
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, 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 September 30, 2003
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**

	September 30, 2003	December 31, 2002
	(unaudited)	*
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 370,395	\$ 395,256
Accounts receivable, net	405,827	199,102
Prepaid Expense	6,031	7,603
Deferred income taxes	10,319	10,319
Total current assets	<u>792,572</u>	<u>612,280</u>
Property and Equipment – at cost, net	187,730	134,280
Purchased Software, net	209,176	293,060
Software Development Costs, net	<u>1,671,815</u>	<u>1,562,141</u>
Total assets	<u>\$ 2,861,293</u>	<u>\$ 2,601,761</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current maturities of long-term debt	\$ 6,779	\$ 13,433
Accounts payable	220,868	75,937
Accrued expense	56,741	51,642
Deferred revenues	235,016	235,016
Total current liabilities	<u>519,404</u>	<u>376,028</u>
Long-term debt	28,008	-
Deferred income taxes	178,474	148,504
Total liabilities	<u>725,886</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	<u>358,366</u>	<u>300,188</u>
Total stockholders' equity	<u>2,135,407</u>	<u>2,077,229</u>
Total liabilities and stockholders' equity	<u>\$ 2,861,293</u>	<u>\$ 2,601,761</u>

The accompanying notes are an integral part of these financial statements

*These amounts are derived from the audited financial statements.

AVATAR SYSTEMS, INC.
CONDENSED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended September		Nine Months Ended September 30,	
	30,			
	2003	2002	2003	2002
Revenues:				
Software	\$ 115,178	\$ 66,244	\$ 268,304	\$ 212,822
Maintenance	216,815	237,600	733,073	737,209
Professional services	52,193	34,966	128,995	174,458
Hardware	434,403	526,183	540,837	583,338
Net revenues	818,589	864,993	1,671,209	1,707,827
Cost of revenues:				
Software	18,471	19,398	66,311	55,920
Maintenance	36,189	39,528	117,917	193,651
Professional services	10,761	12,244	34,457	44,915
Hardware	320,665	431,518	399,481	485,191
Total cost of revenues	386,086	502,688	618,166	779,677
Gross margin	432,503	362,305	1,053,043	928,150
Operating expenses:				
Sales and marketing	77,289	80,623	270,671	192,800
General and administrative	139,423	104,878	384,953	396,550
Amortization of intangibles	88,809	87,585	266,427	249,177
Depreciation	15,166	20,167	42,775	56,821
Total operating expenses	320,687	293,253	964,826	895,348
Operating income	111,816	69,052	88,217	32,802
Interest income	298	1,221	1,751	5,869
Interest expense	(1,694)	-	(1,820)	(588)
Income from operations	110,420	70,273	88,148	38,083
Deferred income tax expense	37,106	23,893	29,970	12,948
Net income	<u>\$ 73,314</u>	<u>\$ 46,380</u>	<u>\$ 58,178</u>	<u>\$ 25,135</u>
Income per share:				
Basic				
Net income	<u>\$.01</u>	<u>\$.01</u>	<u>\$.01</u>	<u>\$ *</u>
Shares used in per share calculations	<u>8,695,652</u>	<u>8,695,652</u>	<u>8,695,652</u>	<u>8,695,652</u>
Diluted				
Net income	<u>\$.01</u>	<u>\$ *</u>	<u>\$.01</u>	<u>\$ *</u>
Shares used in per share calculations	<u>8,695,652</u>	<u>14,514,007</u>	<u>8,695,652</u>	<u>14,514,007</u>

* 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**

(Unaudited)

	Nine Months Ended September	
	30,	
	2003	2002
Cash flows from operating activities:		
Net loss	\$ 58,178	\$ 25,135
Adjustments to reconcile net loss to net cash provided by operating activities:		
Amortization of intangibles	266,427	249,318
Depreciation	42,775	56,821
Deferred income taxes	29,970	12,948
Changes in operating assets and liabilities:		
Accounts receivable	(206,725)	(467,508)
Prepaid expense	1,572	13,892
Accounts payable and accrued expense	150,030	389,373
Net cash provided by operating activities	<u>342,227</u>	<u>279,979</u>
Cash flows from investing activities:		
Acquisition of fixed assets	(96,225)	(61,218)
Capitalized software development costs	(292,218)	(293,504)
Payment received on note receivable	-	51,122
Net cash used in investing activities	<u>(388,443)</u>	<u>(303,600)</u>
Cash flows from financing activities:		
Payments on note payable and capital lease obligation	(15,659)	(56,242)
Proceeds from note payable	37,014	-
Net cash provided by (used in) from financing activities	<u>21,355</u>	<u>(56,242)</u>
Net decrease in cash and cash equivalents	<u>(24,861)</u>	<u>(79,863)</u>
Cash and cash equivalents at beginning of period	395,256	397,362
Cash and cash equivalents at end of period	<u>\$ 370,395</u>	<u>\$ 317,499</u>
Supplemental disclosure of cash flow information:		
Cash paid for interest	<u>\$ 1,820</u>	<u>\$ 447</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 third quarter ended September 30, 2003 decreased 5.4% to \$818,589 compared with net revenues of \$864,993 for the same period in 2002. Net revenues for the nine months ended September 30, 2003 decreased 2.1% to \$1,671,209 compared with net revenues of \$1,707,827 for the same period last year.

Software. Software sales for the third quarter of 2003 increased 73.9% to \$115,178 compared with software sales of \$66,244 for the third quarter of 2002. Software sales for the nine months ended September 30, 2003 increased 26.1% to \$268,304, compared with \$212,822 from the same period last year. The increase in software sales is due to our increased marketing efforts and enhancements in our products.

Maintenance. Maintenance revenue for the third quarter of 2003 decreased 8.7% to \$216,815 compared with maintenance revenue of \$237,600 for the third quarter of 2002. Maintenance revenue for the nine months ended September 30, 2003 decreased .6% to \$733,073 compared with maintenance revenue of \$737,209 for the same period last year. The decrease in maintenance revenue impacting the quarter is primarily due to the bankruptcy of one customer. For the nine months ended September 30, 2003 the loss in revenues reflected in the current quarter has been offset by an increase in the number of users from new software sales.

Professional services. Professional services revenue for the third quarter of 2003 increased 49.3% to \$52,193 compared with professional service revenue of \$34,966 for the third quarter of 2002. Professional service revenue for the nine months ended September 30, 2003 decreased 26.1% to \$128,995, compared with \$174,458 for the same period last year. The increase for the current quarter in professional services is due to installation service related to new hardware sales, while the reduction in professional services for the nine months ended September 30, 2003, is due to reduced demand for software training.

Hardware. Hardware sales for the third quarter of 2003 decreased 17.4% to \$434,403, compared with hardware sales of \$526,183 for the third quarter of 2002. Hardware sales for the nine months ended September 30, 2003 decreased 7.3% to \$540,837, compared with \$583,338 from the same period last year. The decline in hardware sales for the quarter and nine months ended September 30, 2003 was due to an unusually strong quarter for the quarter ended September 30, 2002.

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 third quarter of 2003 decreased 23.2% to \$386,086 compared with cost of revenues of \$502,688 for the third quarter of 2002. Cost of revenues for the nine months ended September 30, 2003 decreased 20.7% to \$618,166 compared with \$779,677 for the same period last year. Cost of revenues as a percentage of net revenues decreased to 47.2% for the three months ended September 30, 2003 from 58.0% for the same period in 2002. Cost of revenues as a percentage of net revenue decreased to 37.0% for the nine months ended September 30, 2003, compared with 45.7% 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 the volume of hardware sold and decreases in maintenance personnel necessary to support our products.

Cost of software. Cost of software decreased 4.8% to \$18,471 in the third quarter of 2003 from \$19,398 in the third quarter of 2002. Cost of software increased 18.6% to \$66,311 in the nine months ended September 30, 2003, compared with \$55,920 in the same period last year. Cost of software as a percentage of the related revenue decreased to 16.0% for the third quarter of 2003 compared to 29.3% for the same period in 2002. The decrease in cost as a percentage of revenue is related to the increase in software sales. Cost of software as a percentage of the related revenues decreased to 24.7% for the nine months ended September 30, 2003, compared with 26.3% for the same period last year.

Cost of maintenance. Cost of maintenance revenues decreased 8.4% to \$36,189 for the third quarter of 2003 from \$39,528 for the third quarter of 2002. Cost of maintenance revenues decreased 39.1% to \$117,917 for the nine months ended September 30, 2003, compared with \$193,651 for the same period last year. Cost of maintenance revenues as a percentage of the related revenue was stable at 16.7% for the third quarter 2003. Cost of maintenance revenues as a percentage of the related revenue decreased to 16.1% for the nine months ended September 30, 2003, compared with 26.3% for the same period last year. The reduction in cost of revenues was due primarily to a reduction in maintenance personnel. Demand for maintenance support has declined as our customers have gained experience with our products.

Cost of professional services. Cost of professional services decreased 12.1% to \$10,761 for the quarter ended September 30, 2003, compared with \$12,244 for the same period last year. Cost of professional services decreased 23.3% to \$34,457 for the nine months ended September 30, 2003 from \$44,915 for the same period last year. Cost of professional services as a percentage of the related revenue decreased to 20.6% in the third quarter 2003, compared to 35.0% for the same period last year. Cost of professional services as a percentage of the related revenue were stable at 26.7% for the nine months ended September 30, 2003, compared with 25.7% for the same period last year. The decreases in cost were due to reductions in use of outside training consultants.

Hardware. Cost of hardware sold decreased 25.7% to \$320,665 for the quarter ended September 30, 2003, compared with \$431,518 for the same period last year. Cost of hardware sold decreased 17.7% to \$399,481 for the nine months ended September 30, 2003, compared with \$485,191 for the same period last year. Cost of hardware as a percentage of the related revenue decreased to 73.8% for the quarter ended September 30, 2003, compared with 82.0% for the same period last year. Cost of hardware as a percentage of the related revenue decreased to 73.9% for

the nine months ended September 30, 2003, compared with 83.2% for the same period last year. The reduction in costs of hardware resulting in improved margins were due to incentives provided by our vendors.

OPERATING EXPENSES

Sales and Marketing. Our sales and marketing expenses for the third quarter of 2003 decreased 4.1% to \$77,289, compared with \$80,623 for the third quarter of 2002. Sales and marketing expenses for the nine months ended September 30, 2003 increased 40.4% to \$270,671, compared with \$192,800 in the same period last year. Sales and marketing expenses as a percentage of net revenues was stable at 9.4% for the third quarter of 2003, compared with 9.3% for the same period last year. Sales and marketing expenses as a percentage of net revenues increased to 16.2 for the nine months ended September 30, 2003, compared with 11.3% for the same period last year. The increases in cost and related percentages of revenue were due the implementation of a new marketing program.

General and Administrative. Our general and administrative expenses for the third quarter of 2003 increased 32.9% to \$139,423, compared with general and administrative expenses of \$104,878 for the third quarter of 2002. General and administrative expenses decreased 2.9% to \$384,953 for the nine months ended September 30, 2003, compared with \$396,550 in the same period last year. General and administrative expenses as a percentage of net revenues increased to 17.0% in the third quarter of 2003, compared with 12.1% in the third quarter of 2002. General and administrative expenses as a percentage of net revenues were stable at 23.0% for the nine months ended September 30, 2003, compared with 23.2% in the same period last year. The increase in general and administrative expense for the current quarter was due to a one-time payment for financial consulting services and an increase in the allocation of salaries.

Interest Income. Interest income was \$298 in the third quarter of 2003 compared to \$1,221 in 2002. Interest income was \$1,751 in the nine months ended September 30, 2003, compared with \$5,869 in the same period last year. The decrease was primarily due to lower interest rates.

Provision for Income Taxes. For the three and nine months ended September 30, 2003 we recorded a tax provision on income from operations of \$37,106 and \$29,970, 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.

Liquidity and Capital Resources

We have historically financed our liquidity needs through a variety of sources including proceeds from the sale of common stock, borrowing from banks, loans from our stockholders, and cash flows from operations. At September 30, 2003, we had \$370,395 in cash and cash equivalents. Cash generated from operations for the nine months ended September 30, 2003 was \$342,227 and \$279,979 for the same period last year. Cash used for investing activities was \$388,443 and \$303,600 for the nine months ended September 30, 2003 and 2002, respectively, primarily for cash invested in software development and property and equipment. Net cash provided by financing activities was \$21,355 for the nine months ended September 30, 2003, primarily from the proceeds of a new equipment lease. Cash used by financing activities for the nine months ended September 30, 2002 of \$56,242 was for principal reduction of our long term debt.

At September 30, 2003, we had cash and cash equivalents of \$370,395 as compared to cash and cash equivalents of \$317,499 for the same period last year. Our cash and cash equivalents at December 31, 2002 was \$395,256. Based upon current financial resources, we believe that we will have sufficient reserves to meet our anticipated working capital needs for our business as currently conducted for the next twelve months. However, we anticipate that we will need additional working capital to fund our business strategy including acquisitions. There can be no assurance that additional financing will be available, or if available, that such financing will be on favorable terms. Any such failure to secure additional financing, if needed, could impair our ability to achieve our business strategy. There can be no assurance that we will have sufficient funds or successfully achieve our plans to a level that will have a positive effect on our results of operations or financial condition. Our ability to execute our growth strategy is contingent upon sufficient capital as well as other factors, including our ability to further increase consumer awareness of our products, our ability to consummate acquisitions of complimentary businesses, general economic and industry conditions, our ability to recruit, train and retain a qualified sales staff, and other factors, many of

which are beyond our control. Even if our revenues and earnings grow rapidly, such growth may significantly strain our management and our operational and technical resources. If we are successful in obtaining greater market penetration with our products, we will be required to deliver increasing volumes of our products to our customers on a timely basis at a reasonable cost to us. No assurance can be given that we can meet increased product demand or that we will be able to deliver our products on a timely and cost-effective basis.

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 October 31, 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

On September 19, 2003, Avatar Systems, Inc. held its 2003 Annual Meeting of Shareholders. The results of the ballots cast in person or by proxy at the Meeting are as follows:

PROPOSAL I: For the election as director of all nominees listed below:

	For	Against	Abstain
Robert C. Shreve, Jr.	8,253,094	-	-
Charles Timothy Allen	8,253,094	-	-
Orville Gregory Allen	8,253,094	-	-
Stephen A. Komlosy	8,253,094	-	-
John J. May	8,253,094	-	-

As of July 28, 2002, the record date, there were 8,695,652 common shares issued and outstanding. A quorum consists of a majority of these shares outstanding, or 4,347,827 shares. The number of shares voting for proposal 1 by proxy or in person was 8,253,094. The total number of shares voted was 8,253,094.

Immediately following the Annual Meeting of Shareholders, the newly elected directors by unanimous consent held their Annual Meeting. At the Annual Meeting of Directors, the following officers were elected to serve in the

positions as indicated below until the next Annual Meeting of Directors or until their successors shall have been duly elected and qualified:

Name	Age	Position(s)
Robert C. Shreve, Jr.	41	President, Chief Executive Officer, Chairman of the Board of Directors, and Chief Financial Officer
Cindy Skelton	43	Secretary

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
 - 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 12, 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 September 30, 2003 and in this quarterly period 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: November 12, 2003

/s/ Robert C. Shreve, Jr.

Chief Executive Officer and Chief Financial Officer

(principal executive and accounting officer)

Exhibit 32.1

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 906 OF
THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Raytheon Company (the "Company") on Form 10-QSB for the period ending September 30, 2003 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Robert C. Shreve, Jr., President, Chief Executive Officer and Chief Financial Officer of Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

AVATAR SYSTEMS, INC.

Dated: November 12, 2003

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

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

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.