AVALON DIGITAL MARKETING SYSTEMS INC
Form 10-Q
June 26, 2003

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549-1004

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2003

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ___ to ___

Commission File Number: 0-28403

Avalon Digital Marketing Systems, Inc.
(Exact name of registrant as specified in its charter)

Delaware	77-0511097
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

19782 MacArthur Blvd., Suite 100, Irvine, CA 92612
(Address of principal executive offices)

(949) 660-1700
(Registrant's telephone number, including area code)

2120 Main Street, Suite 200, Huntington Beach, CA 92648
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 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. Yes [X] No [ ]

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

The number of shares outstanding of each of the Registrant's classes of common stock, as of the latest practicable date:

Class	Outstanding at June 25, 2003

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Common Stock, $.001 par value	7,348,279

Avalon Digital Marketing Systems, Inc.

Quarterly Report on Form 10-Q
For the three months ended March 31, 2003

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Part I. Financial Information

NOTE: Avalon Digital Marketing Systems, Inc. ("Avalon") was formed as a result of a merger between MindArrow Systems, Inc. ("MindArrow") and Category 5 Technologies, Inc. ("Category 5") on September 30, 2002. MindArrow was the legal acquirer of Category 5, but because Category 5's business was larger than MindArrow's and because Category 5's former stockholders obtained the majority of the outstanding shares of Avalon at the time of the merger, generally accepted accounting principles require that Category 5 be treated as the acquirer for accounting and reporting purposes. Accordingly, the financial statements in this report reflect the following:

- Consolidated Balance Sheet as of March 31, 2003 - reflects post-merger Avalon.
- Consolidated Balance Sheet as of June 30, 2002 - reflects Category 5 only.
- Statements of Operations for the Quarter and Nine Months Ended March 31, 2002 - reflects Category 5 only. Statements of Operations for the Nine Months Ended March 31, 2003 - reflects one quarter of Category 5 only and two quarters of post-merger Avalon. Statements of Operations for the Quarter Ended March 31, 2003 reflects operations of post-merger Avalon.
- Statements of Cash Flows for the Nine Months Ended March 31, 2002 - reflects Category 5 only. Statements of Cash Flows for the Nine Months Ended March 31, 2003 - reflects one quarter of Category 5 only and two quarters of post-merger Avalon.
- Pro forma combined information as if the merger had taken place on July 1, 2002 is contained in the notes to financial statements.

In addition, references to the "Company" for periods prior to September 30, 2002 are intended to refer to Category 5 and its business.

Item 1. Consolidated Financial Statements:

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Consolidated Statement of Changes in Stockholders' Equity (unaudited) - Nine Months Ended March 31, 2003..

Consolidated Statements of Cash Flows (unaudited) - Nine Months Ended March 31, 2003 and 2002..

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Avalon Digital Marketing Systems, Inc. and Subsidiaries
Consolidated Balance Sheets

March 31, 200

	(unaudited)
ASSETS	
Current assets:	
Cash	$ 60,678
Short term investments	--
Receivables, net	
Contract	348,682
Trade	784,015
Retainages	186,387
Prepaid expenses and other current assets	101,368
Total current assets	1,481,130
Fixed assets, net	1,163,193
Identifiable intangible assets, net	--
Goodwill	--
Contract receivables - long term, net	627,185
Retainage receivables - long term, net	--
Deposits	55,988
Total assets	$ 3,327,496
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)	
Current liabilities:	
Accounts payable and accrued liabilities	$ 7,019,285
Deferred revenue	1,349,792
Notes payable, current portion, net of unamortized discount	2,126,834
Estimated receivable repurchase obligation	--
Due to related parties, net of unamortized discount	277,200
Deferred taxes	--
Total current liabilities	10,773,111
Long-term liabilities:	
Capital lease obligation	--
Deferred taxes	--
Total long-term liabilities	--
Stockholders' equity (deficit):	
Common stock, $0.001 par value; 75,000,000 and 125,000,000 shares authorized, 7,348,279 and 1,659,286 shares issued and outstanding at March 31, 2003 and June 30, 2002, respectively	7,348
Additional paid-in capital	27,220,307
Retained earnings (deficit)	(34,673,270
Total stockholders' equity (deficit)	(7,445,615
Total liabilities and stockholders' equity (deficit)	$ 3,327,496

The accompanying notes are an integral part of these statements.

Avalon Digital Marketing Systems, Inc. and Subsidiaries
Consolidated Statements of Operations

	Three Months Ended		
	March 31, 2003	March 31, 2002	March
	(unaudited)		
Revenues	$ 3,337,260	$ 7,908,122	$ 10
Cost of revenues	1,227,043	3,542,173	2
Gross profit	2,110,217	4,365,949	8
Operating expenses:			
Selling, general and administrative	3,710,319	3,574,856	13
Bad debt expense	245,001	--	4
Depreciation and amortization	855,897	18,988	2
Write-down of intangible assets	24,306,611	--	24
Total operating expenses	29,117,828	3,593,844	44
Income (loss) from operations	(27,007,611)	772,105	(36
Write-down of short-term investment	--	--	(1
Interest income	79,137	--	
Interest expense	(703,006)	(80,165)	
Net income (loss) before income taxes	(27,631,480)	691,940	(37
(Provision) benefit for income taxes			
Current	--	(767,000)	
Deferred	--	543,000	1
Net income (loss)	$(27,631,480)	$ 467,940	(36
Basic earnings (loss) per share	$ (3.79)	$ 0.16	$
Diluted earnings (loss) per share	$ (3.79)	$ 0.13	$
Shares used in computation of basic earnings (loss) per share	7,290,601	2,981,260	6
Shares used in computation of diluted earnings (loss) per share	7,290,601	3,671,720	6

The accompanying notes are an integral part of these statements.

Avalon Digital Marketing Systems, Inc. and Subsidiaries
Consolidated Statement of Changes in Stockholders' Equity (Deficit)

	Common Stock		Additional Paid In Capital	
	Shares	Amount		
Balance, June 30, 2002	1,659,286	$ 1,659	$ 6,960,164	$
Recapitalization of the common stock of Category 5 Technologies, Inc.	2,157,072	2,157	(2,157)	
Issuance of common stock pursuant to exercise of options and warrants	5,290	5	5,759	
Common stock issued for services	18,975	19	59,656	
Recapitalization and issuance of common stock for reverse acquisition of MindArrow Systems, Inc.	3,133,636	3,134	18,321,861	
Sale of common stock, net of issuance costs	71,250	71	174,929	
Common stock issued in acquisition of the assets of AGEA Corporation	175,000	175	336,000	
Common stock issued in acquisition of the assets of Mindwire, Inc.	46,700	47	63,465	
Issuance of common stock pursuant to note conversions	81,070	81	280,630	
Proceeds from notes payable attributable to warrants	--	--	1,020,000	
Net loss	--	--	--	
Balance, March 31, 2003 (unaudited)	7,348,279	$ 7,348	$ 27,220,307	$

The accompanying notes are an integral part of these statements.

Avalon Digital Marketing Systems, Inc. and Subsidiaries
Consolidated Statements of Cash Flows

	Nine Months End	
	March 31, 2003	Mar
	(unaudited)	
Cash flows from operating activities:		
Net income (loss)	$(36,498,467)	$
Adjustments to reconcile net income (loss) to net cash used in operations:		
Bad debt expense	4,605,176	
Depreciation and amortization	2,129,352	
Write-down of short-term investment	1,021,135	
Write-down of intangible assets	24,306,611	

Estimated receivable repurchase obligation	(757,677)	
Amortization of debt discount and loan fees	674,699	
Issuance of stock and options for services	59,675	
Issuance of warrants - debt costs	--	
Deferred tax benefit	(1,144,000)	
Changes in operating assets and liabilities, net of effects of reverse acquisition of MindArrow Systems, Inc. and acquisition of assets of AGEA Corporation and Mindwire, Inc.		
(Increase) decrease in contract receivables	1,214,434	
(Increase) decrease in trade receivables	618,939	
(Increase) decrease in retainages receivable	86,395	
(Increase) decrease in prepaid expenses	271,845	
Decrease in due from shareholder	--	
(Increase) decrease in deposits	184,899	
Increase in accounts payable and accrued expenses	1,636,509	
Increase in income taxes payable	--	
Increase in deferred revenue	351,002	
Net cash used in operations	(1,239,473)	
Cash flows from investing activities:		
Purchases of fixed assets	(45,235)	
Net cash acquired in acquisitions	426,485	
Net cash provided by (used in) investing activities	381,250	
Cash flows from financing activities:		
Net borrowings on notes payable	229,865	
Net (payments) borrowings on shareholder loan	210,000	
Proceeds from issuance of common stock and option exercises	180,764	
Net cash provided by financing activities	620,629	
Net increase (decrease) in cash	(237,594)	
Cash, beginning of period	298,272	
Cash, end of period	$ 60,678	$
Cash paid for interest	$ 85,425	$

The accompanying notes are an integral part of these statements.

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Avalon Digital Marketing Systems, Inc. and Subsidiaries
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note A--The Company and Summary of Significant Accounting Policies

1. Basis of Presentation

Avalon Digital Marketing Systems, Inc. ("Avalon") was formed as a result of a merger between MindArrow Systems, Inc. ("MindArrow") and Category 5

Technologies, Inc. ("Category 5") on September 30, 2002. MindArrow was the legal acquirer of Category 5, but because Category 5's business was larger than MindArrow's and because Category 5's former stockholders obtained the majority of the outstanding shares of Avalon at the time of the merger, generally accepted accounting principles require that Category 5 be treated as the acquirer for accounting and reporting purposes. Accordingly, the accompanying financial statements reflect the following:

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- Pro forma combined information as if the merger had taken place on July 1, 2002 is contained in the notes to financial statements.

In addition, references to the "Company" for periods prior to September 30, 2002 are intended to refer to Category 5 and its business.

The accompanying consolidated financial statements have been prepared by Avalon Digital Marketing Systems, Inc. and subsidiaries (the "Company") pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC") for interim financial reporting. These consolidated financial statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary for a fair presentation of the balance sheets, operating results, and cash flows for the periods presented. Operating results for the three and nine months ended March 31, 2003 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2003. Certain financial information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted in accordance with the rules and regulations of the SEC. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements, and accompanying notes, included in the Annual Report on Form 10-KSB for the fiscal year ended June 30, 2002 of Category 5, our predecessor company. The consolidated balance sheet at June 30, 2002 has been derived from the audited consolidated financial statements at that date.

The Company was founded in 1998 as Executive Credit Services LLC and incorporated under the name ePenzio, Inc. in May 2000. On May 29, 2001, Network Investor Communications, Inc. ("NWIC") acquired all of the outstanding shares of ePenzio, and effective July 23, 2001, NWIC changed its name to Category 5 Technologies, Inc. For accounting purposes the business combination with NWIC was treated as a reverse merger or a recapitalization of ePenzio, with ePenzio being treated as the accounting acquirer. On September 30, 2002, MindArrow Systems, Inc., a Delaware corporation, acquired all of the outstanding shares of Category 5 and changed its name to Avalon Digital Marketing Systems, Inc. For accounting purposes, the business combination with MindArrow was treated as a reverse acquisition, with Category 5

being the acquirer. The results of operations of MindArrow Systems, Inc. are included in the consolidated financial statements of the Company beginning October 1, 2002. Accordingly, the accompanying consolidated statements of operations and cash flows reflect information for Category 5 only from July 1, 2002 to September 30, 2002.

In addition, on September 30, 2002, the Company effected a reverse stock split of the Company's common stock at a ratio of one-for-ten, causing each outstanding share of common stock to convert automatically into one-tenth of a share of common stock. In lieu of fractional shares, stockholders received a cash payment based on the trading price of the common stock prior to the effectiveness of the reverse split. Stockholders' equity has been restated to give retroactive recognition to the reverse split for all periods presented by reclassifying the excess par value resulting from the reduced number of shares from common stock to paid-in capital. All references to common share and per common share amounts for all periods presented have been retroactively restated to reflect this reverse split.

Certain prior year amounts in the consolidated financial statements have been reclassified to conform to the current year presentation.

The Company develops and provides software and services that enable its clients to communicate and sell more effectively and efficiently over the web, via email, and through other digital channels.

The business is divided between the Small Business and Large Enterprise sales channels. The Small Business channel has been the primary source of our historical revenues, and provides small businesses with merchant services and digital marketing software, primarily marketed through workshops. Small Business operations consist primarily of Category 5's subsidiaries, Avalon Business Direct, Inc., ePenzio, Inc., Bring it Home, Inc. and Olympus Financial, Inc. In March 2003, the Company stopped selling its products through seminars operated by our Bring it Home subsidiary, and refocused on selling software and services through alternative distribution methods.

The Large Enterprise channel provides customized software and professional services to large companies. The Large Enterprise channel consists of the former MindArrow, MindArrow Asia, Ltd. and former Category 5 subsidiary, CaptureQuest, Inc.

In May 2003, the Company entered into a non-binding letter of intent to sell certain of the assets of the Large Enterprise operations to Silverpop Systems, Inc. (Note L).

2. Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany balances and transactions have been eliminated.

3. Basic and Diluted Net Earnings (Loss) Per Share

Basic net earnings (loss) per share is computed using the weighted average number of common shares outstanding during the period. Diluted net earnings (loss) per share is computed using the weighted average number of common shares during the period plus dilutive potential common shares. Dilutive potential common shares include the incremental common shares issuable upon the

exercise of stock options and warrants (using the treasury stock method) and the incremental common shares issuable upon conversion of convertible preferred stock and notes payable (using the if-converted method). Potential common shares in the diluted net earnings (loss) per share computation are excluded where their effect would be antidilutive.

In periods where a net loss was incurred, potential common shares were excluded because their effect would be antidilutive. In addition, for the three and nine months ended March 31, 2003, the following options were not included in the computation of diluted EPS for the periods indicated because the options' exercise price was greater than the average market price of the common shares:

	Three Months Ended March 31, 2003	Nine Months Ended March 31, 2003
Options to purchase shares of common stock	1,071,264	1,071,264
Exercise prices	$1.09 to $250	$1.09 to $250
Expiration dates through June 2012		

4. Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

5. Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentration of credit risk consist primarily of cash, cash equivalents, and accounts receivable. Substantially all of the Company's cash and cash equivalents are held in two financial institutions. As of March 31, 2003 and June 30, 2002, the carrying amounts of cash were $60,678 and $298,272, respectively.

The write-down of short-term investment of $1.0 million relates to a certificate of deposit account in the name of our CaptureQuest subsidiary that arose from an investment in CaptureQuest by Omnicorp Bank. The account was held at Omnicorp, which was declared insolvent by regulators in October 2002. Omnicorp has asked account holders to convert their certificates of deposit into an investment in preferred shares of Solara Ventures, Inc. a Canadian-based investment company. As of September 30, 2002, the entire balance was written down due to the uncertainty surrounding any recovery.

Accounts receivable are typically unsecured and derived primarily from

customers located in the United States and Hong Kong. The Company performs ongoing credit evaluations of its customers and will maintain reserves for potential credit losses as the need arises.

In the normal course of business the Company sold certain of its receivables to financing companies. The Company's sales of receivables to financing companies include recourse provisions, which are deemed non-hedging derivatives pursuant to the provisions of Statement of Financial Accounting Standards No. 133 ("SFAS No. 133"), "Accounting for Derivative Instruments and Hedging." The purpose of the limited recourse provisions are normal in the course of business and are meant to facilitate the sale of receivables to financing companies. The fair value of the recourse liability has been determined using a best estimate method, and the fair value estimate was based on historical recourse rates experience by the Company. The fair value of the recourse obligation at March 31, 2003 and June 30, 2002 is $0 and $757,677, respectively. This change is due to the Company's decision to cease selling its products under installment contracts.

6. Segments

The Company has adopted Statement of Financial Accounting Standards No. 131 "Disclosures about Segments of an Enterprise and Related Information" ("SFAS 131"). SFAS 131 establishes standards for reporting information regarding operating segments in annual financial statements and requires selected financial information for those segments to be presented in interim financial reports. SFAS 131 also establishes standards for related disclosures about products and services, and geographic areas. Prior to the acquisition of CaptureQuest in April 2002, the Company has viewed their operations as principally one segment. The business of the former CaptureQuest and MindArrow constitute the Large Enterprise segment, and the historical Category 5 businesses constitute the Small Business segment.

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Avalon Digital Marketing Systems, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - (Continued)

The following is a summary of these segments:

	Small Business	Large Enterpris
For the nine months ended March 31, 2003:		
Net revenues, actual	$6,851,882	$4,035,489
Net revenues, pro forma/1/	6,851,882	5,162,368
Long lived assets	592,958	570,235

Our Asia Pacific business adds a geographic segment to the business. The following is a summary of significant geographic markets:

	North America	Asia Pacific

For the nine months ended March 31, 2003:		
Net revenues, actual	$10,531,777	$ 355,594
Net revenues, pro forma1	11,479,134	535,116
Long lived assets	1,163,193	--

/1/ Assumes the reverse acquisition of MindArrow, which occurred on September 30, 2002, had occurred on July 1, 2002.

7. Revenue Recognition

Revenues are recognized when the consulting or production services are rendered and messages are delivered. The Company recognizes software license fee revenue when persuasive evidence of an agreement exists, the product has been delivered, we have no remaining significant obligations with regard to implementation, the license fee is fixed or determinable and collection of the fee is probable. Revenue from media sales is recognized upon placing advertisements. Revenue from consulting is recognized as the services are rendered. Revenues from products sold by the Small Business sales channel under installment contracts are recognized net of amounts estimated to be uncollectible (Note C1).

The Company records cash receipts from clients and billed amounts due from clients in excess of revenue recognized as deferred revenue. The timing and amount of cash receipts from clients can vary significantly depending on specific contract terms and can therefore have a significant impact on the amount of deferred revenue in any given period.

8. Intangible Assets

Identifiable intangible assets acquired in a business combination are recorded separately from goodwill if they arise from contractual or other legal rights or are separable from the acquired entity and can be sold, transferred, licensed, rented or exchanged, either individually or as part of a related contract, asset or liability. Goodwill, as well as other intangible assets with indefinite lives, are not amortized and will be tested for impairment annually and whenever there is an impairment indicator. All acquired goodwill is assigned to reporting units for purposes of impairment testing and segment reporting.

During the quarter ended March 31, 2003, the Large Enterprise division met its revenue projections, but it did not meet its cash flow projections, and the losses of the expected cash flow from the Small Business division severely impacted Avalon's ability to complete a fundraising. Also during the quarter ended March 31, 2003, Avalon's share price continued to drop as the liquidity situation became more dire, which further decreased the chances of obtaining sufficient financing on acceptable terms. In light of these facts and circumstances, and in accordance with SFAS Nos. 142 and 144, the Company has

re-evaluated the recovery of goodwill and other intangible assets. Such analysis resulted in an impairment of goodwill of $16,820,601 and other intangible assets of $7,486,010 at March 31, 2003.

9. Recent accounting pronouncements

SFAS No. 143, "Accounting for Asset Retirement Obligations," was issued in June 2001. SFAS No. 143 addresses accounting and reporting for legal obligations and related costs associated with the retirement of long-lived assets. The Statement requires that the fair value of the liability for an asset retirement obligation be recognized in the period incurred if a reasonable estimate of fair value can be made. The estimated retirement costs are capitalized as part of the carrying amount of the long-lived asset. SFAS No. 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002. Adoption of this statement did not have a material effect.

In August 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This statement supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" and the accounting and reporting provisions of APB Opinion No. 30. SFAS No. 144 establishes accounting standards for the impairment of long-lived assets, excluding goodwill, and for long-lived assets to be disposed of. SFAS No. 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount 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 assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. The statement retains the basic provisions of APB Opinion No. 30 for the presentation of discontinued operations in the statement of operations but broadens that presentation to include a component of an entity (rather than a segment of a business).

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." This Statement, among other things, rescinds SFAS No. 4, "Reporting Gains and Losses from Extinguishment of Debt," and SFAS No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements." The Statement requires gains and losses from debt extinguishments that are used as part of the Company's risk management strategy to be classified as part of income from operations rather than as extraordinary items, net of tax. SFAS No. 145 is effective for fiscal years beginning after May 15, 2002 with earlier adoption encouraged. Adoption of this statement did not have a material effect.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." SFAS No. 146 requires that a liability for costs associated with an exit or disposal activity be recognized when the liability is incurred rather than when a company commits to such an activity and also establishes fair value as the objective for initial measurement of the liability. The Company will adopt SFAS No. 146 for exit or disposal activities that are initiated after December 31, 2002.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure," which amends SFAS No. 123, "Accounting for Stock-Based Compensation". SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation and is effective for fiscal years ending after December 31, 2002. In addition, SFAS No. 148 amends the

disclosure requirements of SFAS No. 123 to require prominent disclosures in annual and interim financial statements about the method of accounting for stock-based compensation and the effect in measuring compensation expense. The disclosure requirements of SFAS No. 148 are effective for interim periods beginning after December 15, 2002. The Company has chosen to continue to account for stock-based compensation using the intrinsic

value method prescribed in APB Opinion No. 25 and related interpretations. Accordingly, compensation expense for stock options is measured as the excess, if any, of the estimate of the market value of the Company's stock at the date of the grant over the amount an employee must pay to acquire the stock. The Company adopted the annual disclosure provisions of SFAS No. 148 in the quarter ended March 31, 2003.

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." Interpretation No. 45 requires a guarantor to include disclosure of certain obligations, and if applicable, at the inception of the guarantee, recognize a liability for the fair value of other certain obligations undertaken in issuing a guarantee. The recognition requirement is effective for guarantees issued or modified after December 31, 2002 and based on current operations, the Company does not expect the adoption of the recognition requirements of this statement to have a material effect on its financial position or results of operations. The disclosure requirements are effective for financial statements of interim and annual periods ending after December 31, 2002.

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities." Interpretation No. 46 clarifies the application of Accounting Research Bulletin No. 51 and applies immediately to any variable interest entities created after January 31, 2003 and to variable interest entities in which an interest is obtained after that date. This Interpretation is applicable for the Company in the fiscal year beginning July 1, 2003, for interests acquired in variable interest entities prior to February 1, 2003. Based on current operations, the Company does not expect the adoption of Interpretation No. 46 to have a material effect on its financial position or results of operations.

Note B--Liquidity

The Company's liquidity is significantly impacted by credit and collections issues. Its Small Business division formerly generated large balances of receivables and, depending on the quality of the credit and the cash needs, it sold certain of the receivables, at a discount, to financing sources. Receivables that have not been sold are retained and the billing and collecting administration have been outsourced. A large portion of the Small Business division's customers have sub-prime credit. Accordingly, many of the receivables generated by these customers may have high credit risk.

During the last six months of calendar 2002, the Company sold a significant portion of its contracts receivable, at a discount, in order to raise cash. The receivables sold were typically the highest quality in the portfolio, so the remaining contracts receivable represented the lowest quality.

Accordingly, the Company experienced high delinquencies in the remaining receivables portfolios through December 31, 2002. This, coupled with the writedown of a certificate of deposit and the uncertainty experienced with the funding of the East West investment, have severely impacted the Company's liquidity and rendered it insolvent.

At March 31, 2003, the Company's cash balance was $60,678, which requires that it actively seek additional sources of capital. As of March 31, 2003, the Company had current assets of approximately $1.5 million and current liabilities of approximately $10.8 million. This represents a working capital deficit of approximately $9.3 million. The negative working capital balance includes as current liabilities approximately $1.3 million of deferred revenues and is mitigated by approximately $627,000 in net contracts receivable included in long-term assets.

The Company's line of credit facility with Zions Bank includes covenants for tangible net worth and debt coverage ratios. As of March 31, 2003, the balance on the line was $413,687, and the Company was in violation of these covenants, and has sought waivers. As of the date hereof, the bank has not waived the violations, and if it were to demand payment of the entire balance, the Company's liquidity would suffer. In January 2003, in exchange for an advance of $250,000 on the line, the Company designated a recurring revenue stream in the amount of approximately $40,000 per month for repayment of the outstanding balance on the line.

The $250,000 principal payment due to Radical Communication, Inc. on October 1, 2002 was not made. In February 2003, $150,000 of the note balance was converted into 37,500 shares of common stock and warrants to purchase 43,125 shares of common stock at $2 per share (Note E3). The Company is seeking an extension or conversion into equity of some or all of the remaining overdue balance.

The Company had $820,000 of convertible notes payable that were due on November 21, 2002. In November 2002, the note holders agreed to amend the repayment terms of the notes to increase the interest rate to 14%, lower the conversion price to $3 per share, establish payment terms calling for six equal monthly principal payments beginning in January 2003 through June 2003. The note holders also received 179,170 additional warrants to purchase common stock at $3 per share and an amendment to their original 179,170 warrants to reduce the exercise price to $3 per share (Note G2). The grant of additional warrants and repricing of old warrants, combined with the resulting beneficial conversion feature resulted in a discount to the note of $820,000, thus yielding an effective interest rate of 114%. The discount is being amortized over the term of the bridge notes, therefore $528,858 of the discount has been amortized as interest expense as of March 31, 2003. In January 2003, $130,667 of the notes were converted into 43,570 shares of common stock. As of May 31, 2003, the balance of the January payment that was not converted into common stock amounted to $50,107 and has not been paid, nor have any other payments been made.

In February 2003, the Company obtained $200,000 in bridge financing from an investor affiliated with a significant stockholder who is also a director. The bridge loan accrues interest at the rate of 10% per annum, is

secured by fixed assets and intellectual property, and matured on June 18, 2003. The bridge note is convertible into Avalon common stock at the lower of $1.375 per share or the price per share of common stock in an equity financing proposed to be placed on behalf of the Company by its investment bankers, L.H. Friend, Weinress, Frankson & Presson. As consideration for entering into the bridge loan the Company repriced warrants issued in connection with the East West Capital financing transactions (Note G2). This repricing, as computed using the Black-Scholes option pricing model, resulted in a discount to the note of $200,000, thus yielding an effective interest rate of 110%. $68,333 of the discount has been amortized as interest expense as of March 31, 2003.

In May 2003, the Company received a $400,000 bridge loan from an investor affiliated with a significant shareholder and who is a former director. The bridge loan accrues interest at the rate of 25% per annum, is secured by all assets of the Company, matures on the earlier of May 15, 2004, or the closing of the sale of certain assets from the Large Enterprise operations. As consideration for entering into the bridge loan the Company issued warrants to purchase 495,000 shares of common stock at $0.33 per share.

The pending sale of assets to Silverpop is designed to raise cash to pay off certain liabilities and allow the Company to reorganize around its Small Business operations, which have recently released two new software products. The sale of assets has not been completed, and there is no assurance that it will be completed on terms that will be acceptable to the Company, or that the proceeds will be sufficient to allow the Company to successfully restructure and continue operations.

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the company as a going concern.

In the view of the Company, recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheet is dependent upon continued operations of the Company, which in turn is dependent upon the Company's ability to meet obligations on a continuing basis. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or amounts and classification of liabilities that might be necessary should the Company be unable to continue in existence.

Note C--Receivables

1. Contracts Receivable

Contracts receivable consist of amounts due from customers of the Small Business sales channel. The customers have typically entered into 36-month installment contracts and the portion of the balance that is due within one year is included in the current balance. The allowance for doubtful accounts is estimated using the Company's experience in collecting from these customers.

At March 31, 2003, contracts receivable consisted of the following:

	Current	Long-term

Contracts receivable	$ 873,143	$1,694,926
Allowance for uncollectible accounts	(524,461)	(1,067,741)
Net	$ 348,682	$ 627,185

2. Trade Accounts Receivable

Trade accounts receivable are comprised mainly of billings to customers of the Large Enterprise sales channel, and are all due within one year. The allowance for doubtful accounts is provided based on a specific review of amounts due. At March 31, 2003, trade receivables consisted of the following:

Trade accounts receivable	$ 939,015
Allowance for uncollectible accounts	(155,000)
Net	$ 784,015

3. Retainages Receivable

Current retainages receivable consist primarily of amounts held by the Company's credit card merchant accounts and long-term retainage amounts held for resale at their net realizable value. Long-term retainages receivable consist of the reserves held by financing companies that have previously purchased contracts receivable. As the Company sells its contracts receivable, the financing companies retain portions of the funded amounts as reserves in the event of default by the customer. These reserves are to be released to the Company as customers make monthly payments. The amounts to be released are determined periodically by the finance companies in accordance with the terms of the receivables purchase agreements. At March 31, 2003, retainage receivable consisted of the following:

Retainages receivable	$540,715
Allowance for uncollectible accounts	(354,328)
Net	$186,387

Note D--Commitments and Contingencies

1. Legal Proceedings

From time to time the Company is subject to legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights. The Company's liquidity position has resulted in it becoming party to lawsuits for non-payment of liabilities. These amounts are included in "Accounts payable and accrued liabilities" in the accompanying consolidated balance sheet. The Company is working with the creditors to reach settlements and payment terms that are acceptable.

In May 2003, the Company settled a dispute with MindArrow's former landlord over amounts due under a lease for MindArrow's former facilities. The

settlement, in the amount of $803,000, is included in "Accounts payable and accrued liabilities" on the accompanying consolidated balance sheet, and calls for payments of $5,000 per month beginning in July 2003, increasing to $10,000 per month beginning in March 2004, and increasing to $100,000 per quarter beginning in January 2005 until the balance is paid. In June 2003, a judgment lien covering all of the assets of the Company was filed in connection with this settlement.

In 1999 and 2000, MindArrow was a victim of a fraud perpetrated by its former transfer agent and her accomplice, who were convicted of felonies arising from the scheme. At sentencing hearings in April

and July 2002, the perpetrators were ordered to pay to the Company $10.9 million in restitution in addition to amounts already received. In addition, the Company continues to pursue recovery of the loss it incurred as a result of the fraud perpetrated against the Company, and the Audit Committee of the Company's Board of Directors has retained special counsel to assist it in pursuing potential sources of recovery. Eight individuals and twelve entities have been named as defendants in lawsuits initiated by the Company. The Company cannot predict whether or when it will obtain any additional recovery. Because of the uncertainties surrounding recoveries, the Company will not record the impact of recoveries until amounts or assets are received.

Note E--Notes Payable

1. Convertible Notes Payable

In November 2001, the Company issued $820,000 of convertible notes payable to sixteen investors (the "Convertible Notes"). The Convertible Notes bear interest at 8% per annum, were due on November 21, 2002, and were convertible into shares of common stock at the option of the holders, for the lower of $8.70 or the price of a private placement of the Company's common stock. In December 2002, the note holders agreed to amend the repayment terms of the notes to increase the interest rate to 14%, lower the conversion price to $3 per share, establish payment terms calling for six equal monthly principal payments beginning in January 2003 through June 2003. The note holders also received 179,170 additional warrants to purchase common stock at $3 per share and an amendment to their original 179,170 warrants to reduce the exercise price to $3 per share (Note G2). The grant of additional warrants and repricing of old warrants, combined with the resulting beneficial conversion feature resulted in a discount to the note of $820,000, thus yielding an effective interest rate of 114%. The discount is being amortized over the term of the bridge notes, therefore $528,858 of the discount has been amortized as interest expense as of March 31, 2003. In January 2003, $130,667 of the notes were converted into 43,570 shares of common stock. As of May 31, 2003, the balance of the January payment that was not converted into common stock amounted to $50,107 and has not been paid, nor any other payments made.

2. Line of Credit

In August 2002, the Company, through its wholly-owned subsidiary, ePenzio, Inc., renewed its revolving line of credit with Zions First National

Bank (the "Zions Facility") and increased the amount of the credit facility to $2 million. The annual interest rate applied to the unpaid principal balance of the Zions Facility is 1% over Prime (4.25% at March 31, 2003). The Zions Facility is secured by all inventory, chattel paper, accounts and general intangibles owned by ePenzio on or after September 11, 2001. As of March 31, 2003, the Company had a balance of $413,687 under the Zions Facility. In addition to customary affirmative and negative covenants, ePenzio must maintain a tangible net worth not less than $1 million, and a debt coverage ratio (defined as total earnings before interest, taxes, depreciation and amortization to total debt service coverage) of 1.5 to 1.0, measured on a quarterly basis. The Company is not in compliance with such covenants, and is currently pursuing waivers. In January 2003, in exchange for an advance of $250,000 on the line, the Company designated a recurring revenue stream in the amount of approximately $40,000 per month for repayment of the outstanding balance on the line.

3. Radical Communication, Inc.

In September 2001, MindArrow issued an unsecured subordinated note payable in the amount of $1 million to Radical Communication, Inc. ("Radical"), in connection with MindArrow's acquisition of substantially all of the assets of Radical. In August 2002, $250,000 of the principal balance was converted into 62,500 shares of common stock and warrants to purchase 71,875 shares of common stock. The note bears interest at 5% per annum and is due in two principal installments; $250,000 on October 1, 2002 and $500,000 on October 1, 2003. The initial payment was not made when due, and in February 2003, $150,000 of this note was converted into 37,500 shares of common stock and warrants to purchase 43,125 shares of common stock at $2 per share (Note G2). The Company is seeking an extension or an agreement to convert some or all of the remaining balance.

4. Morrison & Foerster Note Payable

On March 18, 2003, the Company issued a promissory note and security agreement in the amount of $715,000 to Morrison & Foerster LLP in consideration of legal services previously provided and recorded in accounts payable and accrued liabilities. The note bears interest at 10% per annum and is due upon the receipt of gross proceeds from a debt or equity financing of $100,000 or greater, in the amount of

15% of net proceeds from the financing, and on the tenth calendar day of each month in the amount of ten percent of the Company's cash and short term investments. This note payable is secured by substantially all of the assets of the Company.

In June 2003, the note agreement was amended to release the security interest in the assets of the Company upon the earlier of the closing of the pending sale to Silverpop Systems, Inc. (Note L) or July 30, 2003. The amendment calls for a cash payment of $150,000 and the issuance of 1,000,000 shares of newly-created Series D preferred stock. If the payment is not made and issuance of preferred stock not completed according to the terms of the amendment, then the terms of the original note and security agreement will be reinstated. Each share of Series D preferred stock, when issued, will be convertible into one share of common stock and carry a liquidation preference of $0.25.

Note F--Due to Related Parties

Two stockholders of the Company have advanced amounts to the Company. The advances do not bear interest and are non-secured. Both of the stockholders who advanced the amounts are employees of the Company, and one is a former member of the Board of Directors.

In February 2003, the Company obtained $200,000 in bridge financing from an investor affiliated with a significant stockholder who is also a director. The bridge loan accrues interest at the rate of 10% per annum, is secured by fixed assets and intellectual property, and matured on June 18, 2003. The bridge note is convertible into Avalon common stock at the lower of $1.375 per share or the price per share of common stock in an equity financing proposed to be placed on behalf of the Company by its investment bankers, L.H. Friend, Weinress, Frankson & Presson. As consideration for entering into the bridge loan the Company repriced warrants issued in connection with the East West Capital financing transactions (Note G2). This repricing, as computed using the Black-Scholes option pricing model, resulted in a discount to the note of $200,000, thus yielding an effective interest rate of 110%. $68,333 of the discount has been amortized as interest expense as of March 31, 2003.

In May 2003, the Company received a $400,000 bridge loan from an investor affiliated with a significant shareholder and who is a former director. The bridge loan accrues interest at the rate of 25% per annum, is secured by all assets of the Company, matures on the earlier of May 15, 2004, or the closing of the sale of the assets of the Large Enterprise division.

Note G--Stockholders' Equity

1. Common Stock

During the quarter ended September 30, 2002, 18,975 shares of common stock were issued for services, resulting in compensation expense of $59,675. In addition, 5,290 shares were issued during the six months ended December 31, 2002 upon exercise of stock options. Proceeds amounted to $5,764.

On September 30, 2002, 3,133,636 shares were issued in the reverse acquisition of MindArrow. (see Note H - Reverse Acquisition of MindArrow Systems, Inc.)

In February 2003, a $50,000 advance from a stockholder was converted into 40,000 shares of common stock. In connection with this investment, the Company issued warrants to purchase 20,000 shares of common stock at $2 per share.

In June 2002, MindArrow obtained a commitment for between $3 million and up to $4 million in financing by offering up to 1 million shares of common stock at a price of $4 per share from a group of investors led by East-West Capital Associates, Inc. ("East-West Capital") and its affiliate, East West Venture Group, LLC. The stock purchase agreement, as amended in February 2003 called for the remaining $175,000 of the minimum commitment to be funded by providing $25,000 in cash in exchange for 6,250 shares of common stock and warrants to purchase 7,188 shares of common stock at $2 per share, and $150,000 through the conversion of a portion of the note payable to Radical Communication, Inc. into 37,500 shares of common stock and warrants to purchase 43,125 shares of common stock at $2 per share. In addition, the February 2003 amendment to the stock purchase agreement terminated the remaining financing commitment of $800,000 in exchange for a cash investment of $200,000 in the Company by

Avalon Digital Marketing Systems, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - (Continued)

East-West Capital in the form of a convertible secured debenture, bearing interest at 10% per annum, and maturing on the earlier of 120 days from the funding date or the closing of a financing for at least an additional $500,000 or more of equity or debt. The debenture may be converted at the option of the holder at the lesser of (i) $1.375 per share or (ii) the same terms and conditions as a proposed new equity financing by the Company. The Company also agreed to reprice previous warrants issued to East-West Capital and its affiliates to $2 per share (Note G2). East-West Capital agreed to eliminate the protective provisions of the related investor rights agreement and provide active assistance to the Company in its proposed new equity financing efforts.

On September 30, 2002, the Company effected a reverse stock split of the Company's common stock at a ratio of one-for-ten, causing each outstanding share of common stock to convert automatically into one-tenth of a share of common stock. In lieu of fractional shares, stockholders will receive a cash payment based on the trading price of the common stock prior to the effectiveness of the reverse split. Stockholders' equity has been restated to give retroactive recognition to the reverse split for all periods presented by reclassifying the excess par value resulting from the reduced number of shares from common stock to paid-in capital. All references to common share and per common share amounts for all periods presented have been retroactively restated to reflect this reverse split.

In January 2003, the Company issued 43,570 shares of common stock in connection with the conversion of $130,667 of convertible notes payable (Note E1).

2. Warrants

In connection with the reverse acquisition of MindArrow on September 30, 2002, MindArrow's outstanding warrants remained outstanding and thus became an obligation of Avalon. As of September 30, 2002, there were 1,511,002 warrants outstanding with exercise prices ranging from $1 to $300 per share, and with expiration dates ranging from January 2003 through April 2010.

In addition, in connection with the reverse acquisition of MindArrow on September 30, 2002, Category 5's stockholders received warrants to purchase one share of Avalon common stock for every twenty shares of Category 5 common stock that they owned immediately prior to the transaction for a total of 833,918 warrants. The exercise price of the warrants is $0.10 per share, and are exercisable if the Company's Small Business division achieves certain financial targets for the twelve months ending September 30, 2003.

In October 2002, the Company issued 28,750 warrants to purchase common stock at prices ranging from $5 to $12.50 per share in connection with common stock issued for financing (Note G1). The Company recognized financing costs of $22,863 during the quarter ended December 31, 2002 based on the fair value of the vested warrants as computed using the Black-Scholes option pricing model.

In December 2002, the Company issued 179,170 warrants to purchase common stock at $3 per share, and reduced the price of 179,170 previously issued warrants to $3 per share, in connection with amendments made to bridge notes (Note E1). The value of the grant of additional warrants and repricing of old warrants as computed using the Black-Scholes option pricing model, combined with the resulting beneficial conversion feature resulted in a discount to the note of $820,000, thus yielding an effective interest rate of 114%. The discount is

being amortized over the term of the bridge notes, therefore $528,858 of the discount has been amortized as interest expense as of March 31, 2003. The unamortized discount balance on the notes at March 31, 2003 was $291,142.

Additionally, the Company issued 17,500 warrants to purchase common stock at $2.37 per share in December 2002 as partial consideration for the acquisition of AGEA Corporation (Note K). The warrants were valued at $7,175 based on the fair value of the vested warrants as computed using the Black-Scholes option pricing model.

In February 2003, the Company issued 20,000 warrants to purchase common stock at $2 per share in connection with conversion of an advance from a stockholder (Note G1). The Company recognized financing costs of $5,200 during the quarter ended March 31, 2003 based on the fair value of the vested warrants as computed using the Black-Scholes option pricing model.

In February 2003, the Company issued warrants to purchase 43,125 shares of common stock at $2 per share in connection with the Radical note conversion (Note E3). The Company recognized financing costs of $6,900 during the quarter ended March 31, 2003 based on the fair value of the vested warrants as computed using the Black-Scholes option pricing model.

In February 2003, the Company issued warrants to purchase 7,188 shares of common stock at $2 per share in connection with the $25,000 cash investment by East West Capital (Note G1). The Company recognized financing costs of $1,150 during the quarter ended March 31, 2003 based on the fair value of the vested warrants as computed using the Black-Scholes option pricing model.

In February 2003, as consideration for entering into a bridge loan, the Company repriced 723,437 warrants issued in connection with the East West Capital financing transactions (Note G1) to $2 per share. This repricing, as computed using the Black-Scholes option pricing model, resulted in a discount to the note of $200,000, thus yielding an effective interest rate of 110%. $68,333 of the discount has been amortized as interest expense as of March 31, 2003.. The unamortized discount balance on the note at March 31, 2003 was $131,667.

3. Options

Following the completion of the reverse acquisition of MindArrow on September 30, 2002, MindArrow's stock option plans became the stock option plans of Avalon.

As amended, the 1999 Stock Option Plan (the "1999 Plan"), reserves 247,500 shares of common stock for option grants to employees, directors and consultants to continue their service to the Company. At March 31, 2003, there remained 55,470 shares available for grant under the 1999 Plan.

As amended, the 2000 Stock Incentive Plan (the "2000 Plan"), reserves 549,750 shares of common stock for option grants to employees, directors and consultants to continue their service to the Company. At March 31, 2003, there remained 96,605 shares available for grant under the 2000 Plan.

Options granted under Category 5's previous option plans, (the "C5 Plans") became obligations of Avalon, but the C5 Plans themselves were discontinued. Accordingly, options granted under the C5 Plans to purchase 426,089 shares of common stock were outstanding as of March 31, 2003, all of which became vested upon completion of the reverse acquisition of MindArrow.

During the quarter ended March 31, 2003, options to purchase 409,215 shares at $1.50 per share were granted and 77,790 options expired.

At March 31, 2003 and 2002, the Company has issued stock options to certain of its employees. The Company accounts for these options under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted had an exercise price equal to or greater than the market value of the underlying common stock on the date of grant. Had compensation cost for the Company's stock option plans been determined based on the fair value consistent with the provisions of SFAS No. 123, "Accounting for Stock-Based Compensation", the Company's net loss and loss per share would have been reduced to the pro forma amounts indicated below for the three and nine months ended March 31, 2003 and 2002:

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Avalon Digital Marketing Systems, Inc. and Subsidiaries
Notes to Consolidated Financial Statements - (Continued)

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2003	2002	2003	200
Net income (loss) as reported	$ (27,631,481)	$ 467,940	$ (36,498,468)	$ 1,7
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(466,505)	(237,667)	(466,505)	(7
Net loss - pro forma	$ (28,097,986)	$ 230,273	$ (36,964,973)	$ 1,0
Earnings (loss) per share:				
Basic - as reported	$ (3.79)	$ 0.16	$ (6.04)	$
Diluted - as reported	$ (3.79)	$ 0.13	$ (6.04)	$
Pro forma:				
Basic	$ (3.85)	$ 0.08	$ (6.12)	$
Diluted	$ (3.85)	$ 0.06	$ (6.12)	$

Note H--Reverse Acquisition of MindArrow Systems, Inc.

On September 30, 2002, all of the outstanding shares of Category 5 were acquired by MindArrow. The former shareholders of Category 5 received shares equal to 55% of the issued and outstanding common stock of Avalon, plus warrants to purchase an additional 5% should the Small Business division achieve certain financial targets for the twelve month period ending September 30, 2003.

The transaction has been accounted for as a reverse acquisition, with Category 5 the acquirer. The total purchase price of the acquisition was $18,324,995, which gives effect to the 3,133,636 outstanding shares of common stock and all outstanding options and warrants of MindArrow. The purchase price was allocated to the assets acquired and the liabilities assumed based on their estimated fair values. Goodwill has resulted from the excess costs over fair value of the net assets acquired.

Intangibles	$ 21,447,474
Cash	36,485
Other tangible assets acquired	2,381,898
Liabilities assumed	(5,490,862)
	$ 18,324,995

The Company performed an evaluation of the intangible assets arising from the transaction, and identified the following:

Existing technology	$ 2,800,000
Patents	1,200,000
Customer relationships	2,900,000
Goodwill	14,547,474
	$21,447,474

All of these intangible assets were determined to be impaired at March 31, 2003 and written off (Note A8).

The following unaudited pro forma results of operations for the nine months ended March 31, 2003, assume the acquisition discussed above occurred on July 1, 2002:

Revenues	$ 12,014,250
Net loss	(38,492,539)
Basic and diluted loss per share	$ (5.42)
Weighted average shares	7,095,872

The above pro forma financial information does not purport to be indicative of the results of operations had the acquisition of MindArrow actually had taken place on July 1, 2002, nor is it intended to be a projection of future results or trends.

Note I--Income Taxes

Components of income tax benefit (expense) reflected in the consolidated statements of operations for the nine months ended March 31, 2003 are as follows:

	Three Months Ended March 31,		Nine Mon Ma
	2003	2002	2003
Expected tax benefit (expense) at federal rate	$ 9,390,000	$ (240,000)	$ 12,410,000
Nondeductible expenses	(8,350,000)	16,000	(8,350,000
Net operating loss producing no current benefit	(1,040,000)	--	(2,916,000
	$ --	$ (240,000)	$ 1,144,000

The components of deferred taxes included in the accompanying consolidated balance sheet as of March 31, 2003, are as follows:

Deferral of revenue related to contracts receivable	$ (332,000)
Accrued vacation	89,000
Net operating loss carryforwards	16,354,000
Deferred tax asset	16,111,000
Valuation allowance	(16,111,000)
Net	$ --

As of March 31, 2003, the Company has approximately $48.1 million in net operating loss carryforwards which are available to offset future taxable income. These losses begin to expire in 2019. Utilization of these losses will likely be significantly limited due to the impact of Internal Revenue Code Section 382 and the regulations thereunder.

Note J--Supplemental Disclosure of Cash Flow Information

Noncash investing and financing activities included the reverse acquisition of MindArrow described above, in exchange for 3,133,636 shares of common stock, the acquisition of the assets of AGEA Corporation and the acquisition of Mindwire, Inc. (Note K).

In addition, noncash investing and financing activities included the conversion of a $150,000 portion of the note payable to Radical Communication, Inc. into 37,500 shares of common stock and warrants to purchase 43,125 shares of common stock.

Note K--Acquisitions

On December 22, 2002 the Company acquired the assets of AGEA Corporation in exchange for 175,000 shares of common stock valued at $1.88 per share and warrants to purchase 17,500 shares of common stock at $2.37 per share (Note G2). The consideration was valued at $336,175 and allocated to the assets acquired and the liabilities assumed as follows:

Cash acquired	$ 390,000
Liabilities assumed	(53,825)
	$ 336,175

On January 31, 2003 the Company acquired Mindwire, Inc. in exchange for 46,700 shares of common stock valued at $1.36 per share. The consideration was valued at $63,512 and allocated to the assets acquired and the liabilities assumed as follows:

Assets acquired	$ 3,361
Liabilities assumed	(25,030)
Goodwill	85,181
	$ 63,512

Note L--Subsequent Events

In May 2003, the Company entered into a non-binding letter of intent to sell certain of the assets from the Large Enterprise operations to Silverpop Systems, Inc. These assets led to approximately $800,000 in revenue for the quarter ended March 31, 2003. After the sale, if consummated, the Company will focus on software-based solutions for Small Business customers. The Company had not considered selling these assets until it received an offer in April 2003. Accordingly, at March 31, 2003, these assets were considered as held and used.

The sale of assets from the Large Enterprise operations is designed to raise cash to pay off certain liabilities and allow the Company to reorganize around the Small Business software and services operations, which have recently released two new software products. The sale of assets has not been completed, and there is no assurance that it will be completed on terms that will be acceptable, or that the proceeds will be sufficient to allow the Company to successfully restructure and continue operations.

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Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read together with our consolidated financial statements and related notes included elsewhere in this quarterly report on Form 10-Q. All references to "pro forma" results for prior periods in this Item 2 assume that the merger between MindArrow and Category 5 occurred in such prior periods.

Overview

Avalon Digital Marketing Systems, Inc. was formed as a result of a

merger between MindArrow Systems, Inc. and Category 5 Technologies, Inc. on September 30, 2002. MindArrow was the legal acquirer or Category 5, but because Category 5's business was larger than MindArrow's and because Category 5's former stockholders obtained the majority of the outstanding shares of the combined company at the time of the merger, generally accepted accounting principles require that Category 5 be treated as the acquirer for accounting and reporting purposes. Accordingly, the financial statements included in this report reflect the following:

- o Consolidated Balance Sheet as of March 31, 2003 - reflects post-merger Avalon.
- o Consolidated Balance Sheet as of June 30, 2002 - reflects Category 5 only.
- o Statements of Operations for the Quarter and Nine Months Ended March 31, 2002 - reflects Category 5 only. Statements of Operations for the Nine Months Ended March 31, 2003 - reflects one quarter of Category 5 only and two quarters of post-merger Avalon. Statements of Operations for the Quarter Ended March 31, 2003 reflects operations of post-merger Avalon.
- o Statements of Cash Flows for the Nine Months Ended March 31, 2002 - reflects Category 5 only. Statements of Cash Flows for the Nine Months Ended March 31, 2003 - reflects one quarter of Category 5 only and two quarters of post-merger Avalon.
- o Pro forma combined information as if the merger had taken place on July 1, 2002 is contained in the notes to financial statements.

In addition, references to the "Company" for periods prior to September 30, 2002 are intended to refer to Category 5 and its business, except for information provided on a "pro forma" basis.

Category 5 was founded in 1998 as Executive Credit Services LLC and incorporated under the name ePenzio, Inc. in May 2000. On May 29, 2001, Network Investor Communications, Inc. ("NWIC") acquired all of the outstanding shares of ePenzio, and effective July 23, 2001, NWIC changed its name to Category 5 Technologies, Inc. ("Category 5"). For accounting purposes the business combination with NWIC was treated as a reverse merger or a recapitalization of ePenzio, with ePenzio being treated as the accounting acquirer. On September 30, 2002, MindArrow Systems, Inc., a Delaware corporation, acquired all of the outstanding shares of Category 5 and changed its name to Avalon Digital Marketing Systems, Inc. For accounting purposes, the business combination with MindArrow was treated as a reverse acquisition, with Category 5 being the acquirer.

Avalon develops and provides software and services that enable our clients to communicate and sell more effectively and efficiently over the web, via email, and through other digital channels.

The business is divided between the Small Business and Large Enterprise sales channels. The Small Business channel has been the primary source of our historical revenues, and provides small businesses with merchant services and digital marketing software, primarily marketed through workshops. Small Business operations consist primarily of Category 5's subsidiaries, Avalon Business Direct, Inc., ePenzio, Inc., Bring it Home, Inc. and Olympus Financial, Inc. In March 2003, we stopped selling our products through seminars operated by our Bring it Home subsidiary, and refocused on selling software and services through alternative distribution methods.

We also provide customized software and professional services to large companies. These operations consist primarily of the former MindArrow, MindArrow Asia, Ltd. and former Category 5

subsidiary, CaptureQuest, Inc. In May 2003, we entered into a non-binding letter of intent to sell certain of the assets from our Large Enterprise operations to Silverpop Systems, Inc. These assets led to approximately $800,000 in revenue for the quarter ended March 31, 2003. After the sale, if consummated, we will focus our business on software-based solutions for our Small Business customers.

Our revenues were derived from the production and delivery of rich media messages and software license fees. Production services include theme development, design and layout, video production, special effects, hyperlink recommendations, hyperlink page design and creation, reporting and sales cycle consultation.

We currently sell our products and services through a direct sales force and a small network of sales affiliates.

Critical accounting policies

Revenues are recognized when the consulting or production services are rendered and messages are delivered. We recognize software license fee revenue when persuasive evidence of an agreement exists, the product has been delivered, we have no remaining significant obligations with regard to implementation, the license fee is fixed or determinable and collection of the fee is probable. Revenue from media sales is recognized upon placing advertisements. Revenue from consulting is recognized as the services are rendered. Revenues from products sold by the Small Business sales channel under installment contracts are recognized net of amounts estimated to be uncollectible.

We record cash receipts from clients and billed amounts due from clients in excess of revenue recognized as deferred revenue. The timing and amount of cash receipts from clients can vary significantly depending on specific contract terms and can therefore have a significant impact on the amount of deferred revenue in any given period.

Identifiable intangible assets acquired in a business combination are recorded separately from goodwill if they arise from contractual or other legal rights or are separable from the acquired entity and can be sold, transferred, licensed, rented or exchanged, either individually or as part of a related contract, asset or liability. Goodwill, as well as other intangible assets with indefinite lives, are not amortized and will be tested for impairment annually and whenever there is an impairment indicator. All acquired goodwill is assigned to reporting units for purposes of impairment testing and segment reporting.

Recent accounting pronouncements

SFAS No. 143, "Accounting for Asset Retirement Obligations," was issued in June 2001. SFAS No. 143 addresses accounting and reporting for legal obligations and related costs associated with the retirement of long-lived assets. The Statement requires that the fair value of the liability for an asset retirement obligation be recognized in the period incurred if a reasonable estimate of fair value can be made. The estimated retirement costs are capitalized as part of the carrying amount of the long-lived asset. SFAS No. 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002. Adoption of this statement did not have a material effect.

In August 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This statement supersedes SFAS No.

121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" and the accounting and reporting provisions of APB Opinion No. 30. SFAS No. 144 establishes accounting standards for the impairment of long-lived assets, excluding goodwill, and for long-lived assets to be disposed of. SFAS No. 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount 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 assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. The statement

retains the basic provisions of APB Opinion No. 30 for the presentation of discontinued operations in the statement of operations but broadens that presentation to include a component of an entity (rather than a segment of a business).

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." This Statement, among other things, rescinds SFAS No. 4, "Reporting Gains and Losses from Extinguishment of Debt," and SFAS No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements." The Statement requires gains and losses from debt extinguishments that are used as part of the Company's risk management strategy to be classified as part of income from operations rather than as extraordinary items, net of tax. SFAS No. 145 is effective for fiscal years beginning after May 15, 2002 with earlier adoption encouraged. Adoption of this statement did not have a material effect.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." SFAS No. 146 requires that a liability for costs associated with an exit or disposal activity be recognized when the liability is incurred rather than when a company commits to such an activity and also establishes fair value as the objective for initial measurement of the liability. The Company will adopt SFAS No. 146 for exit or disposal activities that are initiated after December 31, 2002.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure," which amends SFAS No. 123, "Accounting for Stock-Based Compensation". SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation and is effective for fiscal years ending after December 31, 2002. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in annual and interim financial statements about the method of accounting for stock-based compensation and the effect in measuring compensation expense. The disclosure requirements of SFAS No. 148 are effective for interim periods beginning after December 15, 2002. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25 and related interpretations. Accordingly, compensation expense for stock options is measured as the excess, if any, of the estimate of the market value of the Company's stock at the date of the grant over the amount an

employee must pay to acquire the stock. The Company adopted the annual disclosure provisions of SFAS No. 148 in the quarter ended March 31, 2003.

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." Interpretation No. 45 requires a guarantor to include disclosure of certain obligations, and if applicable, at the inception of the guarantee, recognize a liability for the fair value of other certain obligations undertaken in issuing a guarantee. The recognition requirement is effective for guarantees issued or modified after December 31, 2002 and based on current operations, the Company does not expect the adoption of the recognition requirements of this statement to have a material effect on its financial position or results of operations. The disclosure requirements are effective for financial statements of interim and annual periods ending after December 31, 2002.

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities." Interpretation No. 46 clarifies the application of Accounting Research Bulletin No. 51 and applies immediately to any variable interest entities created after January 31, 2003 and to variable interest entities in which an interest is obtained after that date. This Interpretation is applicable for the Company in the second quarter of fiscal year 2004, which ends September 30, 2003, for interests acquired in variable interest entities prior to February 1, 2003. Based on current operations, the Company does not expect the adoption of Interpretation No. 46 to have a material effect on its financial position or results of operations.

We need additional financing

Our liquidity is significantly impacted by credit and collections issues. Our small business seminar channel formerly generated large balances of receivables and, depending on the quality of the credit and cash needs, we sold certain of the receivables, at a discount, to financing sources. Receivables that have not been sold are retained and billing and collecting administration have been outsourced. A large portion of the seminar customers have historically had sub-prime credit. Accordingly, many of the receivables generated by these customers have high credit risk.

During the last six months of calendar 2002, the Company sold a significant portion of its contracts receivable, at a discount, in order to raise cash. The receivables sold were typically the highest quality in the portfolio, so the remaining contracts receivable represented the lowest quality. Accordingly, the Company experienced high delinquencies in the remaining receivables portfolios through December 31, 2002. This, coupled with the writedown of a certificate of deposit and the uncertainty experienced with the funding of the East West investment, have severely impacted the Company's liquidity and rendered it insolvent.

At March 31, 2003, we had $60,678 in cash, which requires that we seek immediate additional capital. As of March 31, 2003, we had current assets of approximately $1.5 million and current liabilities of approximately $10.8 million. This represents a working capital deficit of approximately $9.3 million. The negative working capital balance includes as current liabilities approximately $1.3 million of deferred revenues and is mitigated by approximately $627,000 in net contracts receivables included in long-term assets.

Our line of credit facility with Zions Bank includes covenants for tangible net worth and debt coverage ratios. As of March 31, 2003, the balance on the line was $413,687, and we were in violation of these covenants, and have sought waivers. As of the date hereof, the bank has not waived the violations, and if it were to demand payment of the entire balance, our liquidity would suffer. In January 2003, in exchange for an advance of $250,000 on the line, we designated a recurring revenue stream in the amount of approximately $40,000 per month for repayment of the outstanding balance on the line.

The $250,000 principal payment due to Radical Communication, Inc. on October 1, 2002 has not been made, and in February 2003, $50,000 of the past due amount, and $100,000 of the $500,000 remaining balance due was converted into common stock at $4 per share. We are seeking an extension or conversion into equity of some or all of the remaining past due balance.

We had $820,000 of convertible notes payable that were due on November 21, 2002. In November 2002, the note holders agreed to amend the repayment terms of the notes to increase the interest rate to 14%, lower the conversion price to $3 per share, establish payment terms calling for six equal monthly principal payments beginning in January 2003 through June 2003. The value of the grant of additional warrants and repricing of old warrants as computed using the Black-Scholes option pricing model, combined with the resulting beneficial conversion feature resulted in a discount to the note of $820,000, thus yielding an effective interest rate of 114%. The discount is being amortized over the term of the bridge notes, therefore $528,858 of the discount has been amortized as interest expense as of March 31, 2003. In January 2003, $130,667 of the notes were converted into 43,570 shares of common stock. As of May 31, 2003, the balance of the January payment that was not converted into common stock amounted to $50,107 and has not been paid, nor any other payments made.

In February 2003, a group of investors led by East-West Capital Associates, Inc. ("East-West Capital") and its affiliate, East West Venture Group, LLC agreed to fund the $175,000 remainder of its $3 million obligation to purchase our common stock at $4 per share, by providing $25,000 in cash and $150,000 through the conversion of a portion of the note payable to Radical Communication, Inc. into common stock on the same terms. In addition, the February 2003 amendment to the stock purchase agreement terminated the remaining financing commitment of $800,000 in exchange for a cash investment of $200,000 in the Company by East-West Capital in the form of a convertible secured debenture, bearing interest at 10% per annum, and maturing on the earlier of 120 days from the funding date or the closing of a financing for at least an additional $500,000 or more of equity or debt. The debenture may be converted at the option of the holder at the lesser of (i) $1.375 per share or (ii) the same terms and conditions as a proposed new equity financing by the Company. The Company also agreed to reprice previous warrants issued to East-West Capital and its affiliates to $2.00 per share. This repricing, as computed using the Black-Scholes option pricing model, resulted in a discount to the note of $200,000, thus yielding an effective interest rate of 110%. $68,333 of the discount has been amortized as interest expense as of March 31, 2003. East-West Capital agreed to eliminate the

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protective provisions of the related investor rights agreement and provide active assistance to the Company in its proposed new equity financing efforts.

In May 2003, we received a $400,000 bridge loan from an investor affiliated with a significant shareholder and who is a former director. The bridge loan accrues interest at the rate of 25% per annum, is secured by all assets of the Company, matures on the earlier of May 15, 2004, or the closing of

the sale of certain assets from the Large Enterprise operations.

The sale of assets from the Large Enterprise operations is designed to raise cash to pay off certain liabilities and allow us to reorganize around the Small Business software and services operations, which have recently released two new software products. The sale of assets has not been completed, and there is no assurance that it will be completed on terms that will be acceptable to us, or that the proceeds will be sufficient to allow us to successfully restructure and continue operations.

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the company as a going concern.

In our view, recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheet is dependent upon our continued operations, which in turn is dependent upon our ability to meet obligations on a continuing basis. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or amounts and classification of liabilities that might be necessary should we be unable to continue in existence.

Results of operations

Revenues from sales to the Large Enterprise customers increased to $1.9 million for the quarter ended March 31, 2003, a 61% increase over pro forma combined revenues of MindArrow and CaptureQuest for the same period for the previous year. The increase is primarily related to the addition of several large clients. In May 2003, we entered into a non-binding letter of intent to sell certain of the operating assets of the Large Enterprise division to Silverpop Systems, Inc., representing nearly one-half of these revenues.

In recent months, we have introduced Axis(TM), a new software product that enables small businesses to create, manage and host websites using Macromedia, Inc.'s Flash(TM) technology, as well as Courier(TM), which is a Flash-enabled email marketing tool designed for small business customers. These products, together with professional services that will enable our customers to make the best use of them, are central to our strategy going forward.

These new products allow us to shift our Small Business focus away from selling third-party products through the third-party seminar channel, formerly operated by our subsidiary, ePenzio, Inc. ("ePenzio"). At third-party workshops, known as "lead sources," ePenzio customers generally entered into long-term installment contracts to pay for the products and services they purchased, and we have experienced high rates of payment default in these contracts in the past several quarters. Accordingly, we have significantly reduced the number of installment contracts we are accepting, and have begun to seek new lead sources and other third-party sales channels. Quarterly revenues from our ePenzio subsidiary have decreased from $5.6 million for the quarter ended March 31, 2002 to $0.3 million in the current quarter.

We have also shifted from selling through our direct seminar channels operated by our subsidiary Bring it Home, Inc., ("BiH"). The seminars operated by BiH required significant up-front cash investments in marketing in order to be successful, and our deteriorating liquidity made it increasingly difficult to operate the seminars profitably. Accordingly, in March 2003, we stopped selling through the seminar channel. Revenues from BiH decreased to $1.0 million in the quarter ended March 31, 2003, from $2.3 million in the same period of the prior year.

Quarterly revenues totaled $3.3 million, a 58% decrease from the same quarter in the previous year. Revenues for the nine months ended March 31, 2003 decreased to $10.9 million from $19.3 million for the nine months ended March 31, 2002, a 44% decrease. The decreases are primarily the result of management's plan to reduce our dependency on lower quality ePenzio revenues.

Gross profit decreased from $4.4 million for the three months ended March 31, 2002 to $2.1 million for the three months ended March 31, 2003. Gross profit decreased from $11.9 million, or 62% of revenues, to $8.4 million, or 77% of revenues, for the nine months ended March 31, 2003.

Selling, general and administrative expenses increased from $3.6 million, or 45% of revenues, and $9.0 million, or 47% of revenues, for the quarter and nine months ended March 31, 2002, respectively, to $3.7 million, or 111% of revenues, and $13.6 million, or 125% of revenues, for the quarter and nine months ended March 31, 2003, respectively. These increases were associated with additional costs of integrating previously acquired companies and professional service and other costs associated with the combination of MindArrow and Category 5. During the quarter ended March 31, 2003, we completed cost reductions which will reduce costs in subsequent quarters.

Bad debt expense increased to $245,001 and $4.6 million for the quarter and nine months ended March, 31, 2003, respectively, compared to no bad debt expense for the same periods from 2002. The increase resulted primarily from defaults on ePenzio's contracts receivable and the discount taken when contracts receivable were sold to financing companies. We have decreased our use of long-term contracts receivable for revenues generated by ePenzio, and therefore expect bad debt expense to decrease on both an absolute and relative basis in future quarters.

We incurred a loss from operations of $27.0 million and $36.2 million for the quarter and nine months ended March 31, 2003, respectively, compared to income from operations of $772,105 and $2.8 million for the same periods from 2002. The loss resulted from a number of factors, including the factors discussed in the foregoing paragraphs and the following factors:

- Writedown of goodwill and identifiable intangibles.
- The decrease in lead-source revenues and significant bad debt expense.
- Costs associated with organizing and marketing Bring It Home seminars;
- Increases in costs related to the acquisitions completed during the year; and

Certain of these costs are nonrecurring, such as the costs associated with integrating acquired companies, and the curtailing of entering into installment contracts will significantly reduce bad debt expense in future quarters.

The write-down of short-term investment of $1.0 million relates to a certificate of deposit account in the name of our CaptureQuest subsidiary that arose from an investment in CaptureQuest by Omnicorp Bank. The account was held at Omnicorp, which was declared insolvent by regulators in October 2002. Omnicorp has asked account holders to convert their certificates of deposit into an investment in preferred shares of Solara Ventures, Inc. a Canadian-based

investment company. As of March 31, 2003, the entire balance was written down due to the uncertainty surrounding any recovery.

We incurred a net loss of $27.6 million or $3.79 per share, and $36.5 million, or $6.04 per share, for the quarter and nine months ended March 31, 2003, respectively, compared to net income of $467,940, or $0.16 per share, and $1.8 million, or $0.63 per share, for the same periods in 2002.

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Liquidity and sources of capital

Our liquidity is significantly impacted by credit and collections issues. Our Small Business channel formerly generated large balances of receivables and, depending on the quality of the credit and cash needs, we sold certain of the receivables, at a discount, to financing sources. Receivables that have not been sold are retained and billing and collecting administration have been outsourced. A large portion of the Small Business customers have historically had sub-prime credit. Accordingly, many of the receivables generated by these customers may have high credit risk.

During the last six months of calendar 2002, the Company sold a significant portion of its contracts receivable, at a discount, in order to raise cash. The receivables sold were typically the highest quality in the portfolio, so the remaining contracts receivable represented the lowest quality. Accordingly, the Company experienced high delinquencies in the remaining receivables portfolios through December 31, 2002. This, coupled with the writedown of a certificate of deposit and the uncertainty experienced with the funding of the East West investment, have severely impacted the Company's liquidity and rendered it insolvent.

At March 31, 2003, we had $60,678 in cash, which requires that we seek immediate additional capital. As of March 31, 2003, we had current assets of approximately $1.5 million and current liabilities of approximately $10.8 million. This represents a working capital deficit of approximately $9.3 million. The negative working capital balance includes as current liabilities approximately $1.3 million of deferred revenues and is mitigated by approximately $627,000 in net contracts receivables included in long-term assets.

Our line of credit facility with Zions Bank includes covenants for tangible net worth and debt coverage ratios. As of March 31, 2003, the balance on the line was $413,687, and we were in violation of these covenants, and have sought waivers. As of the date hereof, the bank has not waived the violations, and if it were to demand payment of the entire balance, our liquidity would suffer. In January 2003, in exchange for an advance of $250,000 on the line, we designated a recurring revenue stream in the amount of approximately $40,000 per month for repayment of the outstanding balance on the line.

The $250,000 principal payment due to Radical Communication, Inc. on October 1, 2002 has not been made, and in February 2003, $50,000 of the past due amount, and $100,000 of the $500,000 remaining balance due was converted into common stock at $4 per share. We are seeking an extension or conversion into equity of some or all of the past due balance.

We had $820,000 of convertible notes payable that were due on November 21, 2002. In November 2002, the note holders agreed to amend the repayment terms of the notes to increase the interest rate to 14%, lower the conversion price to $3 per share, establish payment terms calling for six equal monthly principal payments beginning in January 2003 through June 2003. The value of the grant of

additional warrants and repricing of old warrants as computed using the Black-Scholes option pricing model, combined with the resulting beneficial conversion feature resulted in a discount to the note of $820,000, thus yielding an effective interest rate of 114%. The discount is being amortized over the term of the bridge notes, therefore $528,858 of the discount has been amortized as interest expense as of March 31, 2003. In January 2003, $130,667 of the notes were converted into 43,570 shares of common stock. As of May 31, 2003, the balance of the January payment that was not converted into common stock amounted to $50,107 and has not been paid, nor any other payments made.

In February 2003, a group of investors led by East-West Capital Associates, Inc. ("East-West Capital") and its affiliate, East West Venture Group, LLC agreed to fund the $175,000 remainder of its $3 million obligation to purchase our common stock at $4 per share, by providing $25,000 in cash and $150,000 through the conversion of a portion of the note payable to Radical Communication, Inc. into common stock on the same terms. In addition, the February 2003 amendment to the stock purchase agreement terminated the remaining financing commitment of $800,000 in exchange for a cash investment of $200,000 in the Company by East-West Capital in the form of a convertible secured debenture, bearing interest at 10% per annum, and maturing on the earlier of 120 days from the funding date or the closing of a financing for at least an additional $500,000 or more of equity or debt. The debenture may be converted at the option of the holder at the lesser of (i) $1.375 per share or (ii) the same terms and conditions as a proposed new equity financing by the Company. The Company also agreed to reprice previous warrants issued to East-West Capital and its affiliates to $2.00 per share. This repricing, as computed using the Black-Scholes option pricing model, resulted in a discount to the note of $200,000, thus yielding an effective interest rate of 110%. $68,333 of the discount has been amortized as interest expense as of March 31, 2003. East-West Capital agreed to eliminate

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the protective provisions of the related investor rights agreement and provide active assistance to the Company in its proposed new equity financing efforts.

In May 2003, we received a $400,000 bridge loan from an investor affiliated with a significant shareholder and who is a former director. The bridge loan accrues interest at the rate of 25% per annum, is secured by all assets of the Company, matures on the earlier of May 15, 2004, or the closing of the sale of certain assets of the Large Enterprise division. As consideration for entering into the bridge loan the Company issued warrants to purchase 495,000 shares of common stock at $0.33 per share.

The sale of assets from the Large Enterprise operations is designed to raise cash to pay off certain liabilities and allow us to reorganize around the Small Business software and services operations, which have recently released two new software products. The sale of assets has not been completed, and there is no assurance that it will be completed on terms that will be acceptable to us, or that the proceeds will be sufficient to allow us to successfully restructure and continue operations.

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the company as a going concern.

In our view, recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheet is dependent upon our continued operations, which in turn is dependent upon our ability to meet obligations on a

continuing basis. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or amounts and classification of liabilities that might be necessary should we be unable to continue in existence.

During the nine months ended March 31, 2003, we used $1,239,473 of cash from operating activities, generated $381,250 of cash in investing activities and generated $620,629 of cash in financing activities. During the nine months ended March 31, 2002, we used $1,120,991 million of cash in operating activities, used $97,567 of cash in investing activities and generated cash in financing activities of $1,396,486.

Our liquidity has been significantly impacted by credit and collections issues. ePenzio formerly generated large balances of installment contracts receivable and, depending on the quality of the credit and the cash needs, we sold certain of the receivables, at a discount, to financing sources. The receivables that we did not sell were generated by these customers often had high credit risk. We have recently undertaken steps designed to improve collectibility and attempt to reclaim accounts that have been fully reserved or written off.

We need additional capital to continue operations in the near term. Additional capital may come from the sale of certain assets of the Large Enterprise business or other available means, which may include debt and/or equity financings. We cannot give assurance that any additional financing will be available on acceptable terms, if at all. Any equity financing and debt financing, if available, may include restrictive covenants. If we are unable to raise additional capital and/or reach agreement with our creditors to forgive a significant portion of the amounts owed to them, our operations will be severely harmed.

Certain of the matters and subject areas discussed in this quarterly report on Form 10-Q contain "forward-looking statements" that are subject to a number of risks and uncertainties, many of which are beyond our control. All statements, other than statements of historical fact included in this report regarding our business strategy, future operations, financial position, estimated revenues, projected costs, prospects, plans and objectives of management as well as third parties are forward-looking statements. Generally, when used in this report, the words "anticipate," "intend," "estimate," "expect," "project," and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain such identifying words. All forward-looking statements speak only as of the date of this report. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Important factors that could cause our actual results to differ materially from our expectations are described below and in our other filings with the SEC.

Risk Factors

We need additional financing

Our liquidity is significantly impacted by credit and collections issues. Our Small Business channel formerly generated large balances of receivables and, depending on the quality of the credit and cash needs, we sold certain of the receivables, at a discount, to financing sources. Receivables that have not been sold are retained and billing and collecting administration

have been outsourced. A large portion of the Small Business customers have historically had sub-prime credit. Accordingly, many of the receivables generated by these customers may have high credit risk.

During the last six months of calendar 2002, the Company sold a significant portion of its contracts receivable, at a discount, in order to raise cash. The receivables sold were typically the highest quality in the portfolio, so the remaining contracts receivable represented the lowest quality. Accordingly, the Company experienced high delinquencies in the remaining receivables portfolios through December 31, 2002. This, coupled with the writedown of a certificate of deposit and the uncertainty experienced with the funding of the East West investment, have severely impacted the Company's liquidity and rendered it insolvent.

At March 31, 2003, we had $60,678 in cash, which requires that we seek immediate additional capital. As of March 31, 2003, we had current assets of approximately $1.5 million and current liabilities of approximately $10.8 million. This represents a working capital deficit of approximately $9.3 million. The negative working capital balance includes as current liabilities approximately $1.3 million of deferred revenues and is mitigated by approximately $627,000 in net contracts receivables included in long-term assets.

Our line of credit facility with Zions Bank includes covenants for tangible net worth and debt coverage ratios. As of March 31, 2003, the balance on the line was $413,687, and we were in violation of these covenants, and have sought waivers. As of the date hereof, the bank has not waived the violations, and if it were to demand payment of the entire balance, our liquidity would suffer. In January 2003, in exchange for an advance of $250,000 on the line, we designated a recurring revenue stream in the amount of approximately $40,000 per month for repayment of the outstanding balance on the line.

The $250,000 principal payment due to Radical Communication, Inc. on October 1, 2002 has not been made, and in February 2003, $50,000 of the past due amount, and $100,000 of the $500,000 remaining balance due was converted into common stock at $4 per share. We are seeking an extension or conversion into equity of some or all of the remaining past due balance.

We had $820,000 of convertible notes payable that were due on November 21, 2002. In November 2002, the note holders agreed to amend the repayment terms of the notes to increase the interest rate to 14%, lower the conversion price to $3 per share, establish payment terms calling for six equal monthly principal payments beginning in January 2003 through June 2003. The value of the grant of additional warrants and repricing of old warrants as computed using the Black-Scholes option pricing model, combined with the resulting beneficial conversion feature resulted in a discount to the note of $820,000, thus yielding an effective interest rate of 114%. The discount is being amortized over the term of the bridge notes, therefore $528,858 of the discount has been amortized as interest expense as of March 31, 2003. In January 2003, $130,667 of the notes were converted into 43,570 shares of common stock. As of May 31, 2003, the balance of the January payment that was not converted into common stock amounted to $50,107 and has not been paid, nor any other payments made.

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In February 2003, a group of investors led by East-West Capital Associates, Inc. ("East-West Capital") and its affiliate, East West Venture Group, LLC agreed to fund the $175,000 remainder of its $3 million obligation to purchase our common stock at $4 per share, by providing $25,000 in cash and

$150,000 through the conversion of a portion of the note payable to Radical Communication, Inc. into common stock on the same terms. In addition, the February 2003 amendment to the stock purchase agreement terminated the remaining financing commitment of $800,000 in exchange for a cash investment of $200,000 in the Company by East-West Capital in the form of a convertible secured debenture, bearing interest at 10% per annum, and maturing on the earlier of 120 days from the funding date or the closing of a financing for at least an additional $500,000 or more of equity or debt. The debenture may be converted at the option of the holder at the lesser of (i) $1.375 per share or (ii) the same terms and conditions as a proposed new equity financing by the Company. The Company also agreed to reprice previous warrants issued to East-West Capital and its affiliates to $2.00 per share. This repricing, as computed using the Black-Scholes option pricing model, resulted in a discount to the note of $200,000, thus yielding an effective interest rate of 110%. $68,333 of the discount has been amortized as interest expense as of March 31, 2003. East-West Capital agreed to eliminate the protective provisions of the related investor rights agreement and provide active assistance to the Company in its proposed new equity financing efforts.

In May 2003, we received a $400,000 bridge loan from an investor affiliated with a significant shareholder and who is a former director. The bridge loan accrues interest at the rate of 25% per annum, is secured by all assets of the Company, matures on the earlier of May 15, 2004, or the closing of the sale of certain assets of the Large Enterprise division.

The sale of assets from the Large Enterprise operations is designed to raise cash to pay off certain liabilities and allow us to reorganize around the Small Business software and services operations, which have recently released two new software products. The sale of assets has not been completed, and there is no assurance that it will be completed on terms that will be acceptable to us, or that the proceeds will be sufficient to allow us to successfully restructure and continue operations.

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the company as a going concern.

In our view, recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheet is dependent upon our continued operations, which in turn is dependent upon our ability to meet obligations on a continuing basis. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or amounts and classification of liabilities that might be necessary should we be unable to continue in existence.

THERE CAN BE NO ASSURANCE THAT THE PROPOSED SALE OF ASSETS WILL CLOSE OR THAT ANY ADDITIONAL FINANCING WILL BE AVAILABLE ON ACCEPTABLE TERMS, IF AT ALL. IF WE ARE UNSUCCESSFUL IN RAISING ADDITIONAL FUNDS, OUR LIQUIDITY POSITION WILL BE MATERIALLY AND ADVERSELY AFFECTED AND WE COULD BE REQUIRED TO MAKE DRASTIC COST REDUCTIONS, WHICH WOULD NEGATIVELY IMPACT OUR OPERATIONS.

Although we believe our assumptions underlying our operating plan to be reasonable, we lack the operating history of a more seasoned company and there can be no assurance that our forecasts will prove accurate. In the event that our plans change, our assumptions change or prove inaccurate, if the committed financing falls through, or if future private placements, other capital resources and projected cash flow otherwise prove to be insufficient to fund operations, we could be required to seek additional financing sooner than currently anticipated. To the extent that we are able to raise additional funds and it involves the sale of our equity securities, the interests of our shareholders could be substantially diluted.

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Recent actions that we have taken may negatively impact our ability to achieve our business objectives

In order to manage our liquidity and cash position, over the past year we have had to implement certain cost cutting measures, including significant reductions in force. After these staff reductions, as of June 15, 2003, we had 52 full time employees. Although these cost cutting measures have improved our short-term cash requirements, they may negatively impact our ability to grow our business and achieve our business objectives.

Our limited operating history makes evaluation of our business difficult

We have a limited operating history on which to base our evaluation of current business and prospects. Our short operating history makes it difficult to predict future results, and there are no assurances that our revenues will increase, or that we will achieve or maintain profitability or generate sufficient cash from operations in future periods.

Our ability to achieve and sustain profitability would be adversely affected if we:

- fail to effectively market and sell our services;
- fail to develop new and maintain existing relationships with clients;
- fail to continue to develop and upgrade our technology and network infrastructure;
- fail to respond to competitive developments;
- fail to introduce enhancements to our existing products and services to address new technologies and standards; or
- fail to attract and retain qualified personnel.

Our operating results are also dependent on factors outside of our control, such as strength of competition and the growth of the market for our services. There is no assurance that we will be successful in addressing these risks, and failure to do so could have a material adverse effect on our financial performance.

We expect to incur losses in the near term, and if we are unable to generate sufficient cash flow or raise the capital necessary to allow us to continue to meet all of our obligations as they come due, our business could suffer.

Our future revenues are not predictable, and our results could vary significantly

Because of our limited operating history and the emerging nature of our markets, we are unable to reliably forecast our revenues.

Our operating results may fluctuate significantly in the future as a result of a variety of factors. These factors include:

- the demand for our services;

- the addition or loss of individual clients;
- the amount and timing of capital expenditures and other costs relating to the expansion of our operations;
- the introduction of new products or services by us or our competitors; and
- general economic conditions and economic conditions specific to the Internet, such as electronic commerce and online media.

Any one of these factors could cause our revenues and operating results to vary significantly. In addition, as a strategic response to changes in the competitive environment, we may from time to time make certain pricing, service or marketing decisions or acquisitions that could significantly hurt our operating results in a given period.

Due to all of the foregoing factors, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Furthermore, it is possible that our operating results in one or more quarters will fail to meet the expectations of investors. In such event, the market price of our common stock could drop.

If we are unable to obtain funding, our customers and vendors may decide not to do business with us

If we are unable to continue funding our operations at our current levels, and if customers and vendors become concerned about our business prospects, they may decide not to conduct business with us, or may conduct business with us on terms that are less favorable than those customarily extended by them. In that event, our revenues would decrease and our business will suffer significantly.

We are not sure if the market will accept our product offerings

Our ability to succeed will depend on the following, none of which can be assured:

- the effectiveness of our marketing and sales efforts;
- market acceptance of our current and future offerings; and
- the reliability of our networks and services.

We operate in a market that is in the early stage of development, is rapidly evolving, and is characterized by an increasing number of competitors and risk surrounding market acceptance of new technologies and services. Potential customers must view our technologies as a viable alternative to traditional commercial advertising and brochure distribution. Because this market is so new, it is difficult to predict its size and growth rate. If the market fails to develop as we expect, our growth will be slower than expected.

We may make acquisitions of complementary technologies or businesses, which may disrupt our business and be dilutive to our existing stockholders.

We intend to consider acquisitions of businesses and technologies on an opportunistic basis. Acquisitions of businesses and technologies involve numerous risks, including the diversion of management attention, difficulties in assimilating the acquired operations, loss of key employees from the acquired company, and difficulties in transitioning key customer relationships. In addition, these acquisitions may result in dilutive issuances of equity securities, the incurrence of additional debt, large one-time expenses and the creation of goodwill or other intangible assets that result in significant amortization expense and impairment charges. Any acquisition may not provide the benefits originally anticipated, and there may be difficulty in integrating the service offerings and customer and supplier relationships gained through acquisitions with our own. Although we attempt to minimize the risk of unexpected liabilities and contingencies associated with acquired businesses through planning, investigation and negotiation, such unexpected liabilities nevertheless may accompany such acquisitions. We cannot guarantee that we will successfully identify attractive acquisition candidates, complete and finance additional acquisitions on favorable terms, or integrate the acquired businesses or assets into our own. Any of these factors could materially harm our business or our operating results in a given period.

Network and system failures could adversely impact our business

The performance, reliability and availability of our Web sites and network infrastructure is critical to our reputation and ability to attract and retain clients. Our systems and operations are vulnerable to damage or interruption from earthquake, fire, flood, power loss, telecommunications failure, Internet breakdowns, break-ins, tornadoes and similar events. We carry business interruption insurance to compensate for losses that may occur, but insurance is not guaranteed to remove all risk of loss. Services based on sophisticated software and computer systems often encounter development delays and the underlying software may contain errors that could cause system failures. Any system failure that causes an interruption could result in a loss of clients and could reduce the attractiveness of our services.

We are also dependent upon Web browsers, Internet service providers and online service providers to provide Internet users access to our clients, users and Web sites. Users may experience difficulties due to

system failures or delays unrelated to our systems. These difficulties may hurt audio and video quality or result in intermittent interruptions in broadcasting and thereby slow our growth.

Circumvention of our security measures and viruses could disrupt our business

Despite the implementation of security measures, our networks may be vulnerable to unauthorized access, computer viruses and other disruptive problems. Anyone who is able to circumvent security measures could steal proprietary information or cause interruptions in our operations. Service providers have occasionally experienced interruptions in service as a result of the accidental actions of users or intentional actions of hackers. We may have to spend significant capital to protect against security breaches or to fix problems caused by such breaches. Although we have implemented security measures, there can be no assurance that such measures will not be circumvented in the future. Eliminating computer viruses and alleviating other security problems may require interruptions, delays or cessation of service to users, which could hurt our business.

We depend on continued growth in use of the Internet

Rapid growth in use of the Internet is a recent phenomenon and there can be no assurance that use of the Internet will continue to grow or that a sufficient base of users will emerge to support our business. The Internet may not be accepted as a viable medium for broadcasting advertising and brochure distribution, for a number of reasons, including:

- inadequate development of the necessary infrastructure;
- inadequate development of enabling technologies;
- lack of acceptance of the Internet as a medium for distributing rich media advertising; and
- inadequate commercial support for Web-based advertising.

To the extent that Internet use continues to increase, there can be no assurance that the Internet infrastructure will be able to support the demands placed upon it, and especially the demands of delivering high-quality video content.

Furthermore, user experiences on the Internet are affected by access speed. There is no assurance that broadband access technologies will become widely adopted. In addition, the Internet could lose its viability as a commercial medium due to delays in the development or adoption of new standards and protocols required to handle increased levels of Internet activity, or due to increased government regulation. Our business could suffer if use of the Internet grows more slowly than expected, or if the Internet infrastructure does not effectively support the growth that does occur.

We may be unable to collect our receivables and retainages in amounts previously estimated.

In accordance with United States generally accepted accounting principles, we have established reserves against our retainages and receivables. We believe that the established reserves adequately allow for the estimated uncollectible portion of the retainages and receivables. However, we may experience collection rates below established reserves, which could reduce the amount of available funds and require additional reserves. Reduced available funds could adversely affect our ability to successfully implement the objectives of our business plan. There can be no assurance that we will be able to collect retainages and receivables in sufficient amounts. Failure to collect adequate amounts of retainages and receivables could materially adversely affect our business and results of operations. There are low barriers to entry in our small business market, which could result in increased competition in the future.

The market for Internet-based services is relatively new, intensely competitive and rapidly evolving. There are minimal barriers to entry, and current and new competitors can launch new Internet products and services at a relatively low cost within relatively short time periods. We expect competition to persist and intensify and the number of competitors to increase significantly in the future. Should we seek in the future to attempt to expand the scope of our Internet services and product offerings, we will compete with a greater number of Internet companies. Because the operations and strategic plans of existing and

future competitors are undergoing rapid change, it is difficult for us to anticipate which companies are likely to offer competitive products and services in the future.

If we do not respond to technological change, we could lose or fail to develop customers.

The development of our business entails significant technical and business risks. To remain competitive, we must continue to enhance and improve the functionality and features of our technology. The Internet and the ecommerce industry are characterized by:

- rapid technological change;
- changes in client requirements and preferences;
- frequent new product and service introductions embodying new technologies; and
- the emergence of new industry standards and practices.

The evolving nature of the Internet could render our existing systems obsolete.

Our success will depend, in part, on our ability to:

- develop and enhance technologies useful in our business;
- develop new services and technology that address the increasingly sophisticated and varied needs of our current and prospective clients; and
- adapt to technological advances and emerging industry and regulatory standards and practices in a cost-effective and timely manner.

Future advances in technology may not be beneficial to, or compatible with, our business. Furthermore, we may not use new technologies effectively or adapt our systems to client requirements or emerging industry standards on a timely basis. Our ability to remain technologically competitive may require substantial expenditures and lead time. If we are unable to adapt to changing market conditions or user requirements in a timely manner, we will lose clients.

We could face liability for Internet content

As a distributor of Internet content, we face potential liability for negligence, copyright, patent or trademark infringement, defamation, indecency and other claims based on the content of our broadcasts. Such claims have been brought, and sometimes successfully pressed, against Internet content distributors. Our general liability insurance may not be adequate to indemnify us for all liability that may be imposed. Although we generally require our clients to indemnify us for such liability, such indemnification may be inadequate. Any imposition of liability that is not covered by insurance or by an indemnification by a client could harm our business.

Our operating results could be impaired if we become subject to burdensome government regulations and legal uncertainties concerning the Internet

Due to the increasing popularity and use of the Internet, it is possible that a number of laws and regulations may be adopted with respect to

the Internet, relating to:

- user privacy;
- pricing, usage fees and taxes;
- content;
- copyrights;
- distribution;
- characteristics and quality of products and services; and
- online advertising and marketing.

The adoption of any additional laws or regulations may decrease the popularity or impede the expansion of the Internet and could seriously harm our business. A decline in the popularity or growth of the Internet could decrease demand for our products and services, reduce our revenues and margins and increase our cost of doing business. Moreover, the applicability of existing laws to the Internet is uncertain with regard to many important issues, including property ownership, intellectual property, export of encryption technology, libel and personal privacy. The application of laws and regulations from jurisdictions whose laws do not currently apply to our business, or the application of existing laws and regulations to the Internet and other online services, could also harm our business.

Our stock price has been and may continue to be volatile

The trading price of our common stock has been and is likely to continue to be highly volatile. For example, on May 1, 2003, our common stock closed at $0.23 per share, and on November 12, 2002, our common stock closed at $4.70 per share. Our stock price could be subject to wide fluctuations in response to factors such as:

- the average daily trading volume of our common stock;
- actual or anticipated variations in quarterly operating results and our need for additional financing to fund our continuing operations;
- announcements of technological innovations, new products or services by us or our competitors;
- the addition or loss of strategic relationships or relationships with our key customers;
- conditions or trends in the Internet, streaming media, media delivery, and online commerce markets;
- changes in the market valuations of other Internet, online service, or software companies;
- announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures, or

capital commitments;

- sales of our common stock and legal or regulatory developments;
- additions or departures of key personnel;
- our failure to obtain additional financing on satisfactory terms, or at all; and
- general market conditions.
- need to file bankruptcy if we cannot restructure our debt

The historical volatility of our stock price may make it more difficult for investors in our securities to resell shares at prices they find attractive.

In addition, the stock market in general, the Nasdaq SmallCap Market, the market for Internet and technology companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of these companies. These broad market and industry factors may reduce our stock price, regardless of our operating performance.

Failure to satisfy Nasdaq SmallCap Market listing requirements may result in our stock being delisted from The Nasdaq SmallCap Market.

Our common stock is currently listed on The Nasdaq SmallCap Market under the symbol "AVLN." For continued inclusion on The Nasdaq SmallCap Market, we must maintain, among other requirements, a minimum bid price of $1.00 per share. On April 8, 2003, Nasdaq notified us that we are not in compliance with Nasdaq's minimum bid price per share required for continued listing on the Nasdaq SmallCap Market. We have until October 6, 2003 to regain compliance with Nasdaq's minimum bid requirement by maintaining the minimum closing bid price per share for a minimum of 10 consecutive trading days by that date.

In addition, On May 27, 2003, Nasdaq notified us that we were not in compliance with Nasdaq's requirement that we remain current in making all required filings with the SEC and that we had not paid our annual listing fees. We have been granted a hearing before Nasdaq's Listing Qualifications Panel on June 26, 2003, where a determination will be made whether we have regained compliance with the continued listing standards.

In the event that we fail to satisfy the listing standards on a continuous basis, our common stock may be removed from listing on The Nasdaq SmallCap Market. If our common stock was delisted from The Nasdaq SmallCap Market, trading of our common stock, if any, may be conducted in the over-the-counter market in the so-called "pink sheets" or, if available, the "Bulletin Board." As a result, stockholders could find it more difficult to dispose of, or to obtain accurate quotations as to the value of, our common stock, and the trading price per share could be reduced.

Insiders own approximately 38% of our outstanding common stock and their interests could conflict with those of other stockholders.

Our current directors and senior employees own approximately 38% of our outstanding common stock. As a result, the directors and executive officers collectively may be able to substantially influence all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions. Such concentration of ownership may also have the effect of delaying or preventing a change in control.

Future sales of our common stock may depress our stock price

Sales of a substantial number of shares of our common stock in the public market, or the appearance that such shares are available for sale, could adversely affect the market price for our common stock. As of June 25, 2003, we had 7,348,279 shares of common stock outstanding. A significant number of these shares are not publicly traded but are available for immediate resale to the public. We also have reserved shares of our common stock as follows:

- 2,987,509 shares are reserved for issuance upon the exercise of warrants;

- 1,071,264 shares are reserved for issuance upon the exercise of stock options.

Shares underlying vested options are generally eligible for immediate resale in the public market.

Our efforts to protect our intellectual property rights may not sufficiently protect us and we may incur costly litigation to protect our rights

We have filed nineteen patent applications and we plan to file additional patent applications in the future with respect to various additional aspects of our technologies. In addition, we have received patents on technology we obtained in the Control Commerce and Radical Communication acquisitions. We mark our software with copyright notices, and intend to file copyright registration applications where appropriate. We have also filed several federal trademark registration applications for trademarks and service marks we use. There can, however, be no assurance that any patents, copyright registrations, or trademark registrations applied for by us will be issued, or if issued, will sufficiently protect our proprietary rights.

We also rely substantially on certain technologies that are not patentable or proprietary and are therefore available to our competitors. In addition, many of the processes and much of our technology are dependent upon our technical personnel, whose skill, knowledge and experience are not patentable. To protect our rights in these areas, we require all employees, significant consultants and advisors to enter into confidentiality agreements under which they agree not to use or disclose our confidential information as long as that information remains proprietary. We also require that our employees agree to assign to us all rights to any inventions made during their employment relating to our activities, and not engage in activities similar to ours during the term of their employment. There can be no assurance, however, that these agreements will provide meaningful protection for our trade secrets, know-how or other proprietary information in the event of any unauthorized use or disclosure of such trade secrets, know-how or proprietary information. Further, in the absence of patent protection, we may be exposed to competitors

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who independently develop substantially equivalent technology or otherwise gain access to our trade secrets, knowledge or other proprietary information.

Despite our efforts to protect our intellectual property, a third party or a former employee could copy, reverse-engineer or otherwise obtain and use our intellectual property or trade secrets without authorization or could develop technology competitive to ours.

Our intellectual property may be misappropriated or infringed upon. Consequently, litigation may be necessary in the future to enforce our intellectual property rights, to protect our confidential information or trade secrets, or to determine the validity or scope of the rights of others. Litigation could result in substantial costs and diversion of management and other resources and may not successfully protect our intellectual property. Additionally, we may deem it advisable to enter into royalty or licensing agreements to resolve such claims. Such agreements, if required, may not be available on commercially reasonable or desirable terms or at all.

Our technology may infringe on the rights of others

Even if the patents, copyrights and trademarks we apply for are granted, they do not confer on us the right to manufacture or market products or services if such products or services infringe on intellectual property rights held by others. If any third parties hold conflicting rights, we may be required to stop making, using, or marketing one or more of our products or to obtain licenses from and pay royalties to others, which could have a significant and material adverse effect on us. There can be no assurance that we will be able to obtain or maintain any such license on acceptable terms or at all.

We may also be subject to litigation to defend against claims of infringement of the rights of others or to determine the scope and validity of the intellectual property rights of others. If third parties hold trademark, copyright or patent rights that conflict with our business, then we may be forced to litigate infringement claims that could result in substantial costs to us. In addition, if we were unsuccessful in defending such a claim, it could have a negative financial impact. If third parties prepare and file applications in the United States that claim trademarks used or registered by us, we may oppose those applications and be required to participate in proceedings before the United States Patent and Trademark Office to determine priority of rights to the trademark, which could result in substantial costs to us. An adverse outcome in litigation or privity proceedings could require us to license disputed rights from third parties or to cease using such rights. Any litigation regarding our proprietary rights could be costly, divert management's attention, result in the loss of certain of our proprietary rights, require us to seek licenses from third parties and prevent us from selling our services, any one of which could have a negative financial impact. In addition, inasmuch as we broadcast content developed by third parties, our exposure to copyright infringement actions may increase because we must rely upon such third parties for information as to the origin and ownership of such licensed content. We generally obtain representations as to the origin and ownership of such licensed content and generally obtain indemnification to cover any breach of such representations; however, there can be no assurance that such representations will be accurate or given, or that such indemnification will adequately protect us.

The length of our sales cycle increases our costs

Many of our potential customers conduct extensive and lengthy evaluations before deciding whether to purchase or license our products. In our experience to date we've seen the sales cycle range from a few days up to six months. While the potential customer is making this decision, we continue to incur salary, travel and other similar costs of following up with these accounts. Therefore, the risk associated with our lengthy sales cycle is that we may expend substantial time and resources over the course of the sales cycle only to realize no revenue from such efforts if the customer decides not to purchase from us. Any significant change in customer buying decisions or sales

cycles for our products could have a material adverse effect on our business, results of operations, and financial conditions.

There are risks inherent in conducting international operations

There are many risks associated with our international operations in eastern Asia, including, but not limited to:

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- o difficulties in collecting accounts receivable and longer collection periods;
- o changing and conflicting regulatory requirements;
- o potentially adverse tax consequences;
- o tariffs and general export and customs restrictions;
- o difficulties in staffing and managing foreign operations;
- o political instability;
- o fluctuations in currency exchange rates;
- o the need to develop localized versions of our products;
- o national standardization and certification requirements;
- o seasonal reductions of business activity; and
- o the impact of local economic conditions and practices.

Any of the above-listed risks could have a material adverse effect on our future business, financial condition, or results of operations.

International markets for online marketing are in their very early stages of development

We distribute email messages globally. To date, we have developed or modified into foreign language text and delivered rich media content to recipients in the United Kingdom, France, Switzerland, Austria, Norway, Sweden, Iceland, Finland, Denmark, Greece, Lebanon, Mexico, Panama, Peru, Philippines, Australia, Singapore, Hong Kong, China, and Taiwan. The markets for online advertising and direct marketing in these countries are generally in earlier stages of development than in the United States, and we cannot assure you that the market for, and use of online advertising and direct marketing in international markets such as these and others will be significant in the future. Factors that may account for slower growth in the online advertising and direct marketing markets include, but are not limited to:

- o slower growth in the number of individuals using the Internet internationally;
- o privacy concerns;
- o a lower rate of advertising spending internationally than in the United States; and

- a greater reluctance to use the Internet for advertising and direct marketing.

Any of the above-listed risks could have a material adverse effect on our future business, financial condition, or results of operations.

We are subject to risks associated with governmental regulation and legal uncertainties

We are subject to general business laws and regulations. These laws and regulations, as well as new laws and regulations that may be adopted in the United States and other countries with respect to the Internet, may impede the growth of the Internet. These laws may relate to areas such as advertising, taxation, personal privacy, content issues (such as obscenity, indecency, and defamation), copyright and other intellectual property rights, encryption, electronic contracts and "digital signatures," electronic commerce liability, email, network and information security, and the convergence of traditional communication services with Internet communications, including the future availability of broadband transmission capability. Other countries and political organizations are likely to impose or favor more and different regulation than that which has been proposed in the United States, thus furthering the complexity of regulation. In addition, state and local governments may impose regulations in addition to, inconsistent with, or stricter than, federal regulations. The adoption of such laws or regulations, and uncertainties associated with their validity, applicability, and enforcement, may affect the available distribution channels for and costs associated with our products and services, and may affect the growth of the Internet. Such laws or regulations may therefore harm our business.

We do not know for certain how existing laws governing issues such as privacy, property ownership, copyright and other intellectual property issues, taxation, illegal or obscene content, retransmission of media, and data protection, apply to the Internet. The vast majority of such laws were adopted before the advent of the Internet and related technologies and do not address the unique issues associated with the Internet and related technologies. Most of the laws that relate to the Internet have not yet been interpreted. Changes to or the interpretation of these laws could:

- limit the growth of the Internet;
- create uncertainty in the marketplace that could reduce demand for our products and services;
- increase our cost of doing business;
- expose us to significant liabilities associated with content distributed or accessed through our products or services, and with our provision of products and services, and with the features or performance of our products;
- lead to increased product development costs, or otherwise harm our business; or
- decrease the rate of growth of our user base and limit our ability to effectively communicate with and market to our user base.

Any of the above-listed consequences could have a material adverse effect on our future business, financial condition, or results of operations.

We may be subject to legal liability in connection with the data collection capabilities of our products and services

Our products are interactive Internet applications that by their very nature require communication between a client and server to operate. To provide better consumer experiences and to operate effectively, our products occasionally send information to servers at MindArrow. Many of the services we provide also require that users provide information to us. We post privacy policies concerning the use and disclosure of our user data. Any failure by us to comply with our posted privacy policies could impact the market for our products and services, subject us to litigation, and harm our business.

In addition, the Child Online Privacy Protection Act ("COPPA") became effective as of April 21, 2000. COPPA requires operators of commercial Web sites and online services directed to children (under 13), and general audience sites that know that they are collecting personal information from a child, to:

- provide parents notice of their information practices;
- obtain verifiable parental consent before collecting a child's personal information, with certain limited exceptions;
- give parents a choice as to whether their child's information will be disclosed to third parties;
- provide parents access to their child's personal information and allow them to review it and/or have it deleted;
- give parents the opportunity to prevent further use or collection of information; not require a child to provide more information than is reasonably necessary to participate in an activity; and
- maintain the confidentiality, security, and integrity of information collected from children.

We do not knowingly collect and disclose personal information from such minors, and therefore believe that we are fully compliant with COPPA. However, the manner in which COPPA may be interpreted and enforced cannot be fully determined, and thus COPPA and future legislation such as COPPA could subject us to potential liability, which in turn would harm our business.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not believe that we currently have material exposure to interest rate, foreign currency exchange rate or other relevant market risks.

Interest Rate and Market Risk. Our exposure to market risk for changes in interest rates relates primarily to our investment profile. As of March 31, 2003, our investment portfolio consisted primarily of cash and cash equivalents, substantially all of which were held at two financial institutions. We do not use derivative financial instruments in our investment portfolio.

Foreign Currency Exchange Risk. We do not believe that we currently have material exposure to foreign currency exchange risk because of the relative insignificance of our foreign subsidiaries. We intend to assess the need to use financial instruments to hedge currency exposures on an ongoing basis.

We do not use derivative financial instruments for speculative trading purposes.

Item 4. CONTROLS AND PROCEDURES

(a.) Our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934) as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"). Based on such evaluation, such officers have concluded that, as of the Evaluation Date, our disclosure controls and procedures are effective in alerting our management on a timely basis to material information required to be disclosed in our reports filed under the Exchange Act.

(b.) There have been no significant changes in our internal controls or in other factors that could significantly affect such controls since the Evaluation Date.

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PART II-OTHER INFORMATION

Item 1. Legal Proceedings

From time to time the Company is subject to legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights.

In 1999 and 2000, MindArrow was a victim of a fraud perpetrated by its former transfer agent and her accomplice, who were convicted of felonies arising from the scheme. At sentencing hearings in April and July 2002, the perpetrators were ordered to pay to the Company $10.9 million in restitution in addition to amounts already received. In addition, the Company continues to pursue recovery of the loss it incurred as a result of the fraud perpetrated against the Company, and the Audit Committee of the Company's Board of Directors has retained special counsel to assist it in pursuing potential sources of recovery. Eight individuals and twelve entities have been named as defendants in lawsuits initiated by the Company. The Company cannot predict whether or when it will obtain any additional recovery. Because of the uncertainties surrounding recoveries, the Company will not record the impact of recoveries until amounts or assets are received.

In May 2003, the Company settled a dispute with MindArrow's former landlord over amounts due under a lease for MindArrow's former facilities. The settlement, in the amount of $803,000, is included in "Accounts payable and accrued liabilities" on the accompanying consolidated balance sheet, and calls for payments of $5,000 per month beginning in July 2003, increasing to $10,000 per month beginning in March 2004, and increasing to $100,000 per quarter beginning in January 2005 until the balance is paid.

The Company settled a lawsuit filed by Sunrise International Leasing Corporation with the District Court, Fourth Judicial District, in the County of Hennepin, Minnesota, on May 6, 2002, for default of payment and breach of lease on two equipment leases. The equipment has been returned and we agreed to pay a

net of $137,000 to Sunrise in settlement, the full amount of which has been included in accounts payable and accrued liabilities at March 31, 2003.

The Company settled a lawsuit filed by EMC Corporation with the Orange County Superior Court on July 11, 2002, for failure of payment on equipment. The plaintiff is seeking monetary damages in the amount of $117,526. The Company has agreed to a settlement of $9,564, to be paid by July 17, 2003. The full amount of the claim has been included with accounts payable and accrued liabilities at March 31, 2003.

The Company is a defendant in a lawsuit filed by RR Donnelley & Sons Company with the Orange County Superior Court on March 25, 2003, for failure of payment for services provided to Category 5 Technologies, Inc. The plaintiff is seeking monetary damages in the amount of $82,324. The Company anticipates settling for damages, the full amount of which have been included with accounts payable and accrued liabilities at March 31, 2003.

The Company is a defendant in a lawsuit filed by Bowne of Los Angeles, Inc. with the Los Angeles County Superior Court on March 13, 2003, for failure of payment for services. The plaintiff is seeking monetary damages in the amount of $141,169. The Company anticipates settling for damages, the full amount of which have been included with accounts payable and accrued liabilities at March 31, 2003.

The Company is a defendant in a lawsuit filed by iMatcher, Inc. with the Supreme Court of the State of New York, County of Suffolk on May 28, 2003, for failure of payment for services. The plaintiff is seeking monetary damages in the amount of $156,460. The Company anticipates settling for damages, the $53,673 of which have been included with accounts payable and accrued liabilities at March 31, 2003.

Item 2. Changes in Securities and Use of Proceeds

During the quarter ended March 31, 2003, the Company issued the following equity securities in transactions not registered under the Securities Act:

On January 31, 2003 the Company acquired Mindwire, Inc. in exchange for 46,700 shares of common stock valued at $1.36 per share, which were issued to the stockholders of Mindwire, Inc.

In February 2003, a $50,000 advance made by Michael Ray was converted into 40,000 shares of common stock and warrants to purchase an additional 20,000 shares at $2 per share.

In June 2002, MindArrow obtained a commitment for between $3 million and up to $4 million in financing by offering up to 1 million shares of common stock at a price of $4.00 per share from a group of investors led by East-West Capital Associates, Inc. ("East-West Capital") and its affiliate, East West Venture Group, LLC. Through December 31, 2002, the Company had received $2.825 million in proceeds towards the $3.0 million minimum commitment and $200,000 towards the $1 million portion subject to a demand by the Company's board of directors. During the quarter ended December 31, 2002, 25,000 shares of common stock were issued pursuant to partial closings under this commitment. The stock purchase agreement, as amended in February 2003 called for the remaining $175,000 of the minimum commitment to be funded by providing $25,000 in cash and $150,000 through the conversion of a portion of the note payable to Radical

Communication, Inc. into common stock on the same terms. East-West Capital is the owner of 20% of the capital stock of Radical Communication, Inc.

All of the foregoing issuances were without registration under the Securities Act in reliance upon the exemption from the registration requirements of the Securities Act set forth in Section 4(2) of the Securities Act and Regulation D thereunder. The recipients of securities in each transaction represented their intentions to acquire the securities for investment only and not with a view to or for sale in connection with any distribution thereof. These sales were made without general solicitation or advertising. Each recipient was either an accredited or sophisticated investor and had adequate access to relevant information about us.

Item 3. Defaults Upon Senior Securities

The Company is in default on $690,000 of convertible notes payable to sixteen investors (the "Convertible Notes"). The terms of the notes, as amended in November 2002, call for interest to be paid at the rate of 14% per annum, and principal to be paid in six equal monthly principal payments beginning in January 2003 through June 2003. As of May 31, 2003, the balance of the January payment that was not converted into common stock amounted to $50,107 and has not been paid, nor any other payments made. The total amount of past due principal and interest as of that date is $605,527.

The $250,000 principal payment due to Radical Communication, Inc. on October 1, 2002 was not made. In February 2003, $150,000 of the note balance was converted into 37,500 shares of common stock and warrants to purchase 43,125 shares of common stock at $2 per share. The Company is seeking an extension or conversion into equity of some or all of the remaining overdue balance.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K

(A) EXHIBITS

10.10 Second Amendment to Agreements, dated February 18, 2003

(B) REPORTS ON FORM 8-K

On June 20, 2003, the Registrant filed a Report on Form 8-K disclosing under Item 4 that it had made a change in certifying auditors, from Grant Thornton LLP to Tanner + Co., P.C.

Signatures, and Certifications of the Chief Executive Officer and the Chief Financial Officer of the Company.

The following pages include the Signatures page for this Form 10-Q, and two separate Certifications of the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) of the company.

The first form of Certification is required by Rule 13a-14 under the Securities Exchange Act of 1934 (the Exchange Act) in accord with Section 302 of the Sarbanes-Oxley Act of 2002 (the Section 302 Certification). The Section 302 Certification includes references to an evaluation of the effectiveness of the design and operation of the company's "disclosure controls and procedures" and its "internal controls and procedures for financial reporting". Item 4 of Part I of this Quarterly Report presents the conclusions of the CEO and the CFO about the effectiveness of such controls based on and as of the date of such evaluation (relating to Item 4 of the Section 302 Certification), and contains additional information concerning disclosures to the company's Audit Committee and independent auditors with regard to deficiencies in internal controls and fraud (Item 5 of the Section 302 Certification) and related matters (Item 6 of the Section 302 Certification).

The second form of Certification is required by section 1350 of chapter 63 of title 18 of the United States Code.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Avalon Digital Marketing Systems, Inc.
(Registrant)

Date: June 26, 2003

/s/ ROBERT I. WEBBER
Robert I. Webber
Chief Executive Officer and President
(Principal Executive Officer)

Date: June 26, 2003

/s/ MICHAEL R. FRIEDL
Michael R. Friedl
Chief Financial Officer, Secretary, and Treasurer (Principal Financial and Accounting Officer)

CERTIFICATION

I, Robert I. Webber, certify that:

1) I have reviewed this quarterly report on Form 10-Q of Avalon Digital Marketing Systems, Inc.;

2) Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3) Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4) The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

    a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

    b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

    c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5) The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

    a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

    b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6) The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Dated: June 26, 2003, by

/s/ ROBERT I. WEBBER

Robert I. Webber
Chief Executive Officer and President
(Principal Executive Officer)

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CERTIFICATION

I, Michael R. Friedl, certify that:

1) I have reviewed this quarterly report on Form 10-Q of Avalon Digital Marketing Systems, Inc.;

2) Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3) Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4) The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

   a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

   b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

   c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5) The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

   a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

   b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6) The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Dated: June 26, 2003, by

/s/ MICHAEL R. FRIEDL

Michael R. Friedl
Chief Financial Officer, Secretary, and
Treasurer (Principal Financial and
Accounting Officer)

CERTIFICATION (continued)

Each of the undersigned hereby certifies, for the purposes of section 1350 of chapter 63 of title 18 of the United States Code, in his capacity as an officer of Avalon Digital Marketing Systems, Inc. ("Avalon"), that, to his knowledge, the Quarterly Report of Avalon on Form 10-Q for the period ended March 31, 2003, fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934 and that the information contained in such report fairly presents, in all material respects, the financial condition and results of operation of Avalon.

Date: June 26, 2003

/s/ ROBERT I. WEBBER

Robert I. Webber
Chief Executive Officer and President
(Principal Executive Officer)

Date: June 26, 2003

/s/ MICHAEL R. FRIEDL

Michael R. Friedl
Chief Financial Officer, Secretary, and
Treasurer (Principal Financial and
Accounting Officer)