
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, 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 June 30, 2003
Common stock, \$0.001 par value	8,695,652

INDEX

PART I. FINANCIAL INFORMATION.....	1
Item 1. Financial Statements.....	1
Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations	4
Item 3. Controls and Procedures.....	6
PART II. OTHER INFORMATION	6
Item 1. Legal Proceedings	6
Item 2. Changes in Securities	6
Item 3. Defaults Upon Senior Securities.....	7
Item 4. Submission of Matters to a Vote of Security Holders	7
Item 5. Other Information.....	7
Item 6. Exhibits And Reports On Form 8-K.....	7
Signatures	8

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

**AVATAR SYSTEMS, INC.
BALANCE SHEETS**

	June 30 2003 (unaudited)	December 31, 2002
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 415,039	\$ 395,256
Accounts receivable, net	101,741	199,102
Prepaid Expense	6,031	7,603
Deferred income taxes	10,319	10,319
Total current assets	<u>533,130</u>	<u>612,280</u>
Property and Equipment – at cost, net	189,840	134,280
Purchased Software, net	237,137	293,060
Software Development Costs, net	1,632,445	1,562,141
Total assets	<u>\$ 2,592,552</u>	<u>\$ 2,601,761</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current maturities of long-term debt	\$ 9,729	\$ 13,433
Accounts payable	51,204	75,937
Accrued expense	63,464	51,642
Deferred revenues	235,016	235,016
Total current liabilities	<u>359,413</u>	<u>376,028</u>
Deferred income taxes	141,368	148,504
Long-term debt	29,678	-
Total liabilities	<u>530,459</u>	<u>524,532</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	285,052	300,188
Total stockholders' equity	<u>2,062,093</u>	<u>2,077,229</u>
Total liabilities and stockholders' equity	<u>\$ 2,592,552</u>	<u>\$ 2,601,761</u>

The accompanying notes are an integral part of these financial statements

AVATAR SYSTEMS, INC.
CONDENSED STATEMENTS OF INCOME

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Revenues:				
Software	\$ 79,568	\$ 70,248	\$ 153,126	\$ 146,578
Maintenance	230,493	211,655	516,258	499,607
Professional services	43,449	51,855	76,802	139,491
Hardware	8,209	43,216	106,434	57,156
Net revenues	431,719	376,974	852,620	842,832
Cost of revenues:				
Software	31,562	17,551	47,841	36,522
Maintenance	41,882	77,244	81,728	154,124
Professional services	11,510	14,309	23,696	32,670
Hardware	53,531	40,553	78,815	53,673
Total cost of revenues	138,485	149,657	232,080	276,989
Gross margin	293,234	227,317	620,540	565,843
Operating expenses:				
Sales and marketing	105,204	48,565	193,382	112,180
General and administrative	110,334	154,304	245,530	291,664
Amortization of intangibles	88,809	87,585	177,618	161,592
Depreciation	15,474	20,167	27,609	36,654
Total operating expenses	319,821	310,621	644,139	602,090
Operating income (loss)	(26,587)	(83,304)	(23,599)	(36,247)
Interest income	665	1,230	1,453	4,648
Interest expense	126	107	126	588
Loss from operations before income taxes	(26,048)	(82,181)	(22,272)	(32,187)
Deferred income tax benefit	(8,420)	(25,902)	(7,136)	(10,944)
Net loss	\$ (17,628)	\$ (56,279)	\$ (15,136)	\$ (21,243)
Loss per share:				
Basic				
Net loss	\$ *	\$ *	\$ *	\$ *
Shares used in per share calculations	8,695,652	8,695,652	8,695,652	8,695,652
Diluted				
Net loss	\$ *	\$ *	\$ *	\$ *
Shares used in per share calculations	8,695,652	8,695,652	8,695,652	8,695,652

* 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**

	Six Months Ended June 30,	
	2003	2002
	(unaudited)	
Cash flows from operating activities:		
Net loss	\$ (15,136)	\$ (21,243)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Amortization of intangibles	177,618	161,732
Depreciation	27,609	36,654
Deferred income taxes	(7,136)	(10,944)
Changes in operating assets and liabilities:		
Accounts receivable	97,361	10,165
Prepaid expense	1,572	13,106
Accounts payable and accrued expense	(12,911)	7,870
Net cash provided by operating activities	<u>268,977</u>	<u>197,340</u>
Cash flows from investing activities:		
Acquisition of fixed assets	(46,154)	(60,584)
Capitalized software development costs	(192,000)	(192,000)
Payment received on note receivable	-	51,122
Net cash used in investing activities	<u>(238,154)</u>	<u>(201,462)</u>
Cash flows from financing activities:		
Payments on note payable and capital lease obligation	(11,040)	(50,552)
Net change in cash and cash equivalents	19,783	(54,674)
Cash and cash equivalents at beginning of period	395,256	397,362
Cash and cash equivalents at end of period	<u>\$ 415,039</u>	<u>\$ 342,688</u>
Supplemental disclosure of cash flow information:		
Cash paid for interest	<u>\$ 126</u>	<u>\$ 441</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.

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/recurring, professional services and hardware. Our net revenues for the second quarter ended June 30, 2003 increased 14.5% to \$431,719 compared with net revenues of \$376,974 for the same period in 2002. Net revenues for the six months ended June 30, 2003 increased 1.2% to \$852,620 compared with net revenues of \$842,832 for the same period last year. Net revenues were impacted primarily by an increase in maintenance revenue and an increase in sales of AS400 hardware.

Software. Software sales for the second quarter of 2003 increased 13.3% to \$79,568 compared with software sales of \$70,248 for the second quarter of 2002. Software sales for the six months ended June 30, 2003 increased 4.5% to \$153,126, compared with \$146,578 from the same period last year. The increase in software sales is due to our increased marketing efforts.

Maintenance. Maintenance and other recurring revenue for the second quarter of 2003 increased 8.9% to \$230,493 compared with maintenance and other recurring revenue of \$211,655 for the second quarter of 2002. Maintenance and other recurring revenue for the six months ended June 30, 2003 increased 3.3% to \$516,258 compared with maintenance and other recurring revenue of \$499,607 for the same period last year. The increase in maintenance revenue is directly related to the increase in numbers of users from new software sales.

Professional services. Professional services revenue for the second quarter of 2003 decreased 16.2% to \$43,449 compared with professional service revenue of \$51,855 for the second quarter of 2002. Professional service revenue for the six months ended June 30, 2003 decreased 44.9% to \$76,802, compared with \$139,491 for the same period last year. The reduction in professional services is due to reduced demand for software training.

Hardware. Hardware sales for the second quarter of 2003 increased 81.0% to \$78,209, compared with hardware sales of \$43,216 for the second quarter of 2002. Hardware sales for the six months ended June 30, 2003 increased 86.2% to \$106,434, compared with \$57,156 from the same period last year. The increase in hardware sales is due to an increase in demand for AS400 hardware and an unusually low quarter during the previous year.

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 second quarter of 2003 decreased 7.5% to \$138,485 compared with cost of revenues of \$149,657 for the second quarter of 2002. Cost of revenues for the six months ended June 30, 2003 decreased 16.2% to \$232,080 compared with \$276,989 for the same period last year. Cost of revenues as a percentage of net revenues decreased to 32.1% for the six months ended June 30, 2003 from 39.7% for the same period in 2002. Cost of revenues as a percentage of net revenue decreased to 27.2% for the six months ended June 30, 2003, compared with 32.9% for the same period last year. Reductions in the cost of revenues and cost of revenues as a percentage of net revenues were impacted primarily by decreases in maintenance personnel necessary to support our products.

Cost of software. Cost of software increased 79.8% to \$31,562 in the second quarter of 2003 from \$17,551 in the second quarter of 2002. Cost of software increased 16.4% to \$42,502 in the six months ended June 30, 2003, compared with \$36,522 in the same period last year. The increase in cost of software for the current quarter is related to the timing of a payment to a royalty owner and an increase in commissions on higher software sales. The overall increase in cost of software for the six months ended June 30, 2003 is directly related to the increase in software sales. Cost of software as a percentage of the related revenue increased to 39.7% for the second quarter of 2003 compared to 25.0% for the same period in 2002, due to the timing of payment to a royalty owner and an increase in commissions on higher software sales. Cost of software as a percentage of the related revenues increased to 27.8% for the six months ended June 30, 2003, compared with 24.9% for the for the same period last year.

Cost of maintenance. Cost of maintenance revenues decreased 45.8% to \$41,882 for the second quarter of 2003 from \$77,244 for the second quarter of 2002. Cost of maintenance revenues decreased 43.5% to \$87,067 for the six months ended June 30, 2003, compared with \$154,124 for the same period last year. Cost of maintenance revenues as a percentage of the related revenue decreased to 18.2% for the second quarter 2003, compared to 36.5% for the same period last year. Cost of maintenance revenues as a percentage of the related revenue decreased to 16.9% for the six months ended June 30, 2003, compared with 30.8% for the same period last year. The reduction in cost of revenues was due primarily to a reduction in maintenance personnel. Demand for maintenace support has declined as our users have gained experience with recently released products.

Cost of professional services. Cost of professional services decreased 19.6% to \$11,510 for the three months ended June 30, 2003, compared with \$14,309 for the same period last year. Cost of professional services decreased 27.5% to \$23,696 for the six months ended June 30, 2003 from \$32,670 for the same period last year. Cost of professional services as a percentage of the related revenue decreased to 26.5% in the second quarter 2003, compared to 27.6% for the same period last year. Cost of professional services as a percentage of the related revenue increased to 30.9% for the six months ended June 30, 2003, compared with 23.4% for the same period last year. The decreases in cost were due to reductions in use of outside training consultants. The increase in percentage of related revenue for the six months ended June 30, 2003 was due to decreased demand for higher margin training services.

Hardware. Cost of hardware sold increased 32.0% to \$53,531 for the six months ended June 30, 2003, compared with \$40,553 for the same period last year. Cost of hardware sold decreased 46.8% to \$78,815 for the six months ended June 30, 2003, compared with \$53,673 for the same period last year. Cost of hardware as a percentage of the related revenue decreased to 68.4% for the six months ended June 30, 2003, compared with 93.8% for the same period last year. Cost of hardware as a percentage of the related revenue decreased to 74.1% for the six months

ended June 30, 2003, compared with 93.9% for the same period last year. The decrease in software cost as a percentage of the related revenue was from increased demand for hardware products with better margins.

OPERATING EXPENSES

Sales and Marketing. Our sales and marketing expenses for the second quarter of 2003 increased 74.8% to \$105,204, compared with \$60,174 for the second quarter of 2002. Sales and marketing expenses for the six months ended June 30, 2003 increased 56.2% to \$193,382, compared with \$123,789 in the same period last year. Sales and marketing expenses as a percentage of net revenues increased to 24.4% for the second quarter of 2003, compared with 16.0% for the same period last year. Sales and marketing expenses as a percentage of net revenues increased to 22.7% for the six months ended June 30, 2003, compared with 14.7 for the same period last year. The increases in cost and related percentages of revenue were due our implementation of a new marketing program.

General and Administrative. Our general and administrative expenses for the second quarter of 2003 decreased 22.7% to \$110,334, compared with general and administrative expenses of \$142,695 for the second quarter of 2002. General and administrative expenses decreased 12.3% to \$245,530 for the six months ended June 30, 2003, compared with \$280,055 in the same period last year. General and administrative expenses as a percentage of net revenues decreased to 25.6% in the second quarter of 2003, compared with 37.9% in the second quarter of 2002. General and administrative expenses as a percentage of net revenues decreased to 28.8% in the six months ended June 30, 2003, compared with 33.2% in the same period last year. The decreases in the costs and percentage of general and administrative expenses is related to our cost reduction efforts and higher revenues.

Interest Income. Interest income was \$665 in the second quarter of 2003 compared to \$1,230 in 2002. Interest income was \$1,453 in the six months ended June 30, 2003, compared with \$4,645 in the same period last year. The decrease was primarily due to lower interest rates.

Provision for Income Taxes. For the three and six months ended June 30, 2003 we recorded a tax credit on losses from operations of \$8,420 and \$7,136, respectively, 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 June 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

31.1 Section 302 Certification pursuant to Sarbane-Oxley Act.

32.1 Section 906 Certification pursuant to Sarbane-Oxley Act

(b) Reports on Form 8-K

Form 8-K was filed on June 16, 2003. The items included were filed under Item 4 Financial Statements and Exhibits and Item 7 Regulation FD Disclosure of Form 8-K

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 13, 2003

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

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

Exhibit 31.1

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 June 30, 2003 and in this quarterly period then ended presented in this report ("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: August 13, 2003

/s/ Robert C. Shreve, Jr.

Chief Executive Officer and Chief Financial Officer

(principal executive and accounting officer)

Exhibit 32.1

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, 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: August 13, 2003

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

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