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# 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, 2004

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, 2004
Common stock, \$0.001 par value	8,695,652

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**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**AVATAR SYSTEMS, INC.  
CONDENSED BALANCE SHEETS**

	<b>September 30, 2004</b>	<b>December 31, 2003</b>
	<b>(Unaudited)</b>	<b>*</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 495,653	\$ 492,737
Accounts receivable, net	242,240	129,104
Prepaid expense	7,690	7,340
Deferred income taxes	11,180	12,340
Total current assets	<u>756,763</u>	<u>641,521</u>
Property and equipment – at cost, net	249,953	183,385
Purchased software, net	114,207	181,215
Software development costs, net	2,122,410	1,876,094
Total assets	<u>\$ 3,243,333</u>	<u>\$ 2,882,215</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Current maturities of long-term debt and capital lease obligations	\$ 31,262	\$ 6,996
Accounts payable	75,598	56,275
Accrued expense	85,206	50,690
Deferred revenues	302,952	265,328
Total current liabilities	<u>495,018</u>	<u>379,289</u>
Long-term debt and capital lease obligations	66,099	26,120
Deferred income taxes	304,277	235,203
Total liabilities	<u>865,394</u>	<u>640,612</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
Common stock subscribed 142,500 shares	143	-
Additional paid-in capital	1,768,202	1,768,345
Retained earnings	600,898	464,562
Total stockholders' equity	<u>2,377,939</u>	<u>2,241,603</u>
Total liabilities and stockholders' equity	<u>\$ 3,243,333</u>	<u>\$ 2,882,215</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 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
<b>Revenues:</b>				
Software	\$ 130,055	\$ 115,178	\$ 321,780	\$ 268,304
Maintenance	251,926	216,815	732,994	733,073
Professional services	48,707	52,193	111,506	128,995
Hardware	128,670	434,403	174,291	540,837
Net revenues	<u>559,358</u>	<u>818,589</u>	<u>1,340,571</u>	<u>1,671,209</u>
<b>Cost of revenues:</b>				
Software	26,768	18,471	64,656	66,311
Maintenance	31,755	36,189	108,211	117,917
Professional services	13,532	10,761	42,977	34,457
Hardware	102,534	320,665	136,954	399,481
Total cost of revenues	<u>174,589</u>	<u>386,086</u>	<u>352,798</u>	<u>618,166</u>
Gross margin	384,769	432,503	987,773	1,053,043
<b>Operating expenses:</b>				
Sales and marketing	42,840	77,289	137,283	270,671
General and administrative	120,788	139,423	313,643	384,953
Amortization of intangibles	92,782	88,809	278,345	266,427
Depreciation	26,060	15,166	61,863	42,775
Total operating expenses	<u>282,470</u>	<u>320,687</u>	<u>791,134</u>	<u>964,826</u>
Operating income	102,299	111,816	196,639	88,217
Investment income	9,814	298	13,273	1,751
Interest expense	1,957	1,694	3,341	1,820
Income from operations before income taxes	<u>110,156</u>	<u>110,420</u>	<u>206,571</u>	<u>88,148</u>
Income tax expense	<u>37,452</u>	<u>37,106</u>	<u>70,234</u>	<u>29,970</u>
Net income	<u>\$ 72,704</u>	<u>\$ 73,314</u>	<u>\$ 136,337</u>	<u>\$ 58,178</u>
<b>Earnings per share:</b>				
Basic and Diluted	<u>\$ 0.01</u>	<u>\$ 0.01</u>	<u>\$ 0.02</u>	<u>\$ .01</u>
Basic and diluted weighted average shares outstanding	<u>8,695,652</u>	<u>8,695,652</u>	<u>8,695,652</u>	<u>8,695,652</u>

**AVATAR SYSTEMS, INC.**  
**CONDENSED STATEMENTS OF CASH FLOWS**  
(Unaudited)

**Nine Months Ended September 30,**  
**2004**                      **2003**

<b>Cash flows from operating activities:</b>		
Net income	\$ 136,337	\$ 58,178
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of intangibles	278,345	266,427
Depreciation	61,863	42,775
Deferred income taxes	70,234	29,970
Changes in operating assets and liabilities:		
Accounts receivable	(113,136)	(206,725)
Prepaid expense	(350)	1,572
Accounts payable and accrued expenses	53,839	150,030
Deferred revenues	37,624	-
Net cash provided by operating activities	<u>524,756</u>	<u>342,227</u>
<b>Cash flows from investing activities:</b>		
Acquisition of property and equipment	(128,431)	(96,225)
Capitalized software development costs	(457,654)	(292,218)
Net cash used in investing activities	<u>(586,085)</u>	<u>(388,443)</u>
<b>Cash flows from financing activities:</b>		
Payments on long-term debt and capital lease obligations	(13,945)	(15,659)
Proceeds from issuance of long-term debt and capital lease obligations	78,190	37,014
Net cash provided by financing activities	<u>64,245</u>	<u>21,355</u>
Net increase (decrease) in cash and cash equivalents	2,916	(24,861)
Cash and cash equivalents at beginning of period	492,737	395,256
Cash and cash equivalents at end of period	<u>\$ 495,653</u>	<u>\$ 370,395</u>
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid for interest	<u>\$ 3,341</u>	<u>\$ 1,820</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

The condensed financial statements have been prepared 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. The interim financial statements should be read in conjunction with the audited financial statements and related notes included in the company's 2003 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 the opinion of management, the condensed financial statements include all adjustments necessary to present the financial position and results of operations for each interim period shown in conformity with accounting principles generally accepted in the United States of America.

#### 2. Common Stock Subscribed

During April 2004, the Company entered into an agreement with the holders of its 5,700,000 outstanding warrants to purchase its common stock, pursuant to which the Company exchanged .025 shares of common stock for each outstanding warrant. The Company is obligated to issue an aggregate of 142,500 shares of common stock to complete the exchange of the 5,700,000 outstanding warrants. These shares are reflected as common stock subscribed in the accompanying condensed balance sheet at September 30, 2004.

#### 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 2003 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, 2004 decreased 31.7% to \$559,358 compared with net revenues of \$818,589 for the same period in 2003. Net revenues for the nine months ended September 30, 2004 decreased 19.8% to \$1,340,571, compared with \$1,671,209 from the same period last year. The decrease in net revenues for the quarter and the nine months ended September 30, 2004 is primarily attributable to lower hardware sales in the current quarter when compared with an exceptional quarter for September 30, 2003.

**Software.** Software sales for the third quarter of 2004 increased 12.9% to \$130,055 compared with software sales of \$115,178 for the third quarter of 2003. Software sales for the nine months ended September 30, 2004 increased

19.9% to \$321,780, compared with \$268,304 from the same period last year. Demand for our software is historically highest during the third quarter of the fiscal year. Software sales for the third quarter of 2004 were higher compared to the third quarter of 2003 due to the current economic activity in the energy sector and our increased marketing efforts during 2003.

**Maintenance.** Maintenance revenue for the third quarter increased 16.2% to \$251,926 compared with maintenance revenue of \$216,815 for the third quarter of 2003. Maintenance revenue for the nine months ended September 30, 2004 was stable at \$732,994 when compared with maintenance revenue of \$733,073 for the same period last year. Maintenance revenue for the quarter was higher because of installations we made during 2003 and the current quarter. We expect a slight increase in maintenance revenue during the 2004 year because of new installations during 2003 and expected sales for 2004.

**Professional services.** Professional services revenue for the third quarter of 2004 decreased 6.7% to \$48,707 compared with professional service revenue of \$52,193 for the third quarter of 2003. Professional service revenue for the nine months ended September 30, 2004 decreased 13.6% to \$111,506, compared with \$128,995 for the same period last year. We expect professional services revenue to increase because we have installed a higher number of new systems generating increased demand for customization. We have also made improvements in our billing system to better identify services we perform for our clients that are not included in our normal maintenance fees.

**Hardware.** Hardware sales for the third quarter of 2004 decreased 70.4% to \$128,670, compared with hardware sales of \$434,403 for the third quarter of 2003. Hardware sales for the nine months ended September 30, 2004 decreased 67.8% to \$174,291, compared with \$540,837 from the same period last year. The decrease in hardware sales for the quarter is due to exceptionally higher sales during the third quarter of 2003. A hardware sale that we expected during the third quarter did not close until the subsequent quarter. Hardware sales are generally strongest during our third quarter. We anticipate stronger hardware sales during the remainder of the 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 third quarter of 2004 decreased 54.8% to \$174,589 compared with cost of revenues of \$386,086 for the third quarter of 2003. Cost of revenues for the nine months ended September 30, 2004 decreased 42.9% to \$352,798 compared with \$618,166 for the same period last year. Cost of revenues as a percentage of net revenues decreased to 31.2% for the three months ended September 30, 2004 from 47.2% for the same period in 2003. Cost of revenues as a percentage of net revenues decreased to 26.3% for the nine months ended September 30, 2004, compared with 37.0% for the same period in 2003. Lower cost of revenues were primarily related to lower hardware sales.

**Cost of software.** Cost of software increased 44.9% to \$26,768 in the third quarter of 2004 from \$18,471 in the third quarter of 2003. Cost of software decreased 2.5% to \$64,656 in the nine months ended September 30, 2004, compared with \$66,311 in the same period last year. Cost of software as a percentage of the related revenue increased to 20.6% for the third quarter of 2004 compared to 16.0% for the same period in 2003. Cost of software as a percentage of the related revenues decreased to 20.1% for the nine months ended September 30, 2004, compared with 24.7% for the same period last year. The increase in cost and the percentage of cost of software was directly related to higher software sales and increased sales commission costs.

**Cost of maintenance.** Cost of maintenance revenues decreased 12.3% to \$31,755 for the third quarter of 2004 from \$36,189 for the third quarter of 2003. Cost of maintenance revenues decreased 8.2% to \$108,211 for the nine months ended September 30, 2004, compared with \$117,917 for the same period last year. Cost of maintenance revenues as a percentage of the related revenue decreased to 12.6% for the third quarter 2004, compared to 16.7% for the same period last year. Cost of maintenance revenues as a percentage of the related revenue decreased to 14.8% for the nine months ended September 30, 2004, compared with 16.1% for the same period last year. The reduction in cost of maintenance was due primarily to lower maintenance personnel costs.

**Cost of professional services.** Cost of professional services increased 25.8% to \$13,532 for the three months ended September 30, 2004, compared with \$10,761 for the same period last year. Cost of professional services increased 24.7% to \$42,977 for the nine months ended September 30, 2004 from \$34,457 for the same period last year. Cost

of professional services as a percentage of the related revenue increased to 27.8% in the third quarter 2004, compared to 20.6% for the same period last year. Cost of professional services as a percentage of the related revenue increased to 38.5% for the nine months ended September 30, 2004, compared with 26.7% for the same period last year. The increases in cost and the percentage of cost of professional services was due primarily to higher personnel costs.

**Hardware.** Cost of hardware sold decreased 68.0% to \$102,534 for the three months ended September 30, 2004, compared with \$320,665 for the same period last year. Cost of hardware sold decreased 65.7% to \$136,954 for the nine months ended September 30, 2004, compared with \$399,481 for the same period last year. Cost of hardware as a percentage of the related revenue increased to 79.7% for the three months ended September 30, 2004, compared with 73.8% for the same period last year. Cost of hardware as a percentage of the related revenue increased to 78.6% for the nine months ended September 30, 2004, compared with 73.9% for the same period last year. The decrease in hardware costs is directly attributable to the decrease in hardware sales.

## **OPERATING EXPENSES**

**Sales and Marketing.** Our sales and marketing expenses for the third quarter of 2004 decreased 44.6% to \$42,840, compared with \$77,289 for the third quarter of 2003. Sales and marketing expenses for the nine months ended September 30, 2004 decreased 49.3% to \$137,283, compared with \$270,671 in the same period last year. Sales and marketing expenses as a percentage of net revenues decreased to 7.7% for the third quarter of 2004, compared with 9.4% for the same period last year. Sales and marketing expenses as a percentage of net revenues decreased to 10.2% for the nine months ended September 30, 2004, compared with 16.2% for the same period last year. The decreases in cost and related percentages of revenue were due to our completion of a marketing program in 2003.

**General and Administrative.** Our general and administrative expenses for the third quarter of 2004 decreased 13.4% to \$120,788, compared with \$139,423 for the third quarter of 2003. General and administrative expenses decreased 18.5% to \$313,643 for the nine months ended September 30, 2004, compared with \$384,953 in the same period last year. General and administrative expenses as a percentage of net revenues increased to 21.6% in the third quarter of 2004, compared with 17.0% in the third quarter of 2003. General and administrative expenses as a percentage of net revenues increased slightly to 23.4% in the nine months ended September 30, 2004, compared with 23.0% in the same period last year. The decreases in the costs were primarily related to lower personnel costs, while the increases in the percentages of general and administrative expenses to net revenues was primarily related to lower net revenues.

**Investment Income.** Investment income was \$9,814 in the third quarter of 2004 compared to \$298 in 2003. Investment income was \$13,273 for the nine months ended September 30, 2004, compared with \$1,751 in the same period last year.

**Provision for Income Taxes.** For the three and nine months ended September 30, 2004 we recorded income tax expense on income from operations of \$37,452 and \$70,234, respectively, based on our pretax income using an effective tax rate of 34%, which is our anticipated effective tax rate for the fiscal year 2004. 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, 2004, we had \$495,653 in cash and cash equivalents. Cash generated from operations for the nine months ended September 30, 2004 was \$524,756 and \$342,227 for the same period last year. Cash used for investing activities was \$586,085 and \$388,443 for the nine months ended September 30, 2004 and 2003, respectively. Cash used for investing activities was used primarily in software development and property and equipment. Net cash provided by financing activities was \$64,245 and \$21,355 for the nine months ended September 30, 2004 and 2003, respectively. The net cash provided from financing activities was primarily from the proceeds of notes payable and capital lease obligations for equipment.

At September 30, 2004, we had cash and cash equivalents of \$495,653 compared with cash and cash equivalents of \$370,395 for the same period last year. Our cash and cash equivalents at December 31, 2003 was \$492,737. 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, 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.

As of 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 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**

During April 2004, the Company entered into an agreement with the holders of its 5,700,000 outstanding warrants to purchase its common stock, pursuant to which the Company exchanged .025 shares of common stock for each outstanding warrant. The Company is obligated to issue an aggregate of 142,500 shares of common stock to complete the exchange of the 5,700,000 outstanding warrants.

### **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 Sarbanes-Oxley Act.

32.1 Section 906 Certification pursuant to Sarbanes-Oxley Act

(b) Reports on Form 8-K

The Company filed Form 8-K on September 2, 2004. Item 2.02 – Results of Operations and Financial Condition and Item 8.01– Other Events were reported.

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, 2004**

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, 2004 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 independent registered public accounting firm and the audit committee of the 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 independent registered public accounting firm 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

Date: November 12, 2004

/s/ Robert C. Shreve, Jr.

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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 Avatar Systems Inc.(the “Company”) on Form 10-QSB for the period ending September 30, 2004 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, 2004**

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

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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.