
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, 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 September 30, 2002
Common stock, \$0.001 par value	8,695,652

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements and Notes to Condensed Financial Statements

**AVATAR SYSTEMS, INC.
BALANCE SHEETS**

	September 2002	December 31, 2001
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 317,499	\$ 397,362
Accounts receivable, net	659,369	191,861
Prepaid Expense	8,389	22,281
Net assets of discontinued ecommerce subsidiary	-	51,122
Deferred income taxes	110,564	110,564
Total current assets	1,095,821	773,190
Property and Equipment – at cost, net	149,665	145,268
Purchased Software, net	323,833	416,154
Software Development Costs, net	1,355,825	1,218,831
Other Assets	-	488
Total assets	\$ 2,925,144	\$ 2,553,931
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current maturities of long-term debt	\$ 7,933	\$ 60,402
Accounts payable	490,310	109,307
Accrued expense	46,458	38,088
Deferred revenues	216,821	216,821
Total current liabilities	761,522	424,618
Deferred income taxes	193,548	180,600
Long-term debt	-	3,773
Total liabilities	955,070	608,991
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	193,033	167,899
Total stockholders' equity	1,970,074	1,944,940
Total liabilities and stockholders' equity	\$ 2,925,144	\$ 2,553,931

The accompanying notes are an integral part of these financial statements

AVATAR SYSTEMS, INC.
CONDENSED STATEMENTS OF INCOME

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Revenues:				
Software	\$ 66,244	\$ 267,722	\$ 212,822	\$ 626,260
Maintenance	237,600	269,426	737,209	778,775
Professional services	34,966	62,316	174,458	317,893
Hardware	526,183	58,434	583,338	126,578
Net revenues	864,993	657,898	1,707,827	1,849,506
Cost of revenues:				
Software	19,398	44,761	55,920	105,443
Maintenance	39,528	82,263	193,651	241,806
Professional services	12,244	20,772	44,915	109,289
Hardware	431,518	48,889	485,191	107,514
Total cost of revenues	502,688	196,685	779,677	564,052
Gross margin	362,305	461,213	928,150	1,285,454
Operating expenses:				
Sales and marketing	80,623	80,668	192,800	218,462
General and administrative	104,878	147,130	396,550	491,788
Amortization of intangibles	87,585	50,974	249,177	152,922
Depreciation	20,167	16,767	56,821	50,300
Write off of acquisition costs	-	-	-	323,539
Total operating expenses	293,253	295,539	895,348	1,237,011
Income from operations	69,052	165,674	32,802	48,443
Interest income	1,221	4,255	5,869	20,837
Interest expense	-	4,388	588	15,146
Income from continuing operations before income taxes	70,273	165,541	38,083	54,134
Provision for income taxes	23,893	56,284	12,948	18,406
Income from continuing operations	46,380	109,257	25,135	35,728
Discontinued operations:				
Income (loss) from operations of Talon Global Systems, Inc. (net of income taxes)	-	(48,091)	-	5,822
Loss on disposal of Talon Global Systems, Inc. (net of income taxes benefit)	-	(11,561)	-	(11,561)
Net Income	\$ 46,380	\$ 49,605	\$ 25,135	\$ 29,989
Earnings per share:				
Basic				
Income from continuing operations	\$ 0.01	\$ 0.01	\$ 0.00	\$ 0.00
Net income	\$ 0.01	\$ 0.01	\$ 0.00	\$ 0.00
Shares used in per share calculations	8,695,652	8,695,652	8,695,652	8,695,652
Diluted				
Income from continuing operations	\$ 0.00	\$ 0.01	\$ 0.00	\$ 0.00
Net income	\$ 0.00	\$ 0.01	\$ 0.00	\$ 0.00
Shares used in per share calculations	14,514,007	8,695,652	14,514,007	8,695,652

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

AVATAR SYSTEMS, INC.
STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30,	
	2002	2001
	(unaudited)	
Cash flows from operating activities:		
Net income	\$ 25,135	\$ 29,989
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of intangibles	249,318	154,149
Depreciation	56,821	50,300
Deferred income taxes	12,948	18,406
Write off of acquisition costs	-	323,539
Changes in operating assets and liabilities:		
Accounts receivable	(467,508)	(103,524)
Inventory	-	24,582
Prepaid expense	13,892	(32,501)
Accounts payable and accrued expense	389,373	7,382
Deferred revenue	-	(398,440)
Net cash provided by operating activities	279,979	73,882
Cash flows from investing activities:		
Acquisition of fixed assets	(61,218)	(58,532)
Capitalized software development costs	(293,504)	(225,000)
Note receivable from disposal of Talon Global Solutions, Inc.	51,122	(75,600)
Deposits	-	(9,314)
Net cash used in investing activities	(303,600)	(368,446)
Cash flows from financing activities:		
Payments on note payable and capital lease obligation	(56,242)	(142,802)
Net cash used in financing activities	(56,242)	(142,802)
Net cash provided by discontinued operations	-	5,739
Net decrease in cash and cash equivalents	(79,863)	(431,627)
Cash and cash equivalents at beginning of period	397,362	933,007
Cash and cash equivalents at end of period	\$ 317,499	\$ 501,380
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 447	\$ 15,277

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:

	<u>Three Months Ended</u> <u>September 30,</u>		<u>Nine Months Ended</u> <u>September 30,</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Revenues	\$ -	\$ 81,753	\$ -	\$ 517,372
Income (loss) before income taxes	-	(72,865)	-	8,821
Income tax (expense) benefit	-	24,774	-	(2,999)
Income (loss) from discontinued operations	-	(48,091)	-	5,822

3. Earnings Per Share

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Income from continuing operations	\$ 46,380	\$ 109,257	\$ 25,135	\$ 35,728
Loss from discontinued operations	-	(59,652)	-	(5,739)
Weighted average common shares outstanding – basic	8,695,652	8,695,652	8,695,652	8,695,652
Weighted average shares outstanding – diluted	14,514,007	8,695,652	14,514,007	8,695,652
Earnings per share from continuing operations				
Basic	<u>\$ 0.01</u>	<u>\$ 0.01</u>	<u>\$ 0.00</u>	<u>\$ 0.00</u>
Diluted	<u>\$ 0.00</u>	<u>\$ 0.01</u>	<u>\$ 0.00</u>	<u>\$ 0.00</u>
Earnings per share from discontinued operations				
Basic	<u>\$ 0.00</u>	<u>\$ (0.01)</u>	<u>\$ 0.00</u>	<u>\$ 0.00</u>
Diluted	<u>\$ 0.00</u>	<u>\$ (0.01)</u>	<u>\$ 0.00</u>	<u>\$ 0.00</u>

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 third quarter ended September 30, 2002 increased 31.5% to \$864,993 compared with net revenues of \$657,898 for the same period in 2001. Net revenues for the nine months ended September 30, 2002 decreased 7.7% to \$1,707,827 compared with net revenues of \$1,849,506. Our overall revenues were affected by higher software sales in 2001 due to the release of our Petroware2000 software package, which was released in October of 2001 and a large hardware sale to one of our customers during the current quarter.

Software. Software sales for the third quarter of 2002 decreased 75.3% to \$66,244 compared with software sales of \$267,722 for the third quarter of 2001. Software sales for the nine months ended September 30, 2002 decreased 66.0% to \$212,822, compared with \$626,260 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 third quarter of 2002 decreased 11.8% to \$237,600 compared with maintenance and other recurring revenue of \$269,426 for the third quarter of 2001. Maintenance and other recurring revenue for the nine months ended September 30, 2002 decreased 5.3% to \$737,209 compared with maintenance and other recurring revenue of \$778,775 for the same period last year.

Professional services. Professional service revenue for the third quarter of 2002 decreased 43.9% to \$34,966 compared with professional service revenue of \$62,316 for the third quarter of 2001. Professional service revenue for the nine months ended September 30, 2002 decreased 45.1% to \$174,458, compared with \$317,893 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 third quarter of 2002 increased 800.5% to \$526,183, compared with hardware sales of \$58,434 for the third quarter of 2001. Hardware sales for the nine months ended September 30, 2002 increased 360.9% to \$583,338, compared with \$126,578 from the same period last year. The increase in hardware sales is due to a large sale to one of our customers.

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 2002 increased 155.0% to \$501,455 compared with cost of revenues of \$196,685 for the third quarter of 2001. Cost of revenues for the nine months ended September 30, 2002 increased 38.2% to \$779,677 compared with \$564,052 for the same period last year. Cost of revenues as a percentage of net revenues increased to 58.0% for the three months ended September 30, 2002 from 29.9% from the same period in 2001. Cost of revenues as a percentage of net revenue increased to 45.7% for the nine months ended September 30, 2002, compared with 30.5% for the same period last year. The increases in cost of revenues are directly related to the higher cost of a hardware sale that we made to one customer.

Cost of software. Cost of software decreased 56.7% to \$19,398 in the third quarter of 2002 from \$44,761 in the third quarter of 2001. Cost of software decreased 47.0% to \$55,920 in the nine months ended September 30, 2002, compared with \$105,443 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 29.3% for the third quarter of 2002 compared to 16.7% for the same period in 2001.

Cost of maintenance and other recurring revenues. Cost of maintenance and other recurring revenues decreased 52.9% to \$38,706 for the third quarter of 2002 from \$82,263 for the third quarter of 2001. Cost of maintenance and other recurring revenues decreased 19.9% to \$193,651 for the nine months ended September 30, 2002, compared with \$241,806 for the same period last year. Cost of maintenance and other recurring revenues as a percentage of the related revenue decreased to 16.3% for the third quarter 2002, compared to 30.5% for the same period last year. Cost of maintenance and other recurring revenues as a percentage of the related revenue decreased to 26.3% for the nine months ended September 30, 2002, compared with 31.0% for the same period last year. The decreases in cost of maintenance and other recurring revenues and percentages of cost of maintenance and other recurring revenues as a percentage of the related revenues are due to reductions in personnel providing maintenance support.

Cost of professional services. Cost of professional services decreased 43.0% to \$11,833 for the three months ended September 30, 2002, compared with \$20,772 for the same period last year. Cost of professional services decreased 58.9% to \$44,915 for the nine months ended September 30, 2002 from \$109,289 for the same period last year. Cost of professional services as a percentage of the related revenue increased to 33.8% in the third quarter 2002, compared to 33.3% for the same period last year. Cost of professional services as a percentage of the related revenue decreased to 25.7% for the nine months ended September 30, 2002, compared with 34.4% for the same period last year. The decreases in cost were due to reductions in use of outside consultants and reductions in personnel.

Hardware. Cost of hardware sold increased 782.6% to \$431,518 for the three months ended September 30, 2002, compared with \$48,889 for the same period last year. Cost of hardware sold increased 351.3% to \$485,191 for the nine months ended September 30, 2002, compared with \$107,514 for the same period last year. Cost of hardware as a percentage of the related revenue decreased to 82.0% for the three months ended September 30, 2002, compared

with 83.7% for the same period last year. Cost of hardware as a percentage of the related revenue decreased to 83.2% for the three months ended September 30, 2002, compared with 84.9% for the same period last year. The increases in cost of hardware are directly related to the cost of a hardware sale that we made to one customer.

OPERATING EXPENSES

Sales and Marketing. Our sales and marketing expenses for the third quarter of 2002 decreased 14.4% to \$69,014, compared with \$80,668 for the third quarter of 2001. Sales and marketing expenses for the nine months ended September 30, 2002 decreased 11.7% to \$192,800, compared with \$218,462 in the same period last year. Sales and marketing expenses as a percentage of net revenues decreased to 8.0% for the three months ended September 30, 2002, compared with 12.3% for the same period last year. Sales and marketing expenses as a percentage of net revenues decreased to 11.3% for the nine months ended September 30, 2002, compared with 11.8% for the same period last year.

General and Administrative. Our general and administrative expenses for the third quarter of 2002 decreased 20.0% to \$117,720 compared with general and administrative expenses of \$147,130 for the third quarter of 2001. General and administrative expenses decreased 19.4% to \$396,550 for the nine months ended September 30, 2002, compared with \$491,788 in the same period last year. General and administrative expenses as a percentage of net revenues decreased to 13.6% in the third quarter of 2002, compared with 22.4% in the third quarter of 2001. General and administrative expenses as a percentage of net revenues decreased to 23.2% in the nine months ended September 30, 2002, compared with 26.6% in the same period last year. The decreases in general and administrative expenses and the percentage of general and administrative expenses are related cost cutting measures implemented by the company during the current quarter.

Interest Income. Interest income was \$1,221 in the third quarter of 2002 compared to \$4,255 in 2001. Interest income was \$5,869 in the nine months ended September 30, 2002, compared with \$20,837 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 and lower interest rates.

Interest Expense. There was no interest expense in the third quarter of 2002 compared to \$4,388 in the same period last year. Interest expense was \$588 in the nine months ended September 30, 2002, compared with \$15,146 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 nine months ended September 30, 2002 we accrued income tax expense on income from continuing operations of \$70,273 and \$38,083, 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.

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 November 12, 2002, 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

The 2002 Annual Meeting of Avatar Systems Inc. was held on September 20, 2002. The results of the 2002 Annual Meeting were previously reported to the Securities and Exchange Commission on Form 8-K on September 25, 2002.

Item 5. Other Information

None

Item 6. Exhibits And Reports On Form 8-K

(a) Exhibits

Exhibit 99.1 Certifications

(b) Reports on Form 8-K

Form 8-K was filed on September 25, 2002. The items reported are included in Part II, Item 4 of this report.

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 12, 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 September 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: November 12, 2002

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: November 12, 2002

/s/ Robert C. Shreve, Jr.

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