
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB



ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF
THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2004
COMMISSION FILE NUMBER: 000-32925

AVATAR SYSTEMS, INC.

(Name of Small Business Issuer Specified in Its Charter)

Texas

(State of incorporation)

5728 LBJ Freeway, Suite 270, Dallas, Texas 75240

(Address of principal executive offices)

75-2796037

(IRS Employer Identification Number)

75240

(Zip Code)

(972) 720-1800

(Registrant's telephone number, including area code)

Securities registered under Section 12(b) of the Exchange Act:
None

Securities registered under Section 12(g) of the Exchange Act:
\$.001 Par Value Common Stock

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. [X] Yes [] No

As of March 14, 2005, 8,838,152 shares of the Issuer's \$0.001 par value common stock were outstanding and the aggregate market value of the share held by non-affiliates was approximately \$260,000 based upon a closing bid price of \$.40 per share of Common Stock on the OTC Bulletin Board.

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in part III of this Form 10-KSB or any amendment to this Form 10-KSB.

The Issuer's revenue for its most recent fiscal year was \$2,661,370.

The following documents are incorporated by reference: None

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PART I

Item 1. Business

Business Development

Avatar Systems, Inc. (“Avatar”, the “Company”, or “we”) provides enterprise resource solution software to companies engaged in the petroleum exploration and production industry. We offer integrated software solutions for automating and integrating data and work flows across the petroleum industry, as well as the information flows between the petroleum organization and external parties. Our products are intended to increase operational efficiency, improve the accuracy of client information, and enable better decision-making. Each solution focuses on specific mission-critical functions of the petroleum organization and is tailored to meet the needs of the particular client, as determined by size, properties under management and complexity of the petroleum industry.

Avatar Systems, Inc. began business on September 1, 1996 as Avatar Systems, Ltd., a Texas limited partnership, in connection with the acquisition of Information Resources, Inc.

On July 7, 2000, the limited partners assigned their respective partnership interests to Avatar International, Inc. for 6,399,000 shares of Avatar International’s common stock. The partnership assigned all of its assets and liabilities to Avatar International and was dissolved. On July 10, 2000, Avatar International changed its name to Avatar Systems, Inc.

On November 14, 2000, HCI Acquisition 1998-2, Inc. acquired all of the outstanding common stock of Avatar Systems, Inc. pursuant to a plan and agreement of merger. The Avatar Systems common stock was acquired from its four shareholders in exchange for 8,000,000 shares of HCI’s common stock representing approximately 92% of the HCI’s common stock. HCI, as the surviving entity, changed its name to Avatar Systems, Inc., its sole officer and director resigned and HCI’s shareholders elected five new directors, who were also serving as directors of Avatar Systems.

HCI Acquisition 1998-2, Inc., (HCI) was incorporated in Texas on August 7, 1998 as a wholly-owned subsidiary of Hospitality Companies, Inc., which was engaged in the leasing, sale and servicing of refrigeration, air conditioning and restaurant equipment.

Avatar’s stock symbol is AVSY.OB. Our common stock began trading on the Over-the-Counter Pink Sheets on April 2, 2001. On November 5, 2001, our Registration Statement on Form 10-SB became effective and our stock was approved for trading December 19, 2001 on the NASD OTC Bulletin Board.

On our investor relations web site, which is accessible through www.avatarsystems.net, we post the following filings as soon as reasonably practicable after they are electronically filed with or furnished to the Securities and Exchange Commission (“SEC”): our annual reports on Form 10-KSB, our quarterly reports on Form 10-QSB, our current reports on Form 8-K and any amendments to those reports. All such filings on our investor relations web site are available free of charge. Information contained or referenced on our website is not incorporated by reference in and does not form a part of this Annual Report on Form 10-KSB. The SEC maintains an Internet site at www.sec.gov that contains reports, proxy and information statements, and other information regarding issuers that is filed electronically with the SEC.

Our principal executive offices are located at 5728 LBJ Freeway, Suite 270, Dallas, Texas 75240, and our telephone number is (972) 720-1800.

Industry Background

The petroleum industry is a data-intensive and complex global industry. The industry consists of three distinct sectors: upstream, midstream and downstream.

- Upstream activities include exploration, producing and selling crude oil, natural gas and gas liquids.

- Midstream activities typically include the gathering, transportation, and storage of petroleum products.
- Downstream activities include refining crude oil into petroleum products, trading crude oil and petroleum products and distributing and marketing refined products.

Within the upstream sector, the exploration and production divisions of oil and gas companies are chartered with finding, developing and managing the production of oil and gas reserves. Petroleum companies need to continually add new reserves of oil and gas at a faster rate than existing reserves are depleted. Optimizing a portfolio of oil and gas reserves is an ongoing process, whereby, petroleum companies explore, evaluate, develop, manage and divest petroleum interests.

The discovery, evaluation, acquisition and processing of properties within the upstream petroleum industry are typically cumbersome, costly, and time-consuming and are characterized by:

- Data-Intensive, Paper-Based Process. Large amounts of geotechnical, engineering, land-related, financial and accounting data must be compiled and integrated from disparate, non-standardized, paper-based and digital sources in order to evaluate and manage properties.
- Geographic Dispersion of Resources. Many new exploration and development projects are conducted in remote parts of the world, creating significant costs and numerous insufficiencies in the management of an upstream business.
- Lack of Back Office Interconnectivity. The ability of companies to exchange data electronically and effect transactions in an efficient manner is currently limited by the numerous incompatible back office land, production and accounting systems.

The energy application market has grown, as major U.S. oil companies have divested many of their U.S.-based assets, in order to pursue opportunities abroad. These divestitures have opened the door for small independent oil companies to acquire the assets of the major oil companies. There is a growing demand for oil and gas accounting and financial software because of the growth of these small independent oil companies.

The computer infrastructure within the petroleum industry has been allowed to age beyond what is traditionally considered the useful life span of many of its component elements. The challenges facing the petroleum industry are: how to take advantage of the anticipated increase in demand, confront the problem of aging IT infrastructure, and deal with the ongoing attrition of the work force. These challenges will be met by changes in the business processes of oil and gas companies to work with fewer people, make efficient use of technology, and move away from capital-intensive computing systems. The oil industry will become a more streamlined and efficient industry based upon technology and services, an enterprise wide resource solution, supplied through application service providers (ASP's). These ASP's will offer enhanced outsourcing capabilities including not only applications, but through professional services including consulting, implementation, integration, software and industry training.

Narrative Description of Business

Products

Avatar provides the petroleum industry with solutions for accounting/financial management, production and land management, oil and gas marketing and electronic data exchange on both a licensed basis and as an application service provider (ASP).

We provide technology products and services to support the ongoing management of an upstream petroleum business and to facilitate the processing of oil and gas transactions through the back office systems of buyers, sellers, and traders. We offer a full line of accounting and resource management software for the petroleum industry through our Avatar400 and Petroware2000 product lines. Our products offer a variety of applications specific to the accounting, billing, financial analysis, and land, royalty and production management functions of a petroleum company.

Petroware2000

Petroware2000 runs on all major operating systems and hardware types, including Microsoft Windows, Hewlett Packard, and IBM products. Petroware2000 runs on virtually any platform and is available in single and multi-user licenses and on an ASP basis. Petroware2000 utilizes the speed, power, flexibility, and infinite expandability of IBM's DB2 database environment to insure reliability, extended product longevity and substantially faster processing speeds. Our Petroware2000 product is designed for the small- to medium-sized petroleum company.

Avatar400

Avatar 400 provides a comprehensive accounting system, which delivers real time information from the database to users. This product takes advantage of the scalability and security of the IBM AS400 line of servers and utilizes the advanced features of IBM technology allowing energy customers to obtain accurate and timely information. Avatar400, which was designed primarily for use by major petroleum companies, provides an extensive array of data elements and multiple sorting capabilities. It automatically generates a host of reports, including lease/well management reports, financial reports and accounting reports. Avatar400 offers a complete selection of real-time accounting software modules which include general ledger, accounts payable, accounts receivable, revenue accounting, joint interest billing, partnership accounting, depletion (cost & statutory), fixed assets (GAAP & tax), budgeting and revenue accrual. Additionally, our Avatar400 product provides functionality for production management, oil and gas marketing, field inventory and data exchange interfaces between accounting and engineering systems.

RAPID and Petroware2000 ASP Products

Our RAPID, or Remote Access Private Integrated Datalink, and Petroware2000 application service provider (ASP) systems deliver enterprise resource solutions to petroleum companies on a worldwide basis. Our ASP products were developed to reduce the high costs of oil and gas accounting software ownership. Users remotely connect to our IBM AS400 or Citrix farm servers on a subscription basis, thereby, eliminating the need for expensive in-house hardware solutions, software purchases, and eventual upgrades. Our ASP solutions provide access to high availability, secure, fast processing servers for a limited monthly expenditure and reduce, or eliminate, the need for an expensive in-house.

Support and Maintenance Services

Due to the mission-critical nature of our products, most clients purchase annual support and maintenance, which entitles them to technical support and product upgrades as they become available. We continually upgrade and enhance our products to respond to changing market needs, evolving regulatory requirements, and new technologies.

Professional Services

Professional services consist of consulting, implementation, integration, custom report writing, and training. Many of our clients purchase consulting services from us to support their implementations, assist in the conversion of their historical data and provide ongoing training and education. We believe that consulting services facilitate a client's early success with our products, strengthen the relationship with the client, and generate valuable feedback for our product development group.

Growth Strategy

Leveraging Existing Customer Relationships

We have an installed base of more than 350 customers. Existing customers expanding or upgrading their information solutions provide us with a market for additional software solutions and services. The majority of our revenues are generated from existing customers.

Developing and Enhancing New Technologies

Our product development efforts are focused on developing new solutions as well as enhancing and broadening our current software solutions. New solutions will continue to emphasize state-of-the-art technologies for Internet-enablement and information exchange. During fiscal 2005, our product development efforts will include development of production /land modules for our Petroware2000 product and integration of new imaging functionality in both our AS400 and Petroware2000 products.

Pursuing Acquisitions and Strategic Alliances

We have successfully completed two acquisitions since 1996. We will continue to evaluate potential acquisitions of other companies or technologies to further expand our solutions, services, or market penetration. In addition, as we expand in our markets, we intend to enter into additional sales and marketing strategic alliances in such markets. We believe that new technical skills, expanded software functionality, a broader client base and an expanded geographic presence may result from these activities.

Expanding ASP Hosting Business

We have offered our AS400 RAPID ASP services since 1999. We began offering our Petroware2000 product as an ASP service in early 2004. Our ASP offerings allow customers to free up resources to concentrate on their core competencies and strategic projects. The ASP business model provides us with a growing source of recurring revenues. Our ASP hosting centers allows us to meet customer demands as well as offer off-site backup and disaster recovery capabilities to our customers.

Sales and Marketing

Our marketing plan is geared to penetrate the energy market. We use regional distributors, trade shows, advertising, conferences, direct mail, telemarketing, referral base, and a written incentive-based compensation plan for our sales representatives to grow our market share. We maintain a database of over 15,000 domestic oil and gas companies registered with Dunn and Bradstreet. Additionally, we have engaged research consultants to access public records as filed with state regulatory agencies by oil and gas companies. Product demonstrations can be provided via the Internet, direct modem connection to customer site, in person at the customer site or at our office in Dallas.

To discover opportunities to sell our products and Internet integration solutions, we call on our existing customer base, as well as leads we receive from customers, inquiries in response to tradeshow and advertisements. We conduct a variety of marketing programs to educate our target market, create awareness, and attract visitors to our products.

Our web site (www.avatarsystems.net) provides customer leads and to promote our products and services over the Internet. Our web site is also used to provide current customers information on new products and services, product training dates and company sponsored seminars.

Competition

The market for enterprise information solutions is intensely competitive, subject to rapid change and significantly affected by new product introductions and other market activities of industry participants. We face direct and indirect competition from a broad range of competitors, many of whom have greater financial, technical and marketing resources than we do. We face competition from other traditional oil and gas service providers, as well as from Internet companies who have established websites and who are pursuing various e-commerce initiatives in bringing accounting solutions to the petroleum industry. Many of our competitors are large well-financed companies who provide an array of accounting and financial management solutions to the petroleum industry.

Customers

The Company completed a hardware sale with one customer during 2004 for \$739,826 and one other customer during 2003 for \$188,532. Total revenues from those customers were \$773,457 in 2004 and \$211,697 in 2003 accounting for 29% and 10% of total revenues, respectively. The Company completed hardware sales with three customers during 2004 for \$941,329 that accounted for 86% of hardware revenue and 35% of total revenue for the year ended December 31, 2004. The Company had a separate customer in 2004 and a 2003 that accounted for more than 10% of revenues.

Suppliers

Our primary supplier is IBM. We purchase most of our equipment for internal use and resale purposes from IBM. Additionally, we purchase from IBM the database product and other value added enhancements used in our Avatar400 and Petroware2000 products. We do not believe the loss of IBM, as a supplier will have a material adverse effect on our business since the products we purchase from IBM are readily available from a number of other vendors.

Licenses, Franchises, Concessions, Royalty Agreement, Patents, Trademarks or Labor Contracts

Our success depends significantly upon our proprietary technology. We currently rely on a combination of copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect our proprietary rights. We hold copyrights to all of our products including, Avatar400, RAPID, Petroware2000, and Petroware Version 6. In addition, we have trademarks for Avatar400, Petroware2000, and Petroware Version 6. We generally enter into confidentiality agreements with our employees and with our resellers and customers. We seek to protect our software, documentation and other written materials under trade secret and copyright laws, which afford only limited protection. Despite these efforts, it may be possible for unauthorized third parties to copy certain portions of our products or to reverse engineer or otherwise obtain and use our proprietary information.

We also rely on certain software that we license from third parties, including software that is integrated with internally developed software and used in our solutions to perform key functions. These third-party software licenses may not continue to be available to us on commercially reasonable terms and the related software may not continue to be appropriately supported, maintained or enhanced by the licensors. The loss of licenses to use, or the inability of licensors to support, maintain, and enhance, any of such software could result in increased costs, delays or reductions in software shipments until equivalent software could be developed or licensed and integrated.

Regulatory and Environmental Matters

Few laws or regulations are currently directly applicable to our access to or our conducting business on the Internet. However, because of the Internet's popularity and increasing use, new laws and regulations may be adopted. Such laws and regulations may cover issues such as: user privacy, pricing, content, copyrights, distribution, and characteristics and quality of products and services. Currently, we do not need any governmental approval for our products or services.

In addition, the growth of the Internet and electronic commerce, coupled with publicity regarding Internet fraud, may lead to the enactment of more stringent consumer protection laws. These laws may impose additional burdens on our business. The enactment of any additional laws or regulations may impede the growth of the Internet, which could decrease our potential revenues from electronic commerce or otherwise adversely affect our business, financial condition, and operating results.

Laws and regulations directly applicable to electronic commerce or Internet communications are becoming more prevalent. Congress recently enacted Internet laws regarding on-line copyright infringement. Although not yet enacted, Congress is considering laws regarding Internet taxation. In addition, various state jurisdictions are considering legislation directed to electronic commerce which if enacted could affect our business. The applicability of many of these laws to the Internet is uncertain and could expose us to substantial liability. Any new legislation or regulation regarding the Internet, or the application of existing laws and regulations to the Internet,

could materially and adversely affect us. If we were alleged to violate federal, state or foreign, civil or criminal law, even if we could successfully defend such claims, it could materially and adversely affect us.

Several telecommunications carriers are seeking to have telecommunications over the Internet regulated by the Federal Communications Commission in the same manner as other telecommunications services. Additionally, local telephone carriers have petitioned the Federal Communications Commission to regulate Internet service providers and online service providers in a manner similar to long distance telephone carriers and to impose access fees on such providers. If either of these petitions are granted, the cost of communicating on the Internet could increase substantially. This, in turn, could slow the growth of use of the Internet. Any such legislation or regulation could materially and adversely affect our business, financial condition and operating results.

Product Development

Our capitalized software development costs have been focused on the development of our Avatar400 and Petroware2000 products. We capitalize software development costs applicable to each product after technological feasibility has been established until the product is released to the market. It was necessary for us to develop a Windows-based application to gain a competitive edge and have successful sales in the oil and gas market. In 2004 and 2003, our product development expenditures were \$624,948 and \$576,540 respectively.

Employees

As of December 31, 2004, we had 11 employees, of which 1 was engaged in professional services, 5 in product development and customer support, 3 in sales and marketing and 2 in finance and administration. We believe our future success will depend, in part, on our continued ability to attract and retain highly qualified personnel in a competitive market for experienced and talented software engineers and sales and marketing personnel. Our success depends, to a significant extent, upon the continued contributions of our senior management and other key personnel, many of whom would be difficult to replace. None of our employees are represented by a labor union or are subject to a collective bargaining agreement. We believe that our employee relations are strong.

Risk Factors and Other Trends and Uncertainties Affecting Future Operations

Investors should carefully consider the risks described below before making an investment decision. These risks are not the only ones we face. Additional risks we are not presently aware of or that we currently believe are immaterial may also impair our business operations. Our business could be harmed by any of these risks. The trading price of our common stock could decline due to any of these risks. In assessing these risks, investors should also refer to the other information contained or incorporated by reference in this Form 10-KSB report, including our financial statements and related notes.

WE INTEND TO GROW OUR BUSINESS BY ACQUIRING OTHER COMPANIES OR TECHNOLOGIES. IF WE ARE UNABLE TO SUCCESSFULLY IDENTIFY, ACQUIRE, AND INTEGRATE NEW COMPANIES OR TECHNOLOGIES, OUR BUSINESS WILL BE HARMED.

We have grown our business primarily through the acquisition of other companies and assets and plan to continue this growth strategy for the foreseeable future. If we are unsuccessful in identifying, acquiring, and integrating other companies, we may not achieve our anticipated levels of growth. A substantial portion of our current revenue is derived from businesses or technologies that we have acquired. Although we continually evaluate acquisition opportunities, we may be unable to identify suitable acquisition candidates or successfully negotiate or finance any future acquisitions. We may also be unable to effectively integrate any acquired companies.

Acquiring other companies or technologies involves many risks and difficulties, including:

- diversion of management's attention from our existing business;
- increased fixed costs, which could cause profits to decrease;
- assumption of unknown material liabilities of acquired companies;
- large write-offs and amortization expenses related to goodwill and other intangible assets;

- difficulty in integrating an acquired company's personnel and culture with our personnel and culture;
- difficulty in integrating an acquired company's accounting and information systems with our accounting and information systems;
- difficulty in maintaining standards, controls, procedures and policies across the combined companies;
- issuances of equity securities that may dilute your interest in our company;
- incurring additional debt; and
- disruption of our ongoing business and operations, which could, among other things, impair our reputation and our relationships with customers and employees and potentially cause the loss of our own key employees or those of an acquired company.

FAILURE TO MANAGE OUR GROWTH COULD RESULT IN INEFFICIENT OPERATIONS.

Our acquisition strategy could strain our infrastructure, management, internal controls and financial systems. We may not be able to effectively manage our present growth or any future expansion, which could cause substantial increases in our operating costs without corresponding increases in our revenue. To support our growth, we will need to continue to hire qualified employees in all areas of our business. This planned strategy could strain our ability to integrate and properly train our new employees. Inadequate integration and training of our employees may result in an inefficient workforce and may harm our operating results.

OUR STRATEGY OF DISTRIBUTING SOFTWARE AND ANALYSIS TOOLS AS AN APPLICATION SERVICE PROVIDER IS UNPROVEN AND MAY NOT BE SUCCESSFUL.

We intend to establish ourselves as an ASP serving the software needs of industry professionals, as well as the general enterprise resource planning needs of the upstream petroleum industry. The ASP model is a new and unproven distribution strategy, particularly in our marketplace. To fully implement our ASP model, we will need to develop additional technology, as well as establish relationships with developers and distributors of software products, which we may be unable to do on a cost-effective basis, if at all. If we are unable to implement our ASP model, or if our ASP distribution model does not generate sufficient revenue to cover the costs of creating, deploying, and supporting this distribution model, our operating results will be harmed. In addition, ASP revenue accounting generally recognizes revenue over the life of the particular contract.

WE MUST CONTINUE TO INTRODUCE NEW PRODUCTS AND PRODUCT ENHANCEMENTS.

The market for our products is characterized by rapid technological change, changes in customer demands and evolving industry standards. New products based on new technologies or new industry standards can render existing products obsolete and unmarketable. As a result, our future success will continue to depend upon our ability to develop new products or product enhancements that address the future needs of our target markets and to respond to these changing standards and practices. We may not be successful in developing, introducing and marketing new products or product enhancements on a timely and cost effective basis, or at all, and our new products and product enhancements may not adequately meet the requirements of the marketplace or achieve market acceptance. Delays in the commencement of commercial shipments of new products or enhancements may result in client dissatisfaction and delay or loss of product revenues. If we are unable, for technological or other reasons, to develop and introduce new products or enhancements of existing products in a timely manner in response to changing market conditions or client requirements, or if new products or new versions of existing products do not achieve market acceptance, our business would be seriously harmed. In addition, our ability to develop new products and product enhancements is dependent upon the products of other software vendors, including certain system software vendors, such as Microsoft Corporation, IBM and development tool vendors. If the products of such vendors have design defects or flaws, are unexpectedly delayed in their introduction, or are unavailable on acceptable terms, our business could be seriously harmed. Our software products are complex and may contain undetected defects or errors when first introduced or as new versions are released. Although we have not experienced adverse effects resulting from any software errors, we cannot be sure that, despite testing by us and our clients, defects or errors will not be found in new products after commencement of commercial shipments, resulting in loss of or delay in market acceptance, which could seriously harm our business.

FAILURES OF HARDWARE SYSTEMS OR SOFTWARE COULD UNDERMINE CUSTOMER CONFIDENCE IN THE RELIABILITY OF OUR PRODUCTS AND SERVICES, WHICH COULD HARM OUR BUSINESS AND REPUTATION.

There are a number of circumstances that can lead to a customer having an unsatisfactory experience with our solutions.

Some of our products and services require our customers to access our web site through the Internet. To do so, they must be connected to the Internet and have sufficiently current hardware, operating system software, web browsers and other software. Because of the complex nature of software and hardware and the rapidly evolving nature of technology, a customers' system may become incompatible with our products or services. As a result, a customer may be unable to access our products or services or their access may be interrupted or delayed while using our products or services.

A significant disruption in our Internet services or the Internet service of our customers could seriously undermine their confidence in our business. During a disruption, participants may lose their online connection for an extended period and be unable to access our Internet marketplace.

Many of our products and services depend on complex software that is both internally developed and licensed from third parties. Complex software often contains defects, particularly when first introduced or when new versions are released. Although we test our software, we may not discover software defects that affect current or planned services or enhancements until after they are deployed. These defects could cause service interruptions.

Any of these events could lead to customer dissatisfaction with one or more of our solutions, damage our reputation, increase our service costs, cause us to lose revenue, delay market acceptance, result in legal proceedings against us or divert our development resources, any of which could cause our business to suffer.

SECURITY RISKS AND CONCERNS MAY DETER THE USE OF THE INTERNET FOR CONDUCTING BUSINESS.

A significant barrier to commerce and communications over public networks is the secure transmission of confidential information. Advances in computer capabilities, new discoveries in the field of cryptography or other events or developments could result in compromises or breaches of our security systems or those of other web sites to protect proprietary information. If any well-publicized compromises of security were to occur, it could have the effect of substantially reducing the use of the internet for commerce and communications. Anyone who circumvents our security measures could misappropriate proprietary information or cause interruptions in our services or operations. The internet is a public network, and data is sent over this network from many sources. In the past, computer viruses, software programs that disable or impair computers, have been distributed and have rapidly spread over the internet. Computer viruses could be introduced into our systems or those of our customers or other third parties, which could disrupt or make it inaccessible to customers. We may be required to expend significant capital and other resources to protect against the threat of security breaches or to alleviate problems caused by breaches. To the extent that our activities may involve the storage and transmission of proprietary information, security breaches could expose us to a risk of loss or litigation and possible liability. Our security measures may be inadequate to prevent security breaches, and our business would be harmed if our security were breached.

IF WE ARE UNABLE TO PROTECT OUR INTELLECTUAL PROPERTY, WE MAY BE SUBJECT TO INCREASED COMPETITION THAT COULD SERIOUSLY HARM OUR BUSINESS.

Our success depends significantly upon our proprietary technology. We currently rely on a combination of copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect our proprietary rights. We generally enter into confidentiality agreements with our employees and with our resellers and customers. We seek to protect our software, documentation and other written materials under trade secret and copyright laws, which afford only limited protection. Despite these efforts, it may be possible for unauthorized third parties to copy certain portions of our products or to reverse engineer or otherwise obtain and use our proprietary information. In addition, we cannot be certain that others will not develop substantially equivalent or superseding

proprietary technology, or that equivalent products will not be marketed in competition with our products, thereby substantially reducing the value of our proprietary rights. Litigation may be necessary to protect our proprietary technology. This litigation may be time-consuming and expensive.

WE MUST RETAIN KEY EMPLOYEES AND RECRUIT QUALIFIED TECHNICAL AND SALES PERSONNEL.

We believe that our success will depend on the continued employment of our senior management and other key personnel. Additionally, our continued success depends, in part, on our ability to identify, attract, motivate, and retain qualified technical, sales and other personnel. Because our future success is dependent on our ability to continue to enhance and introduce new products, we are particularly dependent on our ability to identify, attract, motivate and retain qualified engineers with the requisite education, backgrounds and industry experience. The loss of the services of a significant number of our engineers or sales people could be disruptive to our development efforts or business relationships and could seriously harm our business. We may also be required to create additional performance and retention incentives in order to retain our employees, including the granting of additional stock options to employees at current prices or issuing incentive cash bonuses. Such incentives may either dilute our existing stockholder base or result in unforeseen operating expenses, which may cause our stock price to fall.

OUR OFFICERS, DIRECTORS AND MAJOR STOCKHOLDERS AND THEIR AFFILIATES HAVE SUBSTANTIAL CONTROL OVER OUR BUSINESS.

Our executive officers, directors, and major stockholders beneficially own, in the aggregate, approximately 92% of our common stock. These stockholders, if they vote together, will be able to significantly influence matters that our stockholders must approve, including electing directors and approving significant corporate transactions. This concentration of ownership may also have the effect of delaying or preventing us from effecting a change in control, which could cause our stock price to decline.

RECENTLY ENACTED AND PROPOSED CHANGES IN SECURITIES LAWS AND REGULATIONS WILL INCREASE OUR COSTS.

The Sarbanes-Oxley Act ("the Act") of 2002, which became law in July 2002, requires changes in some of our corporate governance and securities disclosure and/or compliance practices. As part of the Act's requirements, the Securities and Exchange Commission has been promulgating new rules on a variety of subjects, in addition to other rule proposals, and the NASDAQ Stock Market has enacted new corporate governance listing requirements. We believe these developments will increase our accounting and legal compliance costs and could expose us to additional liability. These developments may make retention and recruitment of qualified persons to serve on our board of directors or executive management more difficult. We are presently evaluating and monitoring regulatory and legislative developments and cannot reliably estimate the timing or magnitude of additional cost we will incur as a result of the Act or other related legislation or regulation.

AN ACTIVE TRADING MARKET MAY NOT DEVELOP FOR OUR COMMON STOCK.

There is not an established active public market for our common stock. No assurance can be given that an active market will exist for our common stock.

Item 2. Properties

The Company leases its 7,004 square foot facility at 5728 LBJ Freeway, Suite 270, Dallas, Texas, 75240. The lease for the corporate office was entered into on August 29, 2000 for a sixty-month lease term commencing on August 1, 2000 and expiring on September 30, 2005. The company leases a 1,496 square foot facility at 6 Desta Drive, Suite 3350, Midland, Texas 79705. The lease for the Midland facility was entered into on September 27, 2004 for a twelve-month lease term commencing on October 1, 2004 and expiring on September 30, 2005. The company leases a 250 square foot facility at 1901 Rickety, Suite 216, Tyler, Texas. The lease for the Tyler facility was entered into on April 27, 2004 for a twelve-month lease term commencing on May 1, 2004 and expiring on May 30, 2005.

Item 3. Legal Proceedings

From time to time, we are involved in litigation incidental to the conduct of our business. We are not party to any lawsuit or proceeding that, in our opinion, is likely to seriously harm our business.

Item 4. Submission of Matters To A Vote Of Security Holders

On September 17, 2004, Avatar Systems, Inc. held its 2004 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.	8,136,781	-	-
Charles Timothy Allen	8,136,781	-	-
Orville Gregory Allen	8,136,781	-	-
Stephen A. Komlosy	8,136,781	-	-
John J. May	8,136,781	-	-

As of July 26, 2004, 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 8,136,781. The total number of shares voted was 8,136,781.

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.	42	President, Chief Executive Officer, Chairman of the Board of Directors, and Chief Financial Officer
Cindy Skelton	46	Secretary

PART II

Item 5. Market For The Registrant's Common Equity And Related Shareholder Matters

Our common stock began trading on the Over-the-Counter Pink Sheets on April 2, 2001. On November 5, 2001, our Registration Statement on Form 10-SB became effective and our stock was approved for trading on December 19, 2001, on the NASD OTC Bulletin Board. During 2004, there was only nominal trading in the shares of our common stock. As of March 14, 2005, the last reported trade in our stock was at \$0.42. No assurance can be given that an active market will exist for our common stock in the future. On March 14, 2005, the last date reported for our common stock, the closing bid price was \$0.40 and the closing ask price was \$0.51. Our trading symbol is AVSY.OB.

Holders

As of March 14, 2005, the Company had approximately 450 shareholders of record, its common stock had a closing bid price of \$0.40 per share, and a closing ask price of \$0.51 per share.

Dividends

We have not declared any dividends on our common stock during the last two fiscal years and we do not expect to declare dividends in the near future since we intend to utilize our earnings, if any, to finance our future growth, including possible acquisitions.

Item 6. Management's Discussion And Analysis Of Financial Condition Or Plan Of Operations

Forward Looking Statements

This report contains forward-looking statements, other than historical facts, which reflect the view of Company's management with respect to future events. Such forward-looking statements are based on assumptions made by and information currently available to the Company's management. Although management believes that the expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations will prove to have been correct. Important factors that could cause actual results to differ materially from such expectations include, without limitation, the ability of the Company i) to generate levels of revenue and adequate cash flows from its operations to support and maintain its current cost structure and ii) to develop and deliver products that are competitive, accepted by its markets and are not rendered obsolete by changing technology. The forward-looking statements contained herein reflect the current views of the Company's management with respect to future events and are subject to these factors and other risks, uncertainties and assumptions relating to the operations, results of operations and financial position of the Company. The Company assumes no obligation to update the forward-looking statements or to update the reasons actual results could differ from those contemplated by such forward-looking statements.

Critical Accounting Policies and Estimates

Use of Estimates and Certain Significant Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant assumptions and estimates are required in the capitalization and amortization of software development costs. It is at least reasonably possible those estimates could be revised in the near term and those revisions could be material.

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of trade accounts receivable. Products are sold to customers located principally in the United States. The Company continually evaluates the creditworthiness of its customers' financial condition and generally does not require collateral. The Company evaluates the collectability of its accounts receivable based on a combination of factors. In circumstances where the Company is aware of a specific customer's inability to meet its financial obligations, the Company records a specific reserve for bad debts against amounts due. The Company has not experienced significant losses on uncollectible accounts receivable.

Fair Value of Financial Instruments

In accordance with the reporting requirements of Statement of Financial Accounting Standards ("SFAS") No. 107, *Disclosures About Fair Value of Financial Instruments*, the Company calculates the fair value of its assets and liabilities which qualify as financial instruments under this statement and includes this additional information in the notes to consolidated financial statements when the fair value is different than the carrying value of these financial instruments. The estimated fair value of accounts receivable, accounts payable and accrued liabilities approximate their carrying amounts due to the relatively short maturity of these instruments. The carrying value of

short and long-term debt also approximates fair value since these instruments bear market rates of interest. None of these instruments are held for trading purposes.

Marketable Securities

Marketable securities at December 31, 2004 consisted of corporate equities in exchange traded index funds and corporate bond mutual funds. SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, requires certain investments be recorded at fair value or amortized cost. The appropriate classification of the investments in marketable equity is determined at the time of purchase and re-evaluated at each balance sheet date. As of December 31, 2004, the Company's marketable securities were classified as available-for-sale, which are carried at fair value, with unrealized gains and losses reported as other comprehensive income within the stockholders' equity section of the accompanying balance sheets, net of the related tax effect. The cost of marketable equity securities sold is determined on a specific identification basis. The fair value of marketable equity securities is based on quoted market prices.

Software Development Costs

The Company capitalizes the costs of developing and testing new or significantly enhanced software products in accordance with the provisions of SFAS No. 86 *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*. Under SFAS No. 86, all costs incurred to establish technological feasibility of a computer product are charged to operations as incurred. After technological feasibility is established, costs of developing the computer software product are capitalized until the product is available for general release to customers. The Company capitalized \$624,948 and \$576,540 of software development costs during the years ended December 31, 2004 and 2003, respectively. Capitalized software development costs are amortized by the straight-line method over a period of seven years. The amount, by which unamortized software costs exceed the net realizable value, if any, is recognized in the period the excess is determined. Amortization of capitalized software charged to expense was \$335,952 and \$262,588 for the years ending December 31, 2004 and 2003, respectively.

Impairment of Long-Lived Assets

The Company reviews its long-lived assets and certain identifiable intangibles for impairment when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amounts of an asset to future net cash flows expected to be generated by the asset. If such assets are considered impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds the fair value of the assets based on estimated future cash flows. During the years ended December 31, 2004 and 2003, the Company recorded no impairment charges.

Revenue Recognition

The Company's revenue recognition policies are in accordance with Statement of Position ("SOP") 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions*, Staff Accounting Bulletin ("SAB") No. 104, *Revenue Recognition*, and Emerging Issues Task Force ("EITF") No. 00-21, *Revenue Arrangement with Multiple Deliverables*.

The Company recognizes revenue from the licensing of software when persuasive evidence of an arrangement exists, the product has been delivered, the fee is fixed and determinable, and collection of the resulting receivable is reasonably assured.

Maintenance agreements are renewable on an annual basis, include rights to upgrades, when and if available, telephone support, updates, enhancements (when not separately priced and marketed), and bug fixes. Maintenance fees are charged in the initial licensing year and for renewals of annual maintenance in subsequent years. Revenue is recognized for maintenance ratably over the contract term.

Other recurring revenue services are offered on a subscription-basis. Subscription-based revenues are recognized ratably over the term of the agreement.

Professional services including implementation, data conversion, integration, custom report writing and training are generally billed based on hourly rates together with reimbursement for travel and accommodation expenses. Professional services offered are not essential to the functionality of the software sold.

Inflation

We do not believe that inflation has materially affected our results of operations.

Results of Operations

Revenues

Our net revenues include four components: software licensing fees, maintenance, professional services, and hardware. Our net revenues for the year ended December 31, 2004 increased 27.4% to \$2,661,370 compared with net revenues of \$2,088,950 for the year ended December 31, 2003. Our overall revenues were primarily affected by higher hardware sales during 2004.

Software. Software sales for the year ended December 31, 2004 decreased 2.1% to \$360,746 compared with software sales of \$368,615 in 2003.

Maintenance. Maintenance revenue for the year ended December 31, 2004 increased 4.8% to \$1,029,131 compared with maintenance revenue of \$981,874 in 2003. The increase in maintenance revenue was related to the higher number of customers from software sales.

Professional services. Professional service revenue for the year ended December 31, 2004 increased 15.7% to \$180,234 compared with professional services revenue of \$155,776 in 2003. Professional services increased during 2004 because of higher training and system conversion services related to software sales.

Hardware. Hardware sales for the year ended December 31, 2004 increased 87.3% to \$1,091,259 compared with hardware sales of \$582,685 in 2003. Hardware sales increased dramatically during 2004 because of three transactions with our larger customers that expanded operations during a period of rising petroleum prices. We cannot determine with any certainty whether demand for hardware will remain strong.

Cost of Revenues

Our cost of revenues includes four components: cost of software, cost of maintenance revenue, cost of professional services, and cost of hardware sales. Our cost of revenues for the year ended December 31, 2004 increased 64.3% to \$1,235,370 compared with cost of revenues of \$752,082 in 2003. Cost of revenues as a percentage of net revenues increased to 46.4% for the year ended December 31, 2004 from 36.0% in 2003. The increase in cost of revenues was impacted by the higher volume of hardware sales.

Cost of software. Cost of software increased 11.7% to \$109,117 for the year ended December 31, 2004 from \$97,664 in 2003. Cost of software as a percentage of the related revenues increased to 30.2% for the year ended December 31, 2004 compared to 26.5% in 2003. The increase in cost of software was related to an increase in commissions on higher software sales during the third quarter offset by a decrease in royalty costs under an expired royalty contract.

Cost of maintenance. Cost of maintenance revenue decreased 14.7% to \$152,309 for the year ended December 31, 2004 from \$178,456 in 2003. Cost of maintenance revenue as a percentage of the related revenue decreased to 14.8% for the year ended December 31, 2004, compared to 18.2% for the same period last year. The

decreases in cost of maintenance and percentages of cost of maintenance as a percentage of the related revenues are due to reductions in personnel costs providing maintenance support.

Cost of professional services. Cost of professional services increased 64.6% to \$63,252 for the year ended December 31, 2004, compared with \$38,423 in 2003. Cost of professional services as a percentage of the related revenue increased to 35.1% for the year ended December 31, 2004, compared to 24.7% in 2003. The increase in cost of professional services was related to increases in demand for training and systems conversions services.

Hardware. Cost of hardware sold increased 108.1% to \$910,692 for year ended December 31, 2004, compared with \$437,539 in 2003. Cost of hardware as a percentage of the related revenue increased to 83.5% for the year ended December 31, 2004, compared with 75.1% in 2003. The increase in cost of hardware is directly related to higher hardware sales. The increase in percentage of cost of hardware is attributable to lower margins on larger product sales.

Operating Expenses

Sales and Marketing. Our sales and marketing expenses for the year ended December 31, 2004 decreased 30.8% to \$159,903 compared with \$231,029 in 2003. Sales and marketing expenses as a percentage of net revenues decreased to 6.0% for the year ended December 31, 2004 from 11.1% in 2003. The decrease in sales and marketing was due to an increased marketing effort completed during 2003.

General and Administrative. Our general and administrative expenses for the year ended December 31, 2004 increased 7.3% to \$459,466 compared with general and administrative expenses of \$428,371 in 2003. General and administrative expenses as a percentage of net revenues decreased to 17.3% for the year ended December 31, 2004, compared with 20.5% in 2003.

Investment Income. Investment income was \$12,493 for the year ended December 31, 2004 compared to \$3,980 in 2003. The increase in investment income was due to restructuring of investment assets into higher yielding bond mutual funds and exchange traded equity index funds during 2004 and higher invested balances.

Loss on investments. Loss on investments of \$2,271 includes a realized loss on the sale in 2004 of an investment in a mutual fund investing in variable rate mortgages.

Interest Expense. Interest expense was \$5,524 for the year ended December 31, 2004, compared to \$2,197 in 2003. The increase is due to higher amounts of debt outstanding during 2004 related to the addition of equipment to expand our ASP hosting capability.

Provision for Income Taxes. For the year ended December 31, 2004, we recorded a deferred tax provision on income before income taxes of \$98,681 compared to \$84,678 in 2003. The increase in deferred tax expense is directly attributable to the increase in income before income tax.

Liquidity and Capital Resources

Our cash and cash equivalents and marketable securities at December 31, 2004 were \$617,909 compared with \$492,737 at December 31, 2003.

Cash flows from Operating Activities

Our cash flows from operating activities represent the most significant source of funding for our operations. Operating activities provided \$853,052 and \$759,210 in 2004 and 2003, respectively. Our cash provided by operating activities was impacted primarily by an increase in hardware sales during 2004.

Our accounts receivable balance increased to \$145,770 in 2004 from \$129,104 at the end of 2003 primarily due to higher hardware sales and maintenance revenue.

The major use of our operating cash is to fund obligations that flow through our accounts payable and accrued liabilities, such as funding of payroll and related benefits, rent, facilities costs, insurance, professional fees and other costs incurred in our normal operations.

We expect cash provided by operating activities to remain relatively stable in future periods due primarily to the stability of our recurring maintenance revenues, but will be impacted by fluctuations in software and hardware sales.

Cash Flows from Investing Activities

Net cash used in investing activities in 2004 of \$1,033,341 consisted of software development costs of \$624,948, equipment purchases of \$97,467, and net marketable securities we purchased of \$310,926.

Net cash used in investing activities in 2003 of \$681,412 consisted of \$576,540 in software development costs and \$104,872 primarily in computer equipment additions.

Cash Flows from Financing Activities

Net cash used in financing activities in 2004 was \$21,302 was for principal payments on capital lease obligations and notes payable.

Net cash provided by financing activities in 2003 of \$19,683 reflected the issuance of a note to purchase an automobile offset by reductions in payments on that note of \$17,331.

At December 31, 2004, we had \$321,491 in working capital, up from \$262,232 at December 31, 2003. We currently have no significant capital commitments other than commitments under our capital lease obligations, note payment, and operating leases.

Based upon our past performance and current expectations, we believe that our cash and cash equivalents, marketable securities and cash generated from operations will be sufficient to satisfy our working capital needs, capital expenditures, investment requirements and financing activities for at least the next twelve months.

Recent Accounting Pronouncements

In December 2003, the Financial Accounting Standards Board ("FASB") issued interpretation 46R ("FIN 46R"), a revision to interpretation 46 ("FIN 46"), *Consolidation of Variable Interest Entities*. FIN 46R clarifies some of the provisions of FIN 46 and exempts certain entities from its requirements. FIN 46R is effective at the end of the first interim period after March 15, 2004. Entities that have adopted FIN 46 prior to this effective date can continue to apply the provisions of FIN 46 until the effect date of 46R or elect early adoption of FIN 46R. The Company believes that it has no such variable interest entities and, as a result, FIN 46 and FIN 46R did not have an impact on the Company's financial statements.

In March 2004, the FASB ratified the recognition and measurement guidance and certain disclosure requirements for impaired securities as described in Emerging Issues Task Form (EITF) Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The Company does not believe the adoption of the recognition and measurement guidance in EITF Issue 03-1 will have a material impact on the Company's financial statements.

In December 2004, the FASB issued SFAS 123R, *Share-Based Payment*, which is a revision of SFAS 123 *Accounting for Stock-Based Compensation* and supersedes APB Opinion 25, *Accounting for Stock Issued to Employees*. SFAS 123R focuses primarily on share-based payments for employee services, requiring these payments to be recorded using a fair-value-based method. The use of APB 25's intrinsic value method of accounting for employee stock options has been eliminated. As a result, the fair value of stock options granted to employees in the future will be required to be expensed. The impact on the results of operations of the Company will be dependent on the

number of options granted and the fair value of those options. For the Company, FASB 123R will be effective in 2006.

Item 7. Financial Statements

Avatar Systems, Inc. Index to Financial Statements

Report of Independent Registered Public Accounting Firm	F-1
Report of Independent Registered Public Accounting Firm	F-2
Financial Statements	
Balance Sheets as of December 31, 2004 and 2003	F-3
Statements of Income for the years ended December 31, 2004 and 2003	F-4
Statements of Stockholders' Equity for the years ended December 31, 2004 and 2003	F-5
Statements of Cash Flows for the years ended December 31, 2004 and 2003	F-6
Notes to Financial Statements	F-7 to F-16

Financial Statements and Reports of Independent Registered Public Accounting Firms

Avatar Systems, Inc.

December 31, 2004 and 2003

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders
Avatar Systems, Inc.

We have audited the accompanying balance sheet of Avatar Systems, Inc. as of December 31, 2004 and the related statements of income, changes in stockholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Avatar Systems, Inc. at December 31, 2004 and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ Whitley Penn

Dallas, Texas
February 4, 2005

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders
Avatar Systems, Inc.

We have audited the accompanying balance sheet of Avatar Systems, Inc. as of December 31, 2003 and the related statement of income, changes in stockholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Avatar Systems, Inc. as of December 31, 2003 and the results of operations and cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

HEIN & ASSOCIATES LLP

Dallas, Texas
March 8, 2004

Avatar Systems, Inc.
BALANCE SHEETS

	December 31,	
	2004	2003
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 291,146	\$ 492,737
Marketable securities	326,763	-
Accounts receivable, net of allowance of \$14,368 and \$4,106, respectively	145,770	129,104
Prepaid expense	15,303	7,340
Deferred income taxes	11,101	12,340
Total current assets	790,083	641,521
PROPERTY AND EQUIPMENT , net of accumulated depreciation of \$496,920 and \$401,125, respectively	263,247	183,385
PURCHASED SOFTWARE , net of accumulated amortization of \$769,791 and \$680,447, respectively	91,871	181,215
SOFTWARE DEVELOPMENT COSTS , net of accumulated amortization of \$982,953 and \$647,001, respectively	2,165,090	1,876,094
Total assets	\$ 3,310,291	\$ 2,882,215
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 72,028	\$ 56,275
Accrued expenses	93,618	50,690
Current maturities of long-term debt	7,280	6,996
Current maturities of capital lease obligations	24,938	-
Deferred revenue	270,728	265,328
Total current liabilities	468,592	379,289
DEFERRED INCOME TAXES	338,802	235,203
LONG-TERM DEBT		
Long-term debt	18,839	26,120
Long-term capital lease obligations	38,947	-
Total long-term debt	57,786	26,120
Total liabilities	865,180	640,612
COMMITMENTS AND CONTINGENCIES	-	-
STOCKHOLDERS' EQUITY		
Preferred stock, \$0.001 par value, 10,000,000 shares authorized; none issued	-	-
Common stock, \$0.001 par value; 30,000,000 shares authorized; 8,838,152 and 8,695,652, shares issued and outstanding, respectively	8,839	8,696
Paid-in capital	1,768,202	1,768,345
Retained earnings	656,119	464,562
Accumulated other comprehensive income	11,951	-
Total stockholders' equity	2,445,111	2,241,603
Total liabilities and stockholders' equity	\$ 3,310,291	\$ 2,882,215

See accompanying notes to financial statements.

Avatar Systems, Inc.
STATEMENTS OF INCOME

	Year ended December 31,	
	2004	2003
Revenue:		
Software	\$ 360,746	\$ 368,615
Maintenance	1,029,131	981,874
Consulting	180,234	155,776
Hardware	1,091,259	582,685
Total revenues	2,661,370	2,088,950
Cost of Sales:		
Software	109,117	97,664
Maintenance	152,309	178,456
Consulting	63,252	38,423
Hardware	910,692	437,539
	1,235,370	752,082
Gross profit	1,426,000	1,336,868
Operating Expenses:		
Sales and Marketing	159,903	231,029
General and administrative	459,466	428,371
Depreciation and amortization	521,091	430,199
	1,140,460	1,089,599
Operating income	285,540	247,269
Other income (expense):		
Investment income	12,493	3,980
Loss on investments	(2,271)	-
Interest expense	(5,524)	(2,197)
	4,698	1,783
Income before income taxes	290,238	249,052
Deferred income tax expense	98,681	84,678
NET INCOME	\$ 191,557	\$ 164,374
Net income per share - basic and diluted	\$ 0.02	\$ 0.02
Weighted average common shares outstanding - basic and diluted	8,790,652	8,695,652

See accompanying notes to financial statements.

Avatar Systems, Inc.
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

Years ended December 31, 2004 and 2003

	Common stock		Paid-in capital	Retained earnings	Accumulated other	Total
	Shares	Amount			Comprehensive Income (Loss)	
Balance at January 1, 2003	8,695,652	\$ 8,696	\$ 1,768,345	\$ 300,188	\$ -	\$ 2,077,229
Net income	-	-	-	164,374	-	164,374
Balance at December 31, 2003	8,695,652	8,696	1,768,345	464,562	-	2,241,603
Exchange of 5,700,000 common stock warrants with an exercise price of \$1 expiring in July 2005 for 142,500 shares of common stock	142,500	143	(143)	-	-	-
Change in unrealized gain on available-for-sale investments, net of tax	-	-	-	-	11,951	11,951
Net income	-	-	-	191,557	-	191,557
Balance at December 31, 2004	<u>8,838,152</u>	<u>\$ 8,839</u>	<u>\$ 1,768,202</u>	<u>\$ 656,119</u>	<u>\$ 11,951</u>	<u>\$ 2,445,111</u>

See accompanying notes to financial statements.

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Avatar Systems, Inc.
STATEMENTS OF CASH FLOWS

	Year ended December 31,	
	2004	2003
Cash flows from operating activities		
Net income	\$ 191,557	\$ 164,374
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	521,091	430,199
Loss on investments	2,271	-
Deferred income taxes	98,681	84,678
Changes in operating assets and liabilities		
Accounts receivable	(16,666)	69,998
Prepaid expenses	(7,963)	263
Accounts payable	15,753	(19,662)
Accrued expenses	42,928	(952)
Deferred revenue	5,400	30,312
Net cash provided by operating activities	853,052	759,210
Cash flows from investing activities		
Software development costs capitalized	(624,948)	(576,540)
Purchase of property and equipment	(97,467)	(104,872)
Purchases of marketable securities	(512,215)	-
Sales of marketable securities	201,289	-
Net cash used in investing activities	(1,033,341)	(681,412)
Cash flows from financing activities		
Principal payments on capital lease obligations	(14,305)	-
Proceeds from long-term debt	-	37,014
Principal payments on long-term debt	(6,997)	(17,331)
Net cash provided by (used in) financing activities	(21,302)	19,683
Net increase (decrease) in cash and cash equivalents	(201,591)	97,481
Cash and equivalents at beginning of year	492,737	395,256
Cash and cash equivalents at end of year	\$ 291,146	\$ 492,737
Supplemental disclosure of cash paid for:		
Interest	\$ 5,524	\$ 2,197
Supplemental disclosure of noncash investing and financing activities:		
Purchase of equipment with capital lease	\$ 78,190	\$ -
Issuance of capital stock in exchange for outstanding warrants to purchase common stock	\$ 143	\$ -
Change in unrealized gain on marketable securities	\$ 18,108	\$ -

See accompanying notes to financial statements.

Avatar Systems, Inc.

NOTES TO FINANCIAL STATEMENTS

December 31, 2004 and 2003

NOTE A – ORGANIZATION AND SUMMARY OF ACCOUNTING POLICIES

Nature of Business

Avatar Systems, Inc. and its predecessor, Avatar Systems, Ltd. (collectively, the “Company”) was formed in 1996 to provide Enterprise Resource Planning (ERP) accounting software to small to medium-sized oil and gas producers located throughout the United States.

Use of Estimates and Certain Significant Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant assumptions and estimates are required in the capitalization and amortization of software development costs. It is at least reasonably possible those estimates could be revised in the near term and those revisions could be material.

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of trade accounts receivable. Products are sold to customers located principally in the United States. The Company continually evaluates the creditworthiness of its customers' financial condition and generally does not require collateral. The Company evaluates the collectability of its accounts receivable based on a combination of factors. In circumstances where the Company is aware of a specific customer's inability to meet its financial obligations, the Company records a specific reserve for bad debts against amounts due. The Company has not experienced significant losses on uncollectible accounts receivable.

Fair Value of Financial Instruments

In accordance with the reporting requirements of Statement of Financial Accounting Standards (“SFAS”) No. 107, *Disclosures About Fair Value of Financial Instruments*, the Company calculates the fair value of its assets and liabilities which qualify as financial instruments under this statement and includes this additional information in the notes to financial statements when the fair value is different than the carrying value of these financial instruments. The estimated fair value of accounts receivable, accounts payable and accrued liabilities approximate their carrying amounts due to the relatively short maturity of these instruments. The carrying value of short and long-term debt also approximates fair value since these instruments bear market rates of interest. None of these instruments are held for trading purposes.

Cash Equivalents

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. The Company maintains deposits primarily in one financial institution, which may at times exceed amounts covered by insurance provided by the U.S. Federal Deposit Insurance Corporation (“FDIC”). At December 31, 2004 and 2003, the uninsured portion of these deposits was approximately \$224,000 and \$105,000, respectively. The Company has not incurred any losses related to its cash on deposit with financial institutions.

Avatar Systems, Inc.

NOTES TO FINANCIAL STATEMENTS

December 31, 2004 and 2003

Marketable Securities

Marketable securities at December 31, 2004, consisted of corporate equities in exchange traded index funds and corporate bond mutual funds. SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, requires certain investments be recorded at fair value or amortized cost. The appropriate classification of the investments in marketable equity is determined at the time of purchase and re-evaluated at each balance sheet date. As of December 31, 2004, the Company's marketable securities were classified as available-for-sale, which are carried at fair value, with unrealized gains and losses reported as other comprehensive income within the stockholders' equity section of the accompanying balance sheet, net of the related tax effect. The cost of marketable equity securities sold is determined on a specific identification basis. The fair value of marketable equity securities is based on quoted market prices.

Software Development Costs

The Company capitalizes the costs of developing and testing new or significantly enhanced software products in accordance with the provisions of SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed*. Under SFAS No. 86, all costs incurred to establish technological feasibility of a computer product are charged to operations as incurred. After technological feasibility is established, costs of developing the computer software product are capitalized until the product is available for general release to customers. The Company capitalized \$624,948 and \$576,540 of software development costs during the years ended December 31, 2004 and 2003, respectively. Capitalized software development costs are amortized using the greater of the amount computed by the ratio of current year net revenue to estimated future net revenue of the product, or the amount computed by the straight-line method over a period which approximates the estimated economic life of the products, which historically has been seven years. The amount, by which unamortized software costs exceed the net realizable value, if any, is recognized in the period the excess is determined. Amortization of capitalized software charged to expense was \$335,952 and \$262,588 for the years ending December 31, 2004 and 2003, respectively.

Property and Equipment

Property and equipment are recorded at cost. Expenditures for maintenance and repairs are expensed as incurred. Depreciation of property and equipment is provided primarily on the straight-line method over the estimated useful lives ranging from three to seven years. Amortization of leasehold improvements is provided on the straight-line method over the shorter of the useful lives of the assets or the terms of the corresponding leases.

Impairment of Long-Lived Assets

The Company reviews its long-lived assets and certain identifiable intangibles for impairment when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amounts of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds the fair value of the assets based on estimated future cash flows. During the years ended December 31, 2004 and 2003, the Company recorded no impairment charges.

Avatar Systems, Inc.

NOTES TO FINANCIAL STATEMENTS

December 31, 2004 and 2003

Revenue Recognition

The Company's revenue recognition policies are in accordance with Statement of Position ("SOP") 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions*, Staff Accounting Bulletin ("SAB") No. 104, *Revenue Recognition*, and Emerging Issues Task Force ("EITF") No. 00-21, *Revenue Arrangement with Multiple Deliverables*.

The Company recognizes revenue from the licensing of software when persuasive evidence of an arrangement exists, the product has been delivered, the fee is fixed and determinable, and collection of the resulting receivable is reasonably assured.

Maintenance agreements are renewable on an annual basis, include rights to upgrades, when and if available, telephone support, updates, enhancements (when not separately priced and marketed), and bug fixes. Maintenance fees are charged in the initial licensing year and for renewals of annual maintenance in subsequent years. Revenue is recognized for maintenance ratably over the contract term.

Other recurring revenue services are offered on a subscription-basis. Subscription-based revenues are recognized ratably over the term of the agreement.

Professional services including implementation, data conversion, integration, custom report writing and training are generally billed based on hourly rates together with reimbursement for travel and accommodation expenses. Professional services offered are not essential to the functionality of the software sold.

Stock-based Compensation

The Company accounts for stock-based awards to employees using the intrinsic value method described in Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees* and its related interpretations. Accordingly, no compensation expense has been recognized in the accompanying financial statements for stock-based awards to employees when the exercise price of the award is equal to or greater than the quoted market price of the stock on the date of the grant. SFAS No. 123, *Accounting for Stock-Based Compensation* and SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure - an amendment of FASB Statement No. 123*, require disclosures as if the Company had applied the fair value method to employee awards rather than the intrinsic value method. The fair value of stock-based awards to employees is calculated using option pricing models, which were developed for estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. These models also require subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values. There were no options granted in 2004 or 2003. All the options were vested as of January 1, 2003.

Income Taxes

Deferred income taxes are determined using the liability method in accordance with SFAS No. 109, *Accounting for Income Taxes*. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. In addition, a valuation allowance is established to reduce any deferred tax asset for which it is determined that it is more likely than not that some portion of the deferred tax asset will not be realized.

Avatar Systems, Inc.

NOTES TO FINANCIAL STATEMENTS

December 31, 2004 and 2003

Comprehensive Income

The Company reports comprehensive income in accordance with the provisions of SFAS No. 130, *Reporting Comprehensive Income*. Comprehensive income consists of net income and unrealized gains (losses) on available-for-sale marketable securities, net of the related tax effect, and is presented in the statements of changes in stockholders' equity.

Earnings Per Share

The Company computes earnings per share in accordance with SFAS No. 128, *Earnings Per Share*. SFAS No. 128 provides for the calculation of basic and diluted earnings per share. Basic earnings per share includes no dilution and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflect the potential dilution of securities that could share in the earnings of the Company. The impact of dilutive stock options does not change earnings per share, therefore basic and diluted earnings per share are the same. At December 31, 2004 and 2003, the Company had 56,808 and 5,773,152, respectively, potentially dilutive securities that were not included in the earnings per share calculation because they were antidilutive.

Recent Accounting Pronouncements

In December 2003, the Financial Accounting Standards Board ("FASB") issued interpretation 46R ("FIN 46R"), a revision to interpretation 46 ("FIN 46"), *Consolidation of Variable Interest Entities*. FIN 46R clarifies some of the provisions of FIN 46 and exempts certain entities from its requirements. FIN 46R is effective at the end of the first interim period after March 15, 2004. Entities that have adopted FIN 46 prior to this effective date can continue to apply the provisions of FIN 46 until the effect date of 46R or elect early adoption of FIN 46R. The Company believes that it has no such variable interest entities and, as a result, FIN 46 and FIN 46R did not have an impact on the Company's financial statements.

In March 2004, the FASB ratified the recognition and measurement guidance and certain disclosure requirements for impaired securities as described in Emerging Issues Task Force (EITF) Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The Company does not believe the adoption of the recognition and measurement guidance in EITF Issue 03-1 will have a material impact on the Company's financial statements.

In December 2004, the FASB issued SFAS 123R, *Share-Based Payment*, which is a revision of SFAS 123 *Accounting for Stock-Based Compensation* and supersedes APB Opinion 25, *Accounting for Stock Issued to Employees*. SFAS 123R focuses primarily on share-based payments for employee services, requiring these payments to be recorded using a fair-value-based method. The use of APB 25's intrinsic value method of accounting for employee stock options has been eliminated. As a result, the fair value of stock options granted to employees in the future will be required to be expensed. The impact on the results of operations of the Company will be dependent on the number of options granted and the fair value of those options. FASB 123R will be effective in 2006 for the Company.

Reclassifications

Certain amounts in the December 31, 2003 financial statements have been reclassified to conform with the December 31, 2004 presentations.

Avatar Systems, Inc.

NOTES TO FINANCIAL STATEMENTS

December 31, 2004 and 2003

NOTE B – MARKETABLE SECURITIES

At December 31, 2004, marketable securities are summarized as follows:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Aggregate Fair Value
Corporate equities exchange traded index fund	\$ 99,987	\$ 14,463	\$ -	\$ 114,450
Corporate bond mutual fund one to three year maturities	104,079	-	1,386	102,693
Corporate bond mutual fund intermediate maturities	104,589	5,031	-	109,620
	<u>\$ 308,655</u>	<u>\$ 19,494</u>	<u>\$ 1,386</u>	<u>\$ 326,763</u>

The Company's marketable securities are classified as available-for-sale. Management has the ability and intent, if necessary, to liquidate any of these investments in order to meet liquidity needs with the normal operating cycle. Accordingly, all marketable securities are classified as current assets. Gross realized losses on the sales of marketable securities were \$2,271 in 2004.

NOTE C – PROPERTY AND EQUIPMENT

Property and equipment are summarized as follows:

	December 31,	
	2004	2003
Furniture and fixtures	\$ 110,439	\$ 110,439
Computer equipment and software	515,921	418,454
Transportation	37,014	37,014
Telecommunication equipment	18,603	18,603
Assets under capital lease	78,190	-
	<u>760,167</u>	<u>584,510</u>
Less accumulated depreciation	496,920	401,125
Property and equipment, net	<u>\$ 263,247</u>	<u>\$ 183,385</u>

During the years ended December 31, 2004 and 2003, the Company recorded depreciation expense of \$95,795 and \$55,767, respectively. Depreciation expense in 2004 also included the depreciation expense on assets recorded under capital leases.

Avatar Systems, Inc.

NOTES TO FINANCIAL STATEMENTS

December 31, 2004 and 2003

NOTE D – PURCHASED SOFTWARE

Purchased software is summarized as follows:

	December 31,	
	2004	2003
Purchased software	\$ 861,662	\$ 861,662
Less accumulated amortization	769,791	680,447
Purchased software, net	<u>\$ 91,871</u>	<u>\$ 181,215</u>

Purchased software is recorded at cost. Amortization of purchased software is provided on the straight-line method over 7 years. During the years ended December 31, 2004 and 2003, the Company recorded amortization expense of \$89,344 and \$111,844, respectively.

As of December 31, 2004, future purchased software amortization expense for each calendar year ended December 31 is: \$89,344 for 2005 and \$2,527 in 2006.

NOTE E – SOFTWARE DEVELOPMENT COSTS

Software development costs are summarized as follows:

	December 31,	
	2004	2003
Software development costs	\$ 3,148,043	\$ 2,523,095
Less accumulated amortization	982,953	647,001
Software development costs, net	<u>\$ 2,165,090</u>	<u>\$ 1,876,094</u>

Software development costs are recorded at cost. Amortization of software development costs are provided on the straight-line method over 7 years. During the years ended December 31, 2004 and 2003, the Company recorded amortization expense of \$335,952 and \$262,588, respectively.

Software development costs in process at December 31, 2004 and 2003 were \$417,197 and \$550,612, respectively.

As of December 31, 2004, developed software amortization expense for each calendar year ended December 31 is: \$390,119 for 2005; \$390,119 for 2006; \$324,846 for 2007; \$245,647 for 2008; \$189,225 in 2009; and \$625,134, thereafter.

Avatar Systems, Inc.

NOTES TO FINANCIAL STATEMENTS

December 31, 2004 and 2003

NOTE F - LONG-TERM DEBT

At December 31, 2004 and 2003 long-term debt consisted of a note payable to GMAC, collateralized by an automobile, bearing interest at 0.0% per annum, payable in sixty monthly principal payments of \$683, beginning in June 2003 through maturity in May 2008.

	December 31,	
	2004	2003
Current portion of long-term debt	\$ 7,280	\$ 6,996
Long-term debt	18,839	26,120
	\$ 26,119	\$ 33,116

Future long-term debt obligations in effect at December 31, 2004 were as follows:

	Year ending December 31,
2005	\$ 7,280
2006	7,576
2007	7,884
2008	3,379
	\$ 26,119

NOTE G – CAPITAL LEASE OBLIGATIONS

During 2004, the Company entered into various capital lease arrangements for computer equipment used in our ASP hosting facility in the aggregate amount of \$78,190. The agreements require monthly payments of principal and interest of approximately \$2,500 at interest rates ranging from 8% to 12% and mature thirty-six months from the date of the lease in 2007.

	December 31,	
	2004	2003
Current portion of capital lease obligations	\$ 24,938	\$ -
Long-term portion of capital lease obligations	38,947	-
	\$ 63,885	\$ -

Future minimum capital lease obligations in effect at December 31, 2004 were as follows:

	Year ending December 31,
2005	\$ 24,938
2006	27,584
2007	11,363
	\$ 63,885

Avatar Systems, Inc.

NOTES TO FINANCIAL STATEMENTS

December 31, 2004 and 2003

NOTE H – LEASE OBLIGATIONS

The Company leases office facilities under three non-cancelable operating leases. Future minimum payments are \$112,991 for the year ending December 31, 2005 and none thereafter.

Rent expense under the operating leases was \$152,486 and \$154,613 for the years ended December 31, 2004 and 2003, respectively.

NOTE I – INCOME TAXES

The Company's income tax expense in 2004 and 2003 consisted only of deferred taxes. The Company had no current income tax expense primarily because software development costs are charged to expense for federal income tax purposes and capitalized for financial reporting purposes.

Deferred tax assets and liabilities consist of the following:

	December 31,	
	2004	2003
Deferred tax assets		
Net operating loss carryforwards	\$ 100,242	\$ 82,291
Purchased software amortization	85,145	74,299
Accrued expenses	17,258	12,340
	202,645	168,930
Deferred tax liabilities		
Capitalized software	462,682	364,424
Property and equipment	61,507	27,369
Unrealized gain on marketable securities	6,157	-
	530,346	391,793
Net deferred tax liability	\$ (327,701)	\$ (222,863)
Net deferred tax asset - current	11,101	12,340
Net deferred tax liability - long term	(338,802)	(235,203)
	\$ (327,701)	\$ (222,863)

At December 31, 2004, the Company had federal net operating loss carryforwards of approximately \$295,000, which begin to expire in 2022.

Avatar Systems, Inc.

NOTES TO FINANCIAL STATEMENTS

December 31, 2004 and 2003

NOTE J - RELATED PARTIES

The Company sells computer hardware and provides software maintenance, training, and consulting/development services to a company that is controlled by two members of the Company's Board of Directors. Total revenues from that company were \$22,060 and \$211,697 in 2004 and 2003, respectively. Revenues for 2003 included a hardware sale of \$188,532. The Company had \$1,861 of accounts receivable at December 31, 2004 and 2003, respectively, related to services performed for that company.

In connection with the issuance of 1,600,000 shares of common stock on July 10, 2000 to London & Boston Investments, PLC, the company issued 5,700,000 warrants at \$1.00 per share expiring in July 2005 to London & Boston, the Company's President/CEO, and certain members of the board of directors. On December 10, 2004, the Company completed the exchange of 142,500 of its common shares for the 5,700,000 outstanding warrants with London & Boston Investment, PLC, the Company's President/CEO, and certain members of the board of directors. The exchange of the warrants for common stock was deemed to be at the same market value. The exchange was essentially a reversal of the warrants issued on July 10, 2000. Therefore, the transaction was recorded as a reduction of paid in capital recorded at the inception of the transaction and no expense was recognized in the income statement for the exchange.

NOTE K – MAJOR CUSTOMERS

The Company completed a hardware sale with one customer during 2004 for \$739,826 and another customer during 2003 for \$188,532. Total revenues from those customers were \$773,457 in 2004 and \$211,697 in 2003 accounting for 29% and 10% of total revenues, respectively. The Company completed hardware sales with three customers during 2004 for \$941,329, which accounted for 86% of hardware revenue and 35% of total revenue for the year ended December 31, 2004. The Company had a one customer in 2003 that accounted for more than 10% of revenues.

NOTE L - EMPLOYEE RETIREMENT PLAN

The Company sponsors an IRC 401(k) Profit Sharing Plan (the "Plan"), which covers all the Company's employees. The Plan allows the employees to contribute up to the maximum amount allowed by law, with the Company making a matching contribution of 3% of the employee's salary. Expenses related to matching contributions to the Plan were \$17,445 and \$22,012 for the years ended December 31, 2004 and 2003, respectively.

Avatar Systems, Inc.

NOTES TO FINANCIAL STATEMENTS

December 31, 2004 and 2003

NOTE M - STOCK COMPENSATION PLAN AND WARRANTS

In 2000, the Company's shareholders approved the adoption of a stock compensation plan. Stock options are granted at the quoted market price of the Company's stock at the date of grant, becoming exercisable over periods of up to three years and expire ten years from the date of grant. No stock options were granted by the Company during the years ended December 31, 2004 or 2003. At December 31, 2004, 1,443,192 shares of common stock were reserved for future grant under the 2000 Stock Compensation Plan.

Option activity for the years ended December 31, 2004 and 2003 is summarized as follows:

	2004		2003	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Options outstanding at beginning of year	73,152	\$ 1.25	89,496	\$ 1.25
Options granted	-	-	-	-
Options exercised	-	-	-	-
Options forfeited	<u>(16,344)</u>	<u>1.25</u>	<u>(16,344)</u>	<u>1.25</u>
Options outstanding at end of year	<u>56,808</u>	<u>\$ 1.25</u>	<u>73,152</u>	<u>\$ 1.25</u>
Options exercisable at end of year	<u>56,808</u>	<u>\$ 1.25</u>	<u>73,152</u>	<u>\$ 1.25</u>

The options outstanding at December 31, 2004 have a weighted average remaining life of 6 years with an exercise price of \$1.25 per share.

The Company's outstanding warrants to purchase 5,700,000 shares of common stock with an exercise price of \$1.00 per share and expiring in July 2005 were exchanged for 142,500 shares of common stock effective December 10, 2004. (See Note J)

Item 8. Changes In And Disagreements With Accountants On Accounting And Financial Disclosure

(a) On November 2, 2004, Hein & Associates LLP resigned as the Registrant's independent registered public accounting firm. On November 10, 2004, the Registrant engaged Whitley Penn as its independent registered public accounting firm for the fiscal year ending December 31, 2004.

(b) The reports of Hein & Associates LLP on the Registrant's financial statements for the fiscal years ended December 31, 2003 and 2002, contained no adverse opinion or disclaimer of opinion nor were they modified as to uncertainty, audit scope, or accounting principles.

(c) The Registrant's Board of Directors made the decision to engage Whitley Penn.

(d) In connection with the audits for the fiscal years ended December 31, 2003 and 2002, and during the interim period from December 31, 2003 to November 2, 2004, there were no disagreements with Hein & Associates LLP on any matter of accounting principles or practices, financial statement disclosure or auditing scope or procedures, which disagreements, if not resolved to the satisfaction of Hein & Associates LLP, would have caused it to make reference thereto in its reports.

(e) Neither, the Registrant, nor anyone acting on its behalf, consulted with Whitley Penn during the fiscal years ended December 31, 2003 and 2002, and during the interim period from December 31, 2003 to November 10, 2004 with regard to any matter concerning the application of accounting principles to any specific transactions, either completed or proposed, or the type of audit opinion that might be rendered with respect to the Registrant's financial statements, or any other matters or events set forth in Item 304(a)(2)(ii) of Regulation S-B.

Item 8a. 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 date of this report, the Chief Executive Officer/Chief Financial Officer conducted 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 as of the date of this report, 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.

Item 8b. Other Information

Not applicable.

PART III

Item 9. Directors And Executive Officers Of The Registrant; Compliance With Section 16(A) Of The Exchange Act

The following sets forth information concerning our officers and directors, including their ages, present principal occupations, other business experience during the last five years, memberships on committees of the board of directors and directorships in other publicly held companies.

Name	Age	Position with Avatar
Robert C. Shreve, Jr.	42	President, Chief Executive Officer, Chief Financial Officer, Chairman of the Board and Director
Charles Timothy Allen	54	Director
Allen D. Farris	53	Director
Stephen A. Komlosy	64	Director
John J. May	56	Director
Cindy Skelton	46	Secretary

Robert C. (Chuck) Shreve, Jr. was managing partner of Avatar Systems, Ltd. and an officer of Avatar Systems, Inc., the predecessors of our Company, from 1996 to November 2000. He has served as the President, Chief Executive Officer, Chief Financial Officer, Chairman of the Board and a director of our Company since November 14, 2000. He has over twenty years experience in accounting and financial management with emphasis in the oil and gas industry and the real estate development industry. Mr. Shreve also has technical certifications in the technology field and over eighteen years in PC-based network and IBM AS400 systems. Mr. Shreve received his BBA from the University of Texas of the Permian Basin, and attended graduate school at the University of Texas at Dallas. As a Certified Public Accountant, he is a member of the American Institute of CPAs, the Texas Society of CPAs and the Dallas Chapter of the Texas Society of CPAs.

Charles Timothy (Tim) Allen has served as a director of our Company since November 14, 2000. Mr. Allen was a limited partner of Avatar Systems, Ltd. and an officer of Avatar Systems, Inc., the predecessors of our Company, from 1996 to November 2000. Mr. Allen is the President of Eland Energy Corporation (“Eland”) located in Dallas, Texas and is responsible for the financial affairs of Eland. He has been employed by Eland since 1984 in various positions. He co-founded Eland with his brother, Orville Gregory Allen. He has been drilling and operating wells in Texas, Oklahoma, Louisiana and New Mexico for the past twenty years. Mr. Allen formed Allen Oil Company in 1979, where he was primarily involved in generating prospects for other companies. In 1982, Mr. Allen and three partners started drilling and operating wells in the North Texas area with the primary purpose of developing Mississippi reef wells using CDP seismic, which resulted in over 20 Mississippi reef discoveries in the area. Mr. Allen graduated from Texas Tech University with a BBA in management and a MBA in finance.

Stephen A. Komlosy has served as a director of our Company since November 14, 2000. He is also the Chairman of London & Boston Investments, PLC, formerly Cybertec Holdings PLC., a publicly traded United Kingdom company. Mr. Komlosy has served as Chairman of London & Boston Investments, PLC since February 2000. London & Boston Investments, PLC is an investment company, making strategic investments in companies whose growth and value can be enhanced by management consulting services, financial assistance or mergers with related businesses and public flotation’s. Mr. Komlosy currently resides in England. Since 1967, Mr. Komlosy has managed several family owned businesses, which are engaged in real estate acquisition and development activities. In 1981, he co-founded Branon PLC, a public industrial holding company selling bonded oil drilling and pipe handling equipment to North Sea oil operators; the large-scale manufacture of dump trucks for the Ministry of Defense; and of road planners and oil consoles. At Branon, he had specific responsibility for establishing its oil and gas purchasing associate Covendish Petroleum PLC that purchased 140 producing wells in Ohio, USA. Mr. Komlosy is also a director of Energy Technique, PLC, a company traded on the London Stock Exchange and Chairman of Netcentric Systems PLC that is traded on AIM in London.

John J. May is a Fellow of the Institute of Chartered Accountants. He is a director of The Small Business Bureau Ltd and The Genesis Initiative Ltd, with responsibility for policy. These companies lobby Government on business matters affecting small and medium-sized enterprises. He is also the senior partner of a boutique London based chartered accountancy practice specializing in SMEs. Currently he is director of the Aim listed Netcentric. Previously, he was finance director of MyVal.com PLC, now Interactivity PLC, whose shares are traded on AIM.

He was formerly a senior partner with the leading accountancy practice of Howarth Clark Whitehill, serving eight years on its managing board and for nine years being chairman of its Thames Valley offices. In his capacity as UK national marketing partner and head of its property consultancy arm, he was also a director of its UK and International Associations. He has also held Directorships in a number of diversified businesses both in the UK and internationally.

Allen D. Farris was appointed to the board of directors on September 24, 2004. Mr. Farris is currently the Chief Financial Officer of Eland Energy, Inc. and has held that position since December of 1999. Mr. Farris has thirty years of accounting and financial experience including financial reporting, treasury management, cash forecasting and budgeting, financial forecasting and modeling, computer system installation and maintenance, income tax planning, and maintaining banking relationships. His experience also includes both public and privately owned companies covering a broad range of industries at levels including Chief Financial Officer, Treasurer, Controller, and Tax Manager. Two specific areas of his expertise include all phases of the petroleum and real estate industries. Mr. Farris holds a Bachelor of Business Administration degree in Accounting from the University of Texas at Austin and a Master of Science degree in Accounting from Texas Tech University. He is a Certified Public Accountant and a member of the American Institute, Texas Society, and Dallas Chapter of CPAs, and a member of the Dallas Chapter of the Petroleum Accountants' Society.

Cindy Skelton currently serves as the Secretary of our Company and she manages the benefit plans and employee relations for us. She has served as our Secretary since November 27, 2000. Ms. Skelton is primarily employed by Eland and since 1986 has served as Eland's Accounting Manager and Controller. Since 1994, she has held the position of Director of Human Resources with Eland. She received a BBA degree from Texas Tech University in 1981. She will devote as much of her time as necessary to fulfill her duties as an officer of our Company.

Committees of the Board of Directors

The Company has an Audit Committee. The Company does not have a Compensation Committee or a Nominating Committee. In the absence of such committees, the Board as a whole establishes the compensation of officers of the Company, administers the 2000 Stock Compensation Plan, prepares recommendations to the Board on the adoption of stock option and other incentive plans, and grants stock options. The Board also considers individuals to recommend to the Board for inclusion among management's nominees and considers corporate governance issues. The Board will consider director candidates recommended by shareholders if the name and qualifications of candidates are timely presented to the Board.

Audit Committee

The Audit Committee's functions include evaluating, and recommending to the Board the engagement of the Company's registered independent public accounting firm, reviewing the results of their audit findings, and monitoring on a periodic basis the internal controls of the Company. The Audit Committee does not have a formally approved written charter. The Audit Committee currently consists of Charles Timothy Allen and Stephen A. Komlosy. The Audit Committee currently does not have a financial expert as defined under the Sarbanes-Oxley Act of 2002. The Audit Committee held three meetings during 2004.

Code of Ethics

The Company does not have a formally approved written code of ethics. The Company is in the process of drafting a code of ethics to be presented to the board for approval.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities and Exchange Act of 1934 requires the Company's officers and directors, and persons who own more than ten percent (10%) of a registered class of the Company's equity securities, to file certain reports regarding ownership of, and transactions in, the Company's securities, with the Securities and Exchange Commission. Such officers, directors and 10% stockholders are also required to furnish the Company with copies of all Section 16(a) forms that they file.

Based solely on the Company's review of copies of Forms 3, 4, 5, and amendments thereto furnished to the Company pursuant to Rule 16a-3(e), the Company believes that, during the year ended December 31, 2004, all Section 16(a) filing requirements applicable to the Company's officers, directors, and 10% stockholders were met.

Item 10. Executive Compensation

Executive Officers

Our Board appoints the executive officers to serve at the discretion of the Board until the next annual meeting of the Board of Directors. Robert C. Shreve, Jr. President, Chief Financial Officer and a director of the Company is the only officer to receive \$100,000 or more in annual compensation. Directors who are also employees receive no compensation for serving on the Board. Our non-employee directors receive no compensation for serving on the Board. We intend to reimburse non-employee directors for travel and other expenses incurred in connection with attending the Board meetings.

Employment Agreements

We have entered into a management agreement with Robert C. Shreve, Jr., our President and Chief Executive Officer and Chief Financial Officer, which terminates on July 10, 2005. The management agreement shall be automatically extended for an additional one-year period after the initial term unless at least 30 days prior to the termination date either Mr. Shreve or we give written notice to the other that the management agreement will not be renewed. Mr. Shreve will receive an annual base salary of \$125,000, which may be increased at the discretion of our Board. Additionally, Mr. Shreve may be eligible to receive an annual bonus based on our financial performance in the form of stock options and cash not to exceed 15% of his base salary. Upon agreeing to the terms of the management agreement, we issued to Mr. Shreve a five-year warrant to purchase 1.6 million shares of our common stock at an exercise price of \$1.00 per share. On December 10, 2004, Mr. Shreve's warrants were exchanged for 40,000 shares of the Company's common stock. See "Part III, Item 11- Security Ownership of Certain Beneficial Owners and Management."

Key Man Insurance

We currently pay an annual premium of \$2,118 for a life insurance policy for \$1,000,000 on the life of Robert C. Shreve, Jr., our President, Chief Executive Officer and Chief Financial Officer. The proceeds of the policy are payable to us.

Stock Option Plan

On November 14, 2000, our shareholders approved our 2000 Stock Compensation Plan. The number of shares of common stock which may be issued under the 2000 Plan shall initially be 400,000 shares which amount may, at the discretion of the Board, be increased from time to time to a number of shares of common stock equal to 5% of the total outstanding shares of common stock, provided that the aggregate number of shares of common stock which may be granted under the 2000 Plan shall not exceed 1,500,000 shares. We may also utilize the granting of options under the 2000 Plan to attract qualified individuals to become our employees and non-employee directors, as well as to ensure the retention of management of any acquired business operations. Under the 2000 Plan, we may also grant restricted stock awards. Restricted stock represents shares of common stock issued to eligible participants under the 2000 Plan subject to the satisfaction by the recipient of certain conditions and enumerated in the specific restricted stock grant. Conditions, which may be imposed, include, but are not limited to, specified periods of employment, attainment of personal performance standards or our overall financial performance. The granting of restricted stock represents an additional incentive for eligible participants under the 2000 Plan to promote our development and growth, and may be used by our management as another means of attracting and retaining qualified individuals to serve as our employees and directors. Currently, options to purchase 56,808 shares of our common stock at an exercise price of \$1.25 per share are outstanding to nine employees. Such options expire on January 10, 2011. No options have been granted to our officers or directors.

	(a)	(b)	(c)
Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities in column (a))
Equity compensation plans approved by security holders	56,808	1.25	1,443,192
Equity compensation plans not approved by security holders	-	-	-
Total	56,808	1.25	1,443,192

Compensation Table

The information set forth below concerns the cash and non-cash compensation to executive officers for each of the past three fiscal years ended December 31, 2004, 2003 and 2002. In each case, the compensation listed was paid by our Company. Except for Robert C. Shreve, Jr., our President, Chief Executive Officer, and Chief Financial Officer, no executive officer has an employment agreement with us and all executive officers serve at the discretion of the Board.

Summary Compensation Table

Name/Title	Annual Compensation			Long-Term Compensation Awards	
	Year	Salary/Bonus	Other Annual Compensation	Restricted Stock Awards	Securities Underlying Options/SARs/Warrants
Robert C. Shreve, Jr., President, Chief Executive Officer, Chief Financial Officer and Director	2004	\$125,000	\$7,211	None	None
	2003	\$125,000	\$7,211	None	None
	2002	\$125,000	\$5,208	None	None

Item 11. Security Ownership Of Certain Beneficial Owners And Management

The table below sets forth, as of March 14, 2005, certain information with respect to the beneficial ownership of the common stock of our Company by each person who we know to be a beneficial owner of more than 5% of any class or series of our capital stock, each of the directors and executive officers individually, and all directors and executive officers as a group.

Name(1)	Shares Beneficially Owned	Percentage of Shares Beneficially Owed
Robert C. Shreve, Jr.	1,641,200	18.6
Charles Timothy Allen.....	2,449,973	27.7
Orville Gregory Allen.....	2,406,250	27.2
London & Boston Investments, Plc.....	1,679,002	19.0
Stephen A. Komlosy (2).....	1,695,002	19.2
Allen D. Farris (3).....	-0-	-0-
Cindy Skelton(4).....	-0-	-0-
Officers and directors as a group (4 persons) (5)	8,192,425	92.7

- (1) Unless otherwise indicated, each person named in this table has sole voting and investment power with respect to the shares beneficially owned. In addition, unless otherwise indicated, the address of each beneficial owner identified above is c/o Avatar Systems, Inc., 5728 LBJ Freeway, Suite 270, Dallas, Texas 75240.

- (2) Includes 1,678,002 shares owned by London & Boston. Stephen A. Komlosy is the Managing Director of London & Boston and is authorized to vote such shares on behalf of London & Boston. Also includes 1,000 shares owned by General Trading Corporation, Ltd., a Komlosy family company. Mr. Komlosy has the authority to vote such shares on behalf of General Trading Company. Mr. Komlosy is a director of Avatar. Mr. Komlosy's address is 133 Ebury Street, London SW1W9QU, England.
- (3) Mr. Farris is a director of Avatar.
- (4) Ms. Skelton is the Secretary of Avatar.
- (5) See preceding notes for an explanation of the ownership of the 8,192,425 shares.

We currently have 8,838,152 outstanding shares of common stock of which approximately 646,000 shares are owned by approximately 450 persons. The remaining shares are owned by our principal shareholders as noted in the above table.

Item 12. Certain Relationships And Related Transactions

The Company sells computer hardware and provides software maintenance, training, and consulting/development services to a company that is controlled by two members of the Company's Board of Directors. Total revenues from that company were \$22,060 and \$211,697 in 2004 and 2003, respectively. Revenues for 2003 included a hardware sale of \$188,532. The Company had \$1,861 of accounts receivable at December 31, 2004 and 2003, respectively, related to services performed for that company.

In connection with the issuance of 1,600,000 shares of common stock on July 10, 2000 to London & Boston Investments, PLC, the company issued 5,700,000 warrants at \$1.00 per share expiring in July 2005 to London & Boston, the Company's President/CEO, and certain members of the board of directors. On December 10, 2004, the Company completed the exchange of 142,500 of its common shares for the 5,700,000 outstanding warrants with London & Boston Investment, PLC, the Company's President/CEO, and certain members of the board of directors.

Item 13. Exhibits

The following documents are filed as exhibits herewith, unless otherwise specified, and are incorporated herein by this reference:

31.1 Section 302 Certification pursuant to Sarbanes-Oxley Act.

32.1 Section 906 Certification pursuant to Sarbanes-Oxley Act.

Exhibit Number	Description of Exhibit
2.0*	Joint Plan of Reorganization Proposed by the Debtors dated August 21, 2000 as filed with the U.S. Bankruptcy Court for the Northern District of Texas, Dallas Division, on August 21, 2000 (without exhibits which will be supplied to the Commission upon request)
2.1*	Modification to the Debtors' Joint Plan of Reorganization Proposed by the Debtors Dated August 21, 2000
2.2*	Order Confirming Joint Plan of Reorganization and Fixing Deadlines for Filing Administrative Claims, Fee Claims and Rejection Claims as filed with the U.S. Bankruptcy Court for the Northern District of Texas, Dallas Division, on September 29, 2000
2.3*	Certificate of Compliance with Reverse Acquisition Requirements as filed with the U.S. Bankruptcy Court for the Northern District of Texas, Dallas Division, on November 20, 2000
2.4*	Motion for Post Confirmation Technical Amendment as filed with the U.S. Bankruptcy Court for the Northern District of Texas, Dallas Division, on November 30, 2000
2.5*	Order Granting Debtors' Motion for Post-Confirmation Technical Amendment as filed with the U.S. Bankruptcy Court for the Northern District of Texas, Dallas Division, on January 18, 2001
2.6*	Order Supplementing Order of Confirmation as filed with the U.S. Bankruptcy Court for the Northern District of Texas, Dallas Division, on January 18, 2001

Exhibit Number	Description of Exhibit
2.7*	Agreement and Plan of Merger dated October 9, 2000 by and between Avatar Systems, Inc. and HCI Acquisition 1998-2, Inc. d/b/a Precision Stainless Fabricators whereby Avatar on November 14, 2000 merged with and into HCI Acquisition 1998-2, Inc. with HCI Acquisition 1998-2, Inc. being the surviving corporation (without exhibits and schedules which will be supplied to the Commission upon request)
2.8*	Certificate of Merger of Avatar Systems, Inc. with HCI Acquisition 1998-2, Inc. as filed on November 14, 2000 with the Secretary of State of Texas (please see Exhibit 3.2 attached hereto for a copy of Exhibit "A" to this Certificate of Merger)
3.0*	Articles of Incorporation of HCI Acquisition 1998-2, Inc., as filed with the Secretary of State of Texas on August 7, 1998
3.1*	Articles of Amendment to Articles of Incorporation of HCI Acquisition 1998-2, Inc. as filed with the Secretary of State of Texas on October 23, 2000
3.2*	Certificate of Restated Articles of Incorporation of Avatar Systems, Inc. as filed with the Secretary of State of Texas on November 14, 2000
3.3*	Amended and Restated Bylaws of Avatar Systems, Inc.
4.0*	Common Stock Specimen – Avatar Systems, Inc.
9.0*	Shareholders' Agreement by and between Avatar Systems, Inc., Cybertec Holdings, Plc., Robert C. Shreve, Jr., Tim Allen, Gregg Allen, Stephen A. Komlosy and Merchant Capital Holdings, Ltd. as of July 10, 2000
10.0*	Stock Purchase Agreement by and between Avatar Systems, Inc. and Cybertec Holdings, Plc. dated July 10, 2000 (without exhibits and schedules which will be supplied to the Commission upon request) providing for the issuance of 1,600,000 shares of Avatar's Common Stock to Cybertec for \$1.6 million
10.1*	Management Agreement by and between Avatar Systems, Inc. and Robert C. Shreve, Jr. as of July 10, 2000
10.2*	Consulting Agreement by and among Avatar Systems, Inc., Merchant Capital Holdings, Ltd. and its affiliate, First Merchants Capital Limited, as of July 10, 2000
10.3*	Investors' Rights Agreement by and among Avatar Systems, Inc., Cybertec Holdings, Plc., Merchants Capital Holdings, Ltd., Robert C. Shreve, Jr., Tim Allen, Gregg Allen and Stephen A. Komlosy as of July 10, 2000
10.4*	Warrant to Purchase Common Stock of Avatar Systems, Inc. issued to Cybertec Holdings Plc. as of July 10, 2000
10.5*	Warrant to Purchase Common Stock of Avatar Systems, Inc. issued to Robert C. Shreve, Jr. as of July 10, 2000
10.6*	Warrant to Purchase Common Stock of Avatar Systems, Inc. issued to Merchants Capital Holdings, Ltd. as of July 10, 2000
10.7*	Warrant to Purchase Common Stock of Avatar Systems, Inc. issued to Stephen A. Komlosy as of July 10, 2000
10.8*	Warrant to Purchase Common Stock of Avatar Systems, Inc. issued to Tim Allen as of July 10, 2000
10.9*	Warrant to Purchase Common Stock of Avatar Systems, Inc. issued to Gregg Allen as of July 10, 2000
10.10*	2000 Stock Compensation Plan of Avatar Systems, Inc. dated October 9, 2000
10.11*	Amended and Restated Loan Agreement dated July 10, 2000 between Avatar Systems, Inc. and Bank One, Texas, N.A.
10.12*	Amended and Restated Term Loan Promissory Note dated July 10, 2000 in the principal amount of \$288,888.96
10.13*	Security Agreement dated July 10, 2000 between Avatar Systems, Inc. and Bank One, Texas, N.A.
10.14*	Copyright Security Agreement dated July 10, 2000 between Avatar Systems, Inc. and Bank One, Texas, N.A.
10.15*	Trademark Security Agreement dated July 10, 2000 between Avatar Systems, Inc. and Bank One, Texas, N.A.

Exhibit Number	Description of Exhibit
10.16*	Uniform Commercial Code Financial Statement between Avatar Systems, Inc. and Bank One, Texas, N.A.
10.17*	Guaranty of Charles T. Allen dated July 10, 2000 for benefit of Bank One, Texas, N.A.
10.18*	Guaranty of Orville G. Allen dated July 10, 2000 for the benefit of Bank One, Texas, N.A.
10.19*	Limited Guaranty of Robert C. Shreve, Jr. dated July 10, 2000 for the benefit of Bank One, Texas, N.A.
10.20*	Executive Employment Agreement dated November 23, 2000 between Talon Global Solutions, Inc. and Chad P. Statham
10.21*	Executive Employment Agreement dated November 23, 2000 between Talon Global Solutions, Inc. and Carla Rogers
22.0*	Subsidiaries of the Registrant

* Previously filed as exhibits to the Company's Registration Statement on Form 10-SB as filed on June 25, 2001 with the Commission which are incorporated herein by reference.

Item 14. Principal Accountant Fees And Services

Audit Fees

The aggregate fees for professional services rendered for the audit of the Company's financial statements for the fiscal year ended December 31, 2004 and 2003 were \$18,135 and \$16,708 respectively. The fees for the reviews of the financial statements included in the Company's Form 10-QSB were \$9,522 and \$9,291 for the fiscal year ended December 31, 2004 and 2003, respectively.

All Other Fees

There were no other fees for services rendered to the Company other than those services covered in the section captioned "Audit Fees" for the fiscal years ended December 31, 2004 and 2003.

Signatures

Pursuant to the requirements of Section 13 or 15 (d) 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: March 31, 2005

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

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

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Dated: March 31, 2005

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

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

Dated: March 31, 2005

By: /s/ CHARLES TIMOTHY ALLEN.

Charles Timothy Allen
Director

Dated: March 31, 2005

By: /s/ ALLEN.D. FARRIS

Allen D. Farris
Director

Dated: March 31, 2005

By: /s/ STEPHEN A. KOMLOSY

Stephen A. Komlosy
Director

Dated: March 31, 2005

By: /s/ JOHN J. MAY

John J. May
Director

Exhibit 31.1
Certifications

I, Robert C. Shreve, Jr., certify that:

1. I have reviewed this annual report on Form 10-KSB of Avatar Systems Inc.;
2. Based on my knowledge, this annual 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 annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual 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 annual report;
4. I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rule 13a-14 and 15 (e)) 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 annual report was prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of December 31, 2004 and in this annual period presented in this report ("Evaluation Date"); and
 - c) presented in this annual 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 registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 31, 2005

/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 Annual Report of Avatar Systems Inc. (the "Company") on Form 10-KSB for the year ended December 31, 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: March 31, 2005

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.