
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 September 30, 2001

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 ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS

Check whether the registrant filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Exchange Act after the distribution of securities under a plan confirmed by a court. Yes [] No []

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 September 30, 2001
Common stock, \$0.001 par value	8,695,652

Transitional Small Business Disclosure Format (Check one): Yes [] No []

INDEX

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Condensed Balance Sheets

Condensed Statements of Income

Condensed Statements of Cash Flows

Notes to the Financial Statements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Item 2. Changes in Securities and Use of Proceeds

Item 3. Defaults Upon Senior Securities

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

Item 5. Other Information

Item 6. Exhibits and Reports on Form 8-K

Signatures

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

**AVATAR SYSTEMS, INC.
CONDENSED BALANCE SHEETS**

	September 30, 2001	December 31, 2000
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 501,380	\$ 933,007
Accounts receivable, net	230,142	126,618
Inventory	20,805	45,387
Prepaid expenses	38,532	6,030
Net assets of discontinued ecommerce subsidiary	75,600	-
Deferred income taxes	72,121	72,121
Total current assets	938,580	1,183,163
Property and Equipment – at cost, net	138,436	130,204
Purchased Software, net	494,416	539,248
Software Development Costs, net	1,090,537	972,637
Other Assets	231,949	557,087
Total assets	\$ 2,893,918	\$ 3,382,339
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current maturities of long-term debt	\$ 89,222	\$ 187,037
Accounts payable	199,742	145,053
Accrued expense	68,081	115,386
Deferred revenues	242,440	640,880
Total current liabilities	599,485	1,088,356
Deferred income taxes	128,246	112,797
Long-term debt, less current maturities:	8,216	53,203
Total liabilities	735,947	1,254,356
Stockholders' equity:		
Common stock, \$0.001 par value; 30,000,000 shares authorized		
8,695,652 shares authorized, issued and outstanding	8,696	8,696
Additional paid-in capital	1,999,478	1,999,478

Retained earnings	149,797	119,809
Total stockholders' equity	2,157,971	2,127,983
Total liabilities and stockholders' equity	\$ 2,893,918	\$ 3,382,339

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

AVATAR SYSTEMS, INC.
CONDENSED STATEMENTS OF INCOME

	Three Months Ended September 30,		Nine Months Ended September,	
	2001	2000	2001	2000
	(unaudited)			
Revenues:				
Software	\$ 267,722	\$ 48,404	\$ 626,260	\$ 76,003
Maintenance	269,426	190,422	778,775	601,345
Professional services	62,316	117,354	317,893	299,453
Hardware	58,434	18,147	126,578	225,855
Net revenues	657,898	374,327	1,849,506	1,202,656
Cost of revenues:				
Software	44,761	19,112	105,443	38,002
Maintenance	82,263	76,937	241,806	186,045
Professional services	20,772	26,730	109,289	155,329
Hardware	48,889	18,025	107,514	196,911
Total cost of revenues	196,685	140,804	564,052	576,287
Gross margin	461,213	233,523	1,285,454	626,369
Operating expenses:				
Sales and marketing	80,668	60,078	218,462	155,668
General and administrative	163,897	129,533	542,088	327,597
Amortization of intangibles	50,974	15,274	152,922	45,822
Write off of acquisition costs	-	-	323,539	-
Total operating expenses	295,539	204,885	1,237,011	529,087
Income from operations	165,674	28,638	48,443	97,282
Interest income	4,255	19,514	20,837	26,891
Interest expense	4,388	8,140	15,146	26,271
Income from continuing operations before income taxes	165,541	40,012	54,134	97,902
Provision for income taxes	56,284	-	18,406	-

Income from continuing operations	109,257	40,012	35,728	97,902
Gain (Loss) from operation of discontinued ecommerce subsidiary (less applicable tax benefit (expense) of \$24,774 and tax of \$(2,999), respectively)	(48,091)	-	5,822	-
Loss on disposal of discontinued ecommerce subsidiary including a provision of \$14,200 for operating losses during phaseout (less applicable tax benefit of \$6,976)	(11,561)	-	(11,561)	-
Net income	\$ 49,605	\$ 40,012	\$ 29,989	\$ 97,902
Net Income per Share Data				
Income from continuing operations - basic	\$.01	\$ -	\$ -	\$ -
Income from continuing operations – diluted	\$.01	\$ -	\$ -	\$ -
Gain (Loss) from discontinued operation of ecommerce subsidiary – basic	\$ -	\$ -	\$ -	\$ -
Gain (Loss) from discontinued operation of ecommerce subsidiary – diluted	\$ -	\$ -	\$ -	\$ -
Loss on disposal of ecommerce subsidiary – basic	\$ -	\$ -	\$ -	\$ -
Loss on disposal of ecommerce subsidiary – diluted	\$ -	\$ -	\$ -	\$ -
Net income per share - basic	\$.01	\$ -	\$ -	\$ -
Net income per share - diluted	\$.01	\$ -	\$ -	\$ -
Pro forma financial information				
Income before income taxes	-	40,012	-	97,902
Pro forma income tax expense	-	13,604	-	33,287
Pro forma net income	\$ -	\$ 26,408	\$ -	\$ 64,615

Pro forma income per share

Basic	\$	-	\$.00	\$	-	\$.01
Diluted	\$	-	\$.00	\$	-	\$.01
Weighted average shares outstanding								
Basic and diluted		8,695,652		6,897,778		8,695,652		6,897,778

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

AVATAR SYSTEMS, INC.
CONDENSED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30,	
	2001	2000
	(unaudited)	
Cash flows from operating activities:		
Net income	\$ 29,989	\$ 97,902
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	204,449	97,349
Write off of acquisition costs	323,539	-
Gain from operation of discontinued ecommerce subsidiary	(5,822)	-
Loss on disposal of discontinued ecommerce subsidiary	11,561	-
Deferred income taxes	18,406	-
Cash provided by (used in) operating assets and liabilities:		
Accounts receivable	(103,524)	58,159
Inventory	24,582	-
Prepaid and other current assets	(32,501)	-
Accounts payable and accrued expenses	7,382	57,676
Deferred revenues	(398,440)	79,852
	79,621	390,938
Cash flows from investing activities:		
Acquisition of fixed assets	(58,532)	(10,071)
Capitalized software development costs	(225,000)	(423,476)
Note receivable from disposition of ecommerce subsidiary	(75,600)	-
Deposits	(9,314)	-
	(368,446)	(433,547)
Cash flows from financing activities:		
Capitalized offering costs	-	(62,959)
Sale of common stock	-	1,473,185
Payments on notes payable and capital lease obligations	(142,802)	(134,516)
	(142,802)	1,275,710
Net increase (decrease) in cash and cash equivalents	(431,627)	1,233,101
Cash and cash equivalents at beginning of period	933,007	378,551

Cash and cash equivalents at end of period	\$	501,380	\$	1,611,652
Supplemental disclosure of cash paid for:				
Interest	\$	15,277	\$	26,271

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

AVATAR SYSTEMS, INC.

NOTES TO THE CONDENSED FINANCIAL STATEMENTS (Unaudited)

1. Basis of Presentation

The condensed financial statements include the accounts of Avatar Systems Inc. ("Avatar") and its wholly-owned subsidiary. We have eliminated all significant intercompany balances and transactions.

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 2000 Annual Report on Form 10-SB 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 fairly the financial position and results of operations for each interim period shown.

2. Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board approved for issuance Statement of Financial Accounting Standards No. 141 (SFAS 141), *Business Combinations*. This standard eliminates the pooling method of accounting for business combinations initiated after June 30, 2001. In addition, SFAS 141 addresses the accounting for intangible assets and goodwill acquired in a business combination. This portion of SFAS 141 is effective for business combinations completed after June 30, 2001. The Company does not expect SFAS 141 to have a material effect on the Company's financial position, results of operations or cash flows.

In June 2001, the Financial Accounting Standards Board approved for issuance Statement of financial Accounting Standards No. 142 (SFAS 142), *Goodwill and Intangible Assets*, which clarifies the accounting for impairments to purchased goodwill and intangible assets. Under SFAS 142, goodwill and intangible assets with indefinite lives will no longer be amortized, but will be tested for impairment annually and also in the event of an impairment indicator. SFAS 142 is effective fiscal years beginning after December 15, 2001, with early adoption permitted for companies with fiscal years beginning after March 15, 2001, if their first quarter financial statements have not previously been issued. The Company does not expect SFAS 142 to have a material effect on the Company's financial position, results of operations or cash flows.

In August 2001, the Financial Accounting Standards Board approved for issuance Statement of financial Accounting Standards No. 144 (SFAS 144), *Accounting for the Impairment or Disposal of Long-Lived Assets*. This standard addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This standard establishes a single framework, based on Statement of Financial Accounting Standards No. 121 (SFAS 121), *Accounting for the Impairment of Long-Lived Assets and for Long-Lived to Be Disposed Of*, for long-lived assets to be disposed of by sale and resolves certain implementation issues related to SFAS 121. SFAS 144 is effective for fiscal years beginning after December 15, 2001. The Company does not expect SFAS 144 to have a material effect on the Company's financial position, results of operations or cash flows.

3. Write off of Acquisition Costs

As a result of an inability to secure financing, the Company's standstill agreement related to a proposed acquisition expired in April 2001, and a deposit in the amount of \$250,000 was forfeited. Accordingly, the Company recorded a charge of \$323,539 to write-off the \$250,000 deposit and \$73,539 in related professional fees in the second quarter of 2001.

4. Subsequent Event

On October 17, 2001, the Company completed the sale of the stock of its ecommerce subsidiary, Talon Global Solutions, Inc. for an aggregate purchase price of \$75,600. The Company received \$20,000 in cash and a promissory note for \$55,600. The note matures on December 1, 2002, with accrued interest at 8% and is payable in twelve monthly installments of \$4,852. The company was sold to Chad P. Statham, the president of Talon.

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 Form 10-SB/A filed November 5, 2001 and other documents we file from time to time with the Securities and Exchange Commission

Results of Operations

REVENUES

Our net revenues include four components: software licensing fees, maintenance/recurring, professional services and hardware. Our net revenues for the third quarter ended September 30, 2001 increased 75.8% to \$657,898 compared with net revenues of \$374,327 for the same period in 2000. Net revenues for the nine months ended September 30, 2001 increased 53.8% to \$1,849,506, compared with net revenues of \$1,202,656

Software. Software sales for the third quarter of 2001 increased 453.1% to \$267,722 compared with software sales of \$48,404 for the third quarter of 2000. Software sales for the nine months ended September 30, 2001 increased 724.0% to \$626,260, compared with \$76,003 from the same period last year. The increase in software revenues is primarily from sales of the Petroware 2000 software package, which was released in October 2000.

Maintenance and other recurring revenue. Maintenance and other recurring revenue for the third quarter of 2001 increased 41.5% to \$269,426 compared with maintenance and other recurring revenue of \$190,422 for the third quarter of 2000. Maintenance and other recurring revenue for the nine months ended September 30, 2001 increased 29.5% to \$778,775 compared with maintenance and other recurring revenue of \$601,345 for the same period last year. The increase in maintenance and other recurring revenues is related to the Petroware 2000 software package, which was released in October of 2000.

Professional services. Professional service revenue for the third quarter of 2001 decreased 46.9% to \$62,316, compared with professional services revenue of \$117,354 for the third quarter of 2000. Professional service

revenue for the nine months ended September 30, 2001 increased 6.2% to \$317,893, compared with \$299,453 for the same period last year.

Hardware. Hardware sales for the third quarter of 2001 increased 222.0% to \$58,434, compared with hardware sales of \$18,147 for the third quarter of 2000. Hardware sales for the nine months ended September 30, 2001 declined 44.0% to \$126,578, compared with \$225,855 from the same period last year. The decrease in hardware sales is due to a decline in customer demand as well as a shift in sales focus to the higher margin software sales.

COST OF REVENUES

Our cost of revenues includes four components: cost of software, cost of maintenance and other recurring, cost of professional services, and cost of hardware sales. Our cost of revenues for the third quarter of 2001 increased 39.7% to \$196,685 compared with cost of revenues of \$140,804 for the third quarter of 2000. Cost of revenues for the nine months ended September 30, 2001 decreased 2.1% to \$564,052 compared with \$576,287 the same period last year. Cost of revenues as a percentage of net revenues decreased to 29.9% for the three months ended September 30, 2001 from 37.6% from the same period in 2000. Cost of revenues as a percentage of net revenue decreased to 30.5% for the nine months ended September 30, 2001, compared with 47.9% for the same period last year.

Cost of software. Cost of software increased 134.2% to \$44,761 in the third quarter of 2001 from \$19,112 in the third quarter of 2000. Cost of software increased 177.5% to \$105,443 in the nine months ended September 30, 2001, compared with \$38,002 in the same period last year. The increase in cost of software is directly related to the increase in software revenue. Cost of software as a percentage of the related revenues decreased to 16.7% for the third quarter of 2001 compared to 39.5% for the same period in 2000, primarily due to the increase in software sales. Cost of software as a percentage of the related revenues increased to 16.8% for the nine months ended September 30, 2001, compared with 50.0% for the for the same period last year.

Cost of maintenance and other recurring revenues. Cost of maintenance and other recurring revenues increased 6.9% to \$82,263 for the third quarter of 2001 from \$76,937 for the third quarter of 2000. Cost of maintenance and other recurring revenues increased 30.0% to \$241,806 for the nine months ended September 30, 2001, compared with \$186,045 for the same period last year. This increase was due to the reallocation of certain programming and development personnel from software development, which is capitalized, to customer support. Cost of maintenance and other recurring revenues as a percentage of the related revenue decreased to 30.5% for the third quarter 2001, compared to 40.4% for the same period last year. Cost of maintenance and other recurring revenues as a percentage of the related revenue remained stable at 31.0% for the nine months ended September 30, 2001, compared with 30.9% for the same period last year. .

Cost of professional services. Cost of professional services decreased 22.3% to \$20,772 for the three months ended September 30, 2001, compared with \$26,370 for the same period last year. Cost of professional services decreased 29.6% to \$109,289 for the nine months ended September 30, 2001 from \$155,329 for the same period last year. Cost of professional services as a percentage of the related revenue increased to 33.3% in the third quarter 2001, compared to 22.8% for the same period last year. Cost of professional services as a percentage of the related revenue decreased to 34.4% for the nine months ended September 30, 2001, compared with 51.9% for the same period last year. The decreases in cost were due to reductions in use of outside consultants and the reduction in percentages of related revenue were due to increased demand for professional services.

Hardware. Cost of hardware sold increased 171.2% to \$48,889 for the three months ended September 30, 2001, compared with \$18,025 for the same period last year. Cost of hardware sold decreased 45.4% to \$107,514 for the nine months ended September 30, 2001, compared with \$196,911 for the same period last year. Cost of hardware as a percentage of the related revenue decreased to 83.7% for the three months ended September 30, 2001, compared with 99.3% for the same period last year. Cost of hardware as a percentage of the related revenue decreased to 84.9% for the three months ended September 30, 2001, compared with 87.2% for the same period last year.

OPERATING EXPENSES

Sales and Marketing. Our sales and marketing expenses for the third quarter of 2001 increased 34.3% to \$80,668, compared with \$60,078 for the third quarter of 2000. Sales and marketing expenses for the nine months ended September 30, 2001 increased 40.3% to \$218,462, compared with \$155,668 in the same period last year. The increase in expense for the three and nine months ended September 30, 2001 compared with the same periods last year was primarily due to an increase in sales and marketing personnel and increased sales and marketing in our core markets. Sales and marketing expenses as a percentage of net revenues decreased to 12.3% for the three months ended September 30, 2001, compared with 16.0% for the same period last year. Sales and marketing expenses as a percentage of net revenues decreased to 11.8% for the nine months ended September 30, 2001, compared with 12.9% for the same period last year.

General and Administrative. Our general and administrative expenses for the third quarter of 2001 increased 26.5% to \$163,897, compared with general and administrative expenses of \$129,533 for the third quarter of 2000. General and administrative expenses increased 65.5% to \$542,088 for the nine months ended September 30, 2001, compared with \$327,597 in the same period last year. The increase was due to increased staffing and related costs to support our growth. General and administrative expenses as a percentage of net revenues decreased to 24.9% in the third quarter of 2001, compared with 34.6% in the third quarter of 2000. General and administrative expenses as a percentage of net revenues increased to 29.3% in the nine months ended September 30, 2001, compared with 27.2% in the same period last year.

Interest Income. Interest income was \$4,255 in the third quarter of 2001 compared to \$19,514 in 2000. Interest income was \$20,837 in the nine months ended September 30, 2001, compared with \$26,891 in the same period last year. The decrease was primarily due to smaller balances available for investments because of costs we incurred in our reverse merger and deposits we made on contracts for potential acquisition candidates.

Interest Expense. Interest expense was \$4,388 in the third quarter of 2001 compared to \$8,140 in the same period last year. Interest expense was \$15,277 in the nine months ended September 30, 2001, compared with \$26,271 in the same period last year.

Provision for Income Taxes. For the three and nine months ended September 30, 2001 we recorded a tax provision on income from continuing operations of \$56,284 and \$18,406, respectively, based on our pretax income using an effective tax rate of 34%, which is our anticipated effective tax rate for the fiscal year 2001. The actual effective tax rate for the entire fiscal year could vary substantially depending on actual results achieved.

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

On October 17, 2001, the Company completed the sale of the stock of its ecommerce subsidiary, Talon Global Solutions, Inc. for an aggregate purchase price of \$75,600. The Company received \$20,000 in cash and a promissory note for \$55,600. The note matures on December 1, 2002, with accrued interest at 8% and is payable in twelve monthly installments of \$4,852. The company was sold to Chad P. Statham, the president of Talon.

Item 6. Exhibits And Reports On Form 8-K

(a) Exhibits

None.

(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: November 13, 2001

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

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