
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 June 30, 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 June 30, 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**

	June 2002 (unaudited)	December 31, 2001
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 342,688	\$ 397,362
Accounts receivable, net	181,696	191,861
Prepaid Expense	9,175	22,281
Net assets of discontinued ecommerce subsidiary	-	51,122
Deferred income taxes	110,564	110,564
Total current assets	<u>644,123</u>	<u>773,190</u>
Property and Equipment – at cost, net	169,199	145,268
Purchased Software, net	354,607	416,154
Software Development Costs, net	1,311,132	1,218,831
Other Assets	-	488
Total assets	<u>\$ 2,479,061</u>	<u>\$ 2,553,931</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current maturities of long-term debt	\$ 13,623	\$ 60,402
Accounts payable	129,661	109,307
Accrued expense	25,604	38,088
Deferred revenues	216,821	216,821
Total current liabilities	<u>385,709</u>	<u>424,618</u>
Deferred income taxes	169,656	180,600
Long-term debt	-	3,773
Total liabilities	<u>555,365</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	146,655	167,899
Total stockholders' equity	<u>1,923,696</u>	<u>1,944,940</u>
Total liabilities and stockholders' equity	<u>\$ 2,479,061</u>	<u>\$ 2,553,931</u>

The accompanying notes are an integral part of these financial statements

AVATAR SYSTEMS, INC.
CONDENSED STATEMENTS OF INCOME

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Revenues:				
Software	\$ 70,248	\$ 136,225	\$ 146,578	\$ 358,541
Maintenance	211,655	239,096	499,607	509,349
Professional services	51,855	102,567	139,491	255,577
Hardware	43,216	48,331	57,156	68,143
Net revenues	376,974	526,219	842,832	1,191,610
Cost of revenues:				
Software	17,551	22,130	36,522	60,682
Maintenance	77,244	81,911	154,124	160,462
Professional services	14,309	30,897	32,670	87,598
Hardware	40,553	45,506	53,673	58,626
Total cost of revenues	149,657	180,444	276,989	367,368
Gross margin	227,317	345,775	565,843	824,242
Operating expenses:				
Sales and marketing	48,565	73,940	112,180	137,794
General and administrative	154,304	156,446	291,664	344,660
Amortization of intangibles	87,585	50,974	161,592	101,948
Depreciation	20,167	16,767	36,654	33,533
Write off of acquisition costs		323,539	-	323,539
Total operating expenses	310,621	621,666	602,090	941,474
Loss from operations	(83,304)	(275,891)	(36,247)	(117,232)
Interest income	1,230	6,540	4,648	16,582
Interest expense	107	6,970	588	10,758
Loss from continuing operations before income taxes	(82,181)	(276,321)	(32,187)	(111,408)
Provision for income taxes (credit)	(25,902)	(95,624)	(10,944)	(37,878)
Loss from continuing operations	(56,279)	(180,697)	(21,243)	(73,530)
Discontinued operations:				
Income from operations of Talon Global Systems, Inc. (net of income taxes)	-	35,369	-	53,911
Net loss	\$ (56,279)	\$ (145,328)	\$ (21,243)	\$ (19,619)
Earnings per share:				
Basic				
Loss from continuing operations	\$ (0.01)	\$ (0.02)	\$ 0.00	\$ (0.01)
Net loss	\$ (0.01)	\$ (0.02)	\$ 0.00	\$ 0.00
Shares used in per share calculations	8,695,652	8,695,652	8,695,652	8,695,652
Diluted				
Loss from continuing operations	\$ (0.01)	\$ (0.02)	\$ 0.00	\$ (0.01)
Net loss	\$ (0.01)	\$ (0.02)	\$ 0.00	\$ 0.00
Shares used in per share calculations	8,695,652	8,695,652	8,695,652	8,695,652

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

AVATAR SYSTEMS, INC.
STATEMENTS OF CASH FLOWS

	Six Months Ended June 30,	
	2002	2001
	(unaudited)	
Cash flows from operating activities:		
Net income (loss)	\$ (21,243)	\$ (73,530)
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of intangibles	161,732	102,766
Depreciation	36,654	33,533
Deferred income taxes	(10,944)	(37,878)
Write off of acquisition costs		323,539
Changes in operating assets and liabilities:		
Accounts receivable	10,165	(35,375)
Inventory	-	20,094
Prepaid expense	13,106	
Accounts payable and accrued expense	7,870	14,666
Deferred revenue	-	(281,940)
Net cash provided by operating activities	197,340	65,875
Cash flows from investing activities:		
Acquisition of fixed assets	(60,584)	(37,247)
Capitalized software development costs	(192,000)	(150,000)
Payment received on note receivable	51,122	
Deposits		(4,986)
Net cash used in investing activities	(201,462)	(192,233)
Cash flows from financing activities:		
Payments on note payable and capital lease obligation	(50,552)	(95,201)
Net cash used in discontinued operations	-	(26,319)
Net decrease in cash and cash equivalents	(54,674)	(247,878)
Cash and cash equivalents at beginning of period	397,362	933,009
Cash and cash equivalents at end of period	\$ 342,688	\$ 685,131
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 441	\$ 10,758

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 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 June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Revenues	\$ -	\$ 260,025	\$ -	\$ 435,619
Income before income taxes	-	53,590	-	81,683
Income tax expense	-	18,221	-	27,772
Income from discontinued operations	-	35,369	-	53,911

3. Earnings Per Share

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Loss from continuing operations	\$ (56,279)	\$ (180,697)	\$ (21,243)	\$ (73,530)
Income from discontinued operations	-	35,369	-	53,911

Weighted average common shares outstanding – basic	8,695,652	8,695,652	8,695,652	8,695,652
Weighted average shares outstanding – diluted	8,695,652	8,695,652	8,695,652	8,695,652
Earnings per share from continuing operations				
Basic	\$ (0.01)	\$ (0.02)	\$ 0.00	\$ (0.01)
Diluted	\$ (0.01)	\$ (0.02)	\$ 0.00	\$ 0.00
Earnings per share from discontinued operations				
Basic	\$ 0.00	\$ 0.00	\$ 0.00	\$ 0.01
Diluted	\$ 0.00	\$ 0.00	\$ 0.00	\$ 0.01

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 second quarter ended June 30, 2002 decreased 28.4% to \$376,974 compared with net revenues of \$526,219 for the same period in 2001. Net revenues for the six months ended June 30, 2002 decreased 29.3% to \$842,832 compared with net revenues of \$1,191,610. Revenues for 2001 were higher because of sales of our Petroware2000 software package, which was released in October of 2000.

Software. Software sales for the second quarter of 2002 decreased 48.4% to \$70,248 compared with software sales of \$136,225 for the second quarter of 2001. Software sales for the six months ended June 30, 2002 decreased 59.1% to \$146,578, compared with \$358,541 from the same period last year. The decrease in software revenues is due to the high levels of sales of our Petroware2000 software package in 2001, which was released in October 2000.

Maintenance and other recurring revenue. Maintenance and other recurring revenue for the second quarter of 2002 decreased 11.5% to \$211,655 compared with maintenance and other recurring revenue of \$239,096 for the second quarter of 2001. Maintenance and other recurring revenue for the six months ended June 30, 2002 decreased 1.9% to \$499,607 compared with maintenance and other recurring revenue of \$509,349 for the same period last year.

Professional services. Professional service revenue for the second quarter of 2002 decreased 49.4% to \$51,855 compared with professional service revenue of \$102,567 for the second quarter of 2001. Professional service revenue for the six months ended June 30, 2002 decreased 45.4% to \$139,491, compared with \$255,577 for the

same period last year. The decrease in professional services is related to the lower sales volume of our Petroware2000 software package.

Hardware. Hardware sales for the second quarter of 2002 decreased 10.6% to \$43,216, compared with hardware sales of \$48,331 for the second quarter of 2001. Hardware sales for the six months ended June 30, 2002 declined 16.1% to \$57,156, compared with \$68,143 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 second quarter of 2002 decreased 17.1% to \$149,657 compared with cost of revenues of \$180,444 for the second quarter of 2001. Cost of revenues for the six months ended June 30, 2002 decreased 24.6% to \$276,989 compared with \$367,368 for the same period last year. Cost of revenues as a percentage of net revenues increased to 39.7% for the three months ended June 30, 2002 from 34.3% from the same period in 2001. Cost of revenues as a percentage of net revenue increased to 32.9% for the six months ended June 30, 2002, compared with 30.8% for the same period last year.

Cost of software. Cost of software decreased 20.7% to \$17,551 in the second quarter of 2002 from \$22,130 in the second quarter of 2001. Cost of software decreased 39.8% to \$36,522 in the six months ended June 30, 2002, compared with \$60,682 in the same period last year. 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 increased to 25.0% for the second quarter of 2002 compared to 16.2% for the same period in 2001, primarily due to the decrease in software sales. Cost of software as a percentage of the related revenues increased to 24.9% for the six months ended June 30, 2002, compared with 16.9% for the for the same period last year.

Cost of maintenance and other recurring revenues. Cost of maintenance and other recurring revenues decreased 5.7% to \$77,244 for the second quarter of 2002 from \$81,911 for the second quarter of 2001. Cost of maintenance and other recurring revenues decreased 3.9% to \$154,124 for the six months ended June 30, 2002, compared with \$160,462 for the same period last year. Cost of maintenance and other recurring revenues as a percentage of the related revenue increased to 36.5% for the second quarter 2002, compared to 34.3% for the same period last year. Cost of maintenance and other recurring revenues as a percentage of the related revenue decreased slightly to 30.8% for the six months ended June 30, 2002, compared with 31.5% for the same period last year.

Cost of professional services. Cost of professional services decreased 53.7% to \$14,309 for the three months ended June 30, 2002, compared with \$30,897 for the same period last year. Cost of professional services decreased 62.7% to \$32,670 for the six months ended June 30, 2002 from \$87,598 for the same period last year. Cost of professional services as a percentage of the related revenue decreased to 27.6% in the second quarter 2002, compared to 30.1% for the same period last year. Cost of professional services as a percentage of the related revenue decreased to 23.4% for the six months ended June 30, 2002, compared with 34.3% 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 decreased demand for professional services.

Hardware. Cost of hardware sold decreased 10.9% to \$40,553 for the three months ended June 30, 2002, compared with \$53,673 for the same period last year. Cost of hardware sold decreased 8.4% to \$53,673 for the six months ended June 30, 2002, compared with \$45,506 for the same period last year. Cost of hardware as a percentage of the related revenue decreased to 93.8% for the three months ended June 30, 2002, compared with 94.2% for the same period last year. Cost of hardware as a percentage of the related revenue increased to 93.9% for the three months ended June 30, 2002, compared with 86.0% for the same period last year.

OPERATING EXPENSES

Sales and Marketing. Our sales and marketing expenses for the second quarter of 2002 decreased 34.3% to \$48,565, compared with \$73,940 for the second quarter of 2001. Sales and marketing expenses for the six months ended June 30, 2002 decreased 18.6% to \$112,180, compared with \$137,794 in the same period last year. Sales and marketing expenses as a percentage of net revenues decreased to 12.9% for the three months ended June 30, 2002,

compared with 14.1% for the same period last year. Sales and marketing expenses as a percentage of net revenues increased to 13.3% for the six months ended June 30, 2002, compared with 11.6% for the same period last year.

General and Administrative. Our general and administrative expenses for the second quarter of 2002 decreased 1.4% to \$154,304, compared with general and administrative expenses of \$156,446 for the second quarter of 2001. General and administrative expenses decreased 15.4% to \$291,664 for the six months ended June 30, 2002, compared with \$344,660 in the same period last year. General and administrative expenses as a percentage of net revenues increased to 40.9% in the second quarter of 2002, compared with 29.7% in the second quarter of 2001. General and administrative expenses as a percentage of net revenues increased to 34.6% in the six months ended June 30, 2002, compared with 28.9% in the same period last year. The increase in the percentage of general and administrative expenses is related to the lower overall revenues.

Interest Income. Interest income was \$1,230 in the second quarter of 2002 compared to \$6,540 in 2001. Interest income was \$4,648 in the six months ended June 30, 2002, compared with \$16,582 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, write offs of deposits we made on contracts for potential acquisition candidates and legal and accounting costs we incurred related to being publicly held.

Interest Expense. Interest expense was \$107 in the second quarter of 2002 compared to \$6,970 in the same period last year. Interest expense was \$588 in the six months ended June 30, 2002, compared with \$10,758 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.

Provision for Income Taxes. For the three and six months ended June 30, 2002 we recorded a tax credit on losses from continuing operations of \$25,902 and \$10,944, respectively, based on our pretax income using an effective tax rate of 34%, which is our anticipated effective tax rate for the fiscal year 2002. 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

None

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: August 14, 2002

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

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

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 June 30, 2002. (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: August 14, 2002

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

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