
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, 2002

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, 2002 |
|---------------------------------|--|
| Common stock, \$0.001 par value | 8,695,652 |

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

**AVATAR SYSTEMS, INC.
BALANCE SHEETS**

| | March 31 2002 | December 31, 2001 |
|--|--------------------------|------------------------------|
| | <u>(unaudited)</u> | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 379,942 | \$ 397,362 |
| Accounts receivable, net | 195,984 | 191,861 |
| Prepaid Expense | 14,156 | 22,281 |
| Net assets of discontinued ecommerce subsidiary | - | 51,122 |
| Deferred income taxes | 110,564 | 110,564 |
| Total current assets | <u>700,646</u> | <u>773,190</u> |
| Property and Equipment – at cost, net | 173,066 | 145,268 |
| Purchased Software, net | 385,380 | 416,154 |
| Software Development Costs, net | 1,271,944 | 1,218,831 |
| Other Assets | - | 488 |
| Total assets | <u>\$ 2,531,036</u> | <u>\$ 2,553,931</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Current maturities of long-term debt | \$ 16,468 | \$ 60,402 |
| Accounts payable | 77,676 | 109,307 |
| Accrued expense | 44,538 | 38,088 |
| Deferred revenues | 216,821 | 216,821 |
| Total current liabilities | <u>355,503</u> | <u>424,618</u> |
| Deferred income taxes | 195,558 | 180,600 |
| Long-term debt | - | 3,773 |
| Total liabilities | <u>551,061</u> | <u>608,991</u> |
| Stockholders' equity: | | |
| 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 | 202,934 | 167,899 |
| Total stockholders' equity | <u>1,979,975</u> | <u>1,944,940</u> |
| Total liabilities and stockholders' equity | <u>\$ 2,531,036</u> | <u>\$ 2,553,931</u> |

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

AVATAR SYSTEMS, INC
STATEMENTS OF INCOME

| | Three Months Ended March | |
|--|---------------------------------|-------------|
| | 31, | |
| | 2002 | 2001 |
| | (unaudited) | |
| Revenues: | | |
| Software | \$ 76,330 | \$ 222,316 |
| Maintenance | 287,954 | 270,253 |
| Professional services | 87,636 | 153,011 |
| Hardware | 13,940 | 19,813 |
| Total revenues | 465,860 | 665,393 |
| Cost of revenues: | | |
| Software | 18,972 | 38,552 |
| Maintenance | 110,402 | 136,843 |
| Professional services | 35,123 | 56,701 |
| Hardware | 13,120 | 13,120 |
| Total cost of revenues | 177,617 | 245,216 |
| Gross margin | 288,243 | 420,177 |
| Operating expenses: | | |
| Sales and marketing | 63,614 | 63,854 |
| General and administrative | 87,078 | 129,922 |
| Amortization of intangibles | 74,007 | 50,974 |
| Depreciation | 16,487 | 16,767 |
| Total operating expenses | 241,186 | 261,517 |
| Income from operations | 47,057 | 158,660 |
| Interest income | 3,418 | 10,042 |
| Interest expense | 481 | 3,788 |
| Income from continuing operations before income taxes | 49,994 | 164,914 |
| Provision for income taxes | 14,958 | 57,746 |
| Income from continuing operations | \$ 35,036 | \$ 107,168 |
| Discontinued operations: | | |
| Income from operations of Talon Global Systems, Inc. (net of income taxes) | | 18,542 |
| Net Income | \$ 35,036 | \$ 125,710 |
| Earnings per share | | |
| Basic | | |
| Income from continuing operations | \$ 0.00 | \$ 0.01 |
| Net income | \$ 0.00 | \$ 0.01 |
| Shares used in per share calculations | 8,695,652 | 8,695,652 |
| Diluted | | |
| Income from continuing operations | \$ 0.00 | \$ 0.01 |
| Net income | \$ 0.00 | \$ 0.01 |
| Shares used in per share calculations | 11,590,036 | 8,695,652 |

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

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

| | Three Months Ended March 31, | |
|--|-------------------------------------|-------------------|
| | 2002 | 2001 |
| | (unaudited) | |
| Cash flows from operating activities: | | |
| Net income | \$ 35,036 | \$ 125,709 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Amortization of intangibles | 74,007 | 50,974 |
| Depreciation | 16,487 | 16,767 |
| Deferred income taxes | 14,958 | 57,746 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (4,123) | (36,773) |
| Inventory | - | 14,382 |
| Prepaid expense | 8,125 | - |
| Accounts payable and accrued expense | (25,181) | (19,256) |
| Deferred revenue | - | (182,500) |
| Net cash provided by operating activities | <u>119,309</u> | <u>27,049</u> |
| Cash flows from investing activities: | | |
| Acquisition of fixed assets | (44,285) | (26,637) |
| Capitalized software development costs | (96,000) | (75,000) |
| Payments received on note receivable | 51,122 | - |
| Other | 141 | (4,576) |
| Net cash used in investing activities | <u>(89,022)</u> | <u>(106,213)</u> |
| Cash flows from financing activities: | | |
| Payments on note payable and capital lease obligation | (47,707) | (47,600) |
| Net cash used by financing activities | <u>(47,707)</u> | <u>(47,600)</u> |
| Net cash used in discontinued operations | - | (53,642) |
| Net decrease in cash and cash equivalents | (17,420) | (180,406) |
| Cash and cash equivalents at beginning of period | 397,362 | 933,007 |
| Cash and cash equivalents at end of period | <u>\$ 379,942</u> | <u>\$ 752,601</u> |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for interest | \$ 481 | \$ 3,788 |

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

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 2001 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 fairly the financial position and results of operations for each interim period shown.

2. Discontinued Operations

In October 2001, the Company elected to exit its direct sales software business. In accordance with this plan, the Company sold Talon Global Solutions, Inc., its direct sales software business, to its minority shareholder for \$20,000 and a note receivable for \$55,600. The Company recorded a loss of \$11,561 on the disposition, net of related income tax benefit of \$5,912.

The financial data related to direct sales software business is classified as discontinued operations for all periods presented.

Operating results from discontinued operations were as follows:

| | Three Months Ended March 31 2001 | |
|-------------------------------------|---|---------|
| Revenues | \$ | 175,594 |
| Income before income taxes | | 28,093 |
| Income tax expense | | 9,551 |
| Income from discontinued operations | | 18,542 |

3. Earnings Per Share

| | Three Months Ended March 31, | |
|-------------------------------------|---|-------------|
| | 2002 | 2001 |
| Income from continuing operations | \$ 35,036 | \$ 107,168 |
| Income from discontinued operations | | 18,542 |

| | | |
|--|------------|-----------|
| Weighted average common shares outstanding – basic | 8,695,652 | 8,695,652 |
| Dilutive effect of employee stock options | 44,384 | |
| Dilutive effect of stock warrants | 2,850,000 | |
| | | |
| Weighted average shares outstanding – diluted | 11,590,036 | 8,695,652 |
| | | |
| Earnings per share from continuing operations | | |
| Basic | \$ 0.00 | \$ 0.01 |
| Diluted | \$ 0.00 | \$ 0.01 |
| | | |
| Earnings per share from discontinued operations | | |
| Basic | \$ 0.00 | \$ 0.00 |
| Diluted | \$ 0.00 | \$ 0.00 |

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 2001 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/recurring, professional services and hardware. Our net revenues for the first quarter ended March 31, 2002 decreased 30.0% to \$465,860 compared with net revenues of \$665,393 for the same period in 2001. Revenues for the first quarter of 2001 were higher because of sales of our Petroware2000 software package, which was released in October of 2000.

Software. Software sales for the first quarter of 2001 decreased 65.7% to \$76,330 compared with software sales of \$222,316 for the first quarter of 2001. The decrease in software revenues is due to the high levels of sales of our Petroware 2000 in 2001, which was released in October 2000.

Maintenance and other recurring revenue. Maintenance and other recurring revenue for the first quarter of 2002 increased 6.5% to \$287,954 compared with maintenance and other recurring revenue of \$270,253 for the first quarter of 2001. The increase in maintenance and other recurring revenues is related to the Petroware 2001 software package, which was released in October of 2001. We increased our maintenance fee rates on March 1, 2002.

Professional services. Professional service revenue for the first quarter of 2002 decreased 42.7% to \$87,636 compared with professional service revenue of \$153,011 for the first quarter of 2001. The decrease in professional service revenue is related to the decrease in the installations of our Petroware 2000 product. We increased our professional fee rates on February 1, 2002.

Cost of Revenues

Our cost of revenues includes four components: cost of software, cost of maintenance and other recurring revenue, cost of professional services, and cost of hardware sales. Our cost of revenues for the first quarter of 2002 decreased 27.6% to \$177,617 compared with cost of revenues of \$245,216 for the first quarter of 2001. Cost of revenues as a percentage of net revenues increased to 38.1% for the three months ended March 31, 2002 from 36.9% from the same period in 2001.

Cost of software. Cost of software decreased 50.8% to \$18,972 in the first quarter of 2002 from \$38,552 in the first quarter of 2001. The decrease in cost of software is directly related to the decrease in software revenue. Cost of software as a percentage of the related revenues increased to 24.9% for the first quarter of 2002 compared with 17.3% for the same period in 2001, primarily due to the decrease in software sales.

Cost of maintenance and other recurring revenues. Cost of maintenance and other recurring revenues decreased 19.3% to \$110,402 for the first quarter of 2002 from \$136,843 for the first quarter of 2001. Cost of maintenance and other recurring revenues as a percentage of the related revenue decreased to 38.3% for the first quarter 2002 compared to 50.6% for the same period last year.

Cost of professional services. Cost of professional services decreased 38.1% to \$35,123 for the three months ended March 31, 2002, compared with \$56,701 for the same period last year. Cost of professional services as a percentage of the related revenue increased to 40.1% in the first quarter 2002 compared to 37.1% for the same period last year. The decreases in cost were due to the reduction in related revenue for professional services.

Operating Expenses

Sales and Marketing. Our sales and marketing expenses for the first quarter of 2002 decreased .4% to \$63,614 compared with \$63,854 for the first quarter of 2001. Sales and marketing expenses as a percentage of net revenues increased to 13.7% for the three months ended March 31, 2002, compared with 9.6% for the same period last year.

General and Administrative. Our general and administrative expenses for the first quarter of 2002 decreased 33.0% to \$87,078 compared with general and administrative expenses of \$129,922 for the first quarter of 2001. General and administrative expenses as a percentage of net revenues decreased to 18.7% in the first quarter of 2002 compared with 19.5% in the first quarter of 2001. The decrease in general and administrative expense was due primarily to a reduction in professional fees related to our reverse merger and costs related to our registration with the Securities and Exchange Commission.

Interest Income. Interest income was \$3,418 in the first quarter of 2002 compared to \$10,042 in 2001. The decrease was primarily due to smaller balances available for investment because of costs we incurred in our reverse merger and lower interest rates.

Interest Expense. Interest expense was \$481 in the first quarter of 2002 compared to \$3,788 in the same period last year. The decrease in interest expense was due to lower balances on our long-term debt that was paid in full on March 31, 2002.

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

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: May 14, 2002

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

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