on Form 10-KSB filed with the SEC and other documents we file from time to time with the SEC.

#### Results of Operations

##### REVENUES

Our net revenues include four components: software licensing fees, maintenance, professional services and hardware. Our net revenues for the first quarter ended March 31, 2003 decreased 9.7% to \$420,900 compared with net revenues of \$465,861 for the same period in 2002. The decrease in revenues was due primarily to a reduction in demand for professional services

**Software.** Software sales for the first quarter of 2003 decreased 3.6% to \$73,558 compared with software sales of \$76,330 for the first quarter of 2002.

**Maintenance revenue.** Maintenance revenue for the first quarter of 2003 decreased 0.8% to \$285,764 compared with maintenance of \$287,954 for the first quarter of 2002.

**Professional services.** Professional service revenue for the first quarter of 2003 decreased 61.9% to \$33,353 compared with professional service revenue of \$87,637 for the first quarter of 2002. The decrease in professional services is related to the lower sales volume of our Petroware2000 software package subsequent to its initial release in October of 2001.

**Hardware.** Hardware sales for the first quarter of 2003 increased 102.5% to \$28,225, compared with hardware sales of \$13,940 for the first quarter of 2002.

## **COST OF REVENUES**

Our cost of revenues includes four components: cost of software, cost of maintenance, cost of professional services, and cost of hardware sales. Our cost of revenues for the first quarter of 2003 decreased 26.5% to \$93,596 compared with cost of revenues of \$127,333 for the first quarter of 2002. Cost of revenues as a percentage of net revenues decreased to 22.2% for the three months ended March 31, 2003 from 27.3% for the same period in 2002.

**Cost of software.** Cost of software decreased 14.2% to \$16,279 in the first quarter of 2003 from \$18,972 in the first quarter of 2002. The decrease in cost of software is directly related to the decrease in software revenue. Cost of software as a percentage of the related revenue decreased to 22.1% for the first quarter of 2003 compared to 24.9% for the same period in 2002.

**Cost of maintenance revenue.** Cost of maintenance revenue decreased 48.2% to \$39,846 for the first quarter of 2003 from \$76,879 for the first quarter of 2002. Cost of maintenance revenue as a percentage of the related revenue decreased to 13.9% for the first quarter 2003, compared to 26.7% for the same period last year. The decreases in cost and percentage of maintenance revenue are due to reductions in personnel providing maintenance support.

**Cost of professional services.** Cost of professional services decreased 33.6% to \$12,186 for the three months ended March 31, 2003, compared with \$18,362 for the same period last year. Cost of professional services as a percentage of the related revenue increased to 36.5% in the first quarter 2003, compared to 21.0% for the same period last year. The decrease in cost of professional services was directly related to lower professional services revenue.

**Hardware.** Cost of hardware sold increased 92.7% to \$25,285 for the three months ended March 31, 2003, compared with \$13,120 for the same period last year. Cost of hardware as a percentage of the related revenue decreased to 89.6% for the three months ended March 31, 2003, compared with 94.1% for the same period last year.

## **OPERATING EXPENSES**

**Sales and Marketing.** Our sales and marketing expenses for the first quarter of 2003 increased 38.6% to \$88,180, compared with \$63,614 for the first quarter of 2002. Sales and marketing expenses as a percentage of net revenues increased to 21.0% for the three months ended March 31, 2003, compared with 13.7% for the same period last year. The increases in sales and marketing costs and percentages are the result of the implementation of new marketing programs.

**General and Administrative.** Our general and administrative expenses for the first quarter of 2003 decreased 1.6% to \$135,195 compared with general and administrative expenses of \$137,363 for the first quarter of 2002. General and administrative expenses as a percentage of net revenues increased to 32.1% in the first quarter of 2003, compared with 29.5% in the first quarter of 2002. The increase in general and administrative expenses as a percentage of net revenues was due to the overall decrease in net revenues.

**Interest Income.** Interest income was \$788 in the first quarter of 2003 compared to \$3,418 in 2002. The decrease was primarily due to smaller balances available for investments and lower interest rates.

**Provision for Income Taxes.** For the three months ended March 31, 2003 we accrued income tax expense on operating income of \$1,284, based on our pretax income using an effective tax rate of 34%, which is our anticipated effective tax rate for the fiscal year 2003. The actual effective tax rate for the entire fiscal year could vary substantially depending on actual results achieved.

### **Item 3. Controls and Procedures**

The Chief Executive Officer/Chief Financial Officer of the Company has established and is currently maintaining disclosure controls and procedures for the Company. The disclosure controls and procedures have been designed to ensure that material information relating to the Company is made known to him as soon as it is known by others within the Company. There have been no significant changes in these controls within the reporting period.

During the period immediately after the end of the quarter, the Chief Executive Officer/Chief Financial Officer conducts an update and a review and evaluation of the effectiveness of the Company's disclosure controls and procedures. It is the Chief Executive Officer's/Chief Financial Officer's opinion, based upon the evaluation he completed by April 30, 2003, that the controls and procedures currently being utilized by the Company are sufficiently effective to ensure that any material information relating to the Company would become known to him within a reasonable time.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

None.

### **Item 2. Changes in Securities**

None.

### **Item 3. Defaults Upon Senior Securities**

None.

### **Item 4. Submission of Matters to a Vote of Security Holders**

None

### **Item 5. Other Information**

None

### **Item 6. Exhibits And Reports On Form 8-K**

- (a) Exhibits  
Exhibit 99.3 Certifications
- (b) Reports on Form 8-K  
None

## Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

AVATAR SYSTEMS, INC.

**Dated: May 14, 2003**

By: /s/ROBERT C. SHREVE, JR.  

---

Robert C. Shreve, Jr.  
Chief Executive Officer  
Chief Financial Officer

## Certifications

I, Robert C. Shreve, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-QSB of Avatar Systems Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rule 13a-14 and 15d-14) for the registrant and I have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant is made known to me by others within those entities, particularly during the period in which this quarterly report was prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report my conclusions about the effectiveness of the disclosure controls and procedures based on the required evaluation as of the Evaluation Date;
5. I have disclosed, based on my most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 14, 2003

/s/ Robert C. Shreve, Jr.

-----  
Chief Executive Officer and Chief Financial Officer  
(principal executive and accounting officer)

**Exhibit 99.3**

**Statement Furnished Pursuant To Section 906 Of The Sarbanes-Oxley Act Of 2002, 18 U.S.C. Section 1350**

The undersigned, Robert C. Shreve, Jr., is the President and Chief Executive Officer of Avatar Systems Inc. (the "Company").

This statement is being furnished in connection with the filing by the Company of the Company's Quarterly Report on Form 10-QSB for the quarter ended March 31, 2003. (the "Report").

By execution of this statement, I certify that:

- (A) the report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C 78m(a) or 78o(d) and
- (B) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of the dates and for the periods covered by the Report.

This statement is authorized to be attached as an exhibit to the Report so that this statement will accompany the Report at such time as the Report is filed with the Securities and Exchange Commission, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350. It is not intended that this statement be deemed to be filed for purposes of the Securities Act of 1934, as amended.

AVATAR SYSTEMS, INC.

**Dated: May 14, 2003**

By: /s/ROBERT C. SHREVE, JR.

\_\_\_\_\_  
Robert C. Shreve, Jr.  
Chief Executive Officer  
Chief Financial Officer