

AVALON DIGITAL MARKETING SYSTEMS INC
Form 10QSB
June 03, 2005

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

FORM 10-QSB

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

For the quarterly period ended March 31, 2005

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.)

5255 N. Edgewood Drive, Suite 250, Provo, UT 84604

(Address of principal executive offices)

(801) 225-7073

(Registrant's telephone number, including area code)

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 No

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

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities and Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes No

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 2, 2005
-------	-----------------------------

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

Common Stock, \$.0001 par value 1,175,725

PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

Avalon Digital Marketing Systems, Inc.

Unaudited Condensed Consolidated Balance Sheet

	Successor Company
	As of March 31, 2005

Assets	
Current assets:	
Cash	\$ -
Receivables, net of allowance of doubtful accounts of \$85,591	83,111
Note receivable	150,000
Prepaid assets	19,618

Total current assets	252,729
Property and equipment, net	146,627
Deposits	1,250

Total assets	\$ 400,606

Liabilities and Shareholders' Deficit	
Liabilities not subject to compromise:	
Current liabilities:	
Cash overdraft	\$ 13,983
Accounts payable and accrued liabilities	204,166
Estimated receivable repurchase obligation	111,949

Total current liabilities	330,098

Long-term notes payable	1,337,813

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

Liabilities subject to compromise (Note 3)	-
Commitments and contingencies (Note 6)	
Preferred stock subject to compromise:	
Series D Preferred stock, par value \$0.001, 10,000,000 shares authorized, no shares issued and outstanding	-
Shareholders' deficit:	
Common stock, \$0.0001 par value, 10,000,000 shares authorized, 1,175,725 shares issued and outstanding	118
Additional paid-in capital	931,291
Accumulated deficit	(2,198,714)

Total shareholders' deficit	(1,267,305)

Total liabilities and shareholders' deficit	\$ 400,606

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

1

Avalon Digital Marketing Systems, Inc.

Unaudited Condensed Consolidated Statements of Operations

	Successor Company	Predecessor Company	Successor Company	
	-----	-----	-----	-----
	Three-Month Period Ended March 31,	Three-Month Period Ended March 31,	Three-Month Period Ended March 31,	S Pe D
	2005	2004	2005	
	-----	-----	-----	-----
Revenues	\$ 239,381	\$ 430,608	\$ 239,381	
Cost of goods sold	6,939	33,723	6,939	
	-----	-----	-----	-----
Gross profit	232,442	396,885	232,442	
	-----	-----	-----	-----
Selling, general and administrative	451,911	553,278	451,911	
Impairment of reorganization value in excess				

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

of amounts allocable to identifiable assets	1,972,340	-	1,972,340
Bad debt expense	-	3,157	-
Settlement expense	-	-	-
	-----	-----	-----
Total operating expenses	2,424,251	556,435	2,424,251
	-----	-----	-----
Loss from operations	(2,191,809)	(159,550)	(2,191,809)
Interest income	3,426	28,897	3,426
Interest expense	(10,331)	(23,693)	(10,331)
Reorganization items, net	-	-	-
	-----	-----	-----
Net income (loss) before income taxes	(2,198,714)	(154,346)	(2,198,714)
(Provision) benefit for income taxes:			
Current	-	-	-
Deferred	-	-	-
	-----	-----	-----
Net income (loss)	\$ (2,198,714)	\$ (154,346)	\$ (2,198,714)
	=====	=====	=====
Net loss per common share - basic and diluted	(1.87)	N/A	(1.87)
Weighted average common shares outstanding	1,175,725	N/A	1,175,725

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

2

Avalon Digital Marketing Systems, Inc.

Unaudited Condensed Consolidated Statements of Shareholders' Deficit

	Series D preferred stock		Common stock		Addit
	Shares	Amount	Shares	Amount	Paid-i
	-----		-----		Capita
Balance at June 30, 2004 (Predecessor Company)	1,000,000	\$ 1,000	8,713,279	\$ 8,713	\$ 22,618
Net income	-	-	-	-	-

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

Conversion of preferred securities	(1,000,000)	(1,000)	1,000,000	1,000	
Issuance of warrant in conjunction with Convertible Note	-	-	-	-	1
Issuance of warrant in conjunction with settlement of secured note	-	-	-	-	
Issuance of Successor common stock	-	-	1,175,725	118	931
Application of fresh-start reporting (Note 4):					
Cancellation of Predecessor common stock	-	-	(9,713,279)	(9,713)	(22,620)
Elimination of Predecessor accumulated deficit	-	-	-	-	

Balance at December 31, 2004 (Successor Company)	-	-	1,175,725	118	931
Net loss	-	-	-	-	

Balance at March 31, 2005 (Successor Company)	-	\$ -	1,175,725	\$ 118	\$ 931
=====					

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

3

Avalon Digital Marketing Systems, Inc.

Unaudited Condensed Consolidated Statements of Cash Flows

	Successor Company

	Three Months Ende March 31, 2005

Cash flows from operating activities:	
Net income (loss)	\$ (2,198,71
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:	
Allowance for doubtful accounts	
Depreciation and amortization	51,36
Recovery of accounts receivable previously allowed for	(4,86
Impairment of reorganization value in excess of amounts allocable to identifiable assets	1,972,34
Impairment of goodwill	
Effect of the plan of reorganization and revaluation of assets and liabilities	
Reorganization items settled in cash	
Amortization of debt discount	

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

Issuance of stock related to settlement	
Changes in operating assets and liabilities:	
Receivables	48,77
Prepaid assets	11,48
Deposits	
Accounts payable and accrued liabilities	(77,60)

Net cash (used in) provided by operating activities	(197,23)

Cash flows from investing activities:	
Cash used in purchases of property and equipment	(7,38)
Proceeds from sale of property and equipment	
Issuance of note receivable	(150,00)

Net cash used in investing activities	(157,38)

Cash flows from financing activities:	
Increase in cash overdraft	13,98
Proceeds from notes payable	
Repayments on note payable	(29,75)

Net cash (used in) provided by financing activities	(15,77)

Net increase (decrease) in cash	(370,38)
Cash, beginning of year	370,38

Cash, end of year	\$
	=====
Supplemental disclosures of cash flow information:	
Interest paid	\$
Income taxes paid	\$
	=====

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

4

Avalon Digital Marketing Systems, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

1. BUSINESS AND ORGANIZATION

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

On September 5, 2003 (the "Petition Date"), Avalon Digital Marketing Systems, Inc. (the "Company") filed a voluntary petition for reorganization under Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code") in the United States Bankruptcy Court for the District of Utah, Central Division (the "Bankruptcy Court"). The Company emerged from Chapter 11 Bankruptcy by obtaining confirmation of its Plan, which became effective on November 18, 2004, and received a concurrent debt infusion of approximately \$1.3 million from outside investors. The Bankruptcy Court entered an order on November 3, 2004 confirming the Company's First Amended Plan of Reorganization Pursuant to Chapter 11 of the United States Bankruptcy Code (the "Plan"). The Plan became effective on November 18, 2004, with the closing of the financing and related confirmation matters effective December 9, 2004. All conditions required for adoption of fresh-start reporting were met on November 18, 2004 and the Company selected December 31, 2004 as the date to adopt the accounting provisions of fresh-start reporting. As a result, the fair value of the Predecessor Company's assets became the new basis for the Successor Company's consolidated balance sheet as of December 31, 2004, and all results of operations beginning January 1, 2005 are those of the Successor Company.

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 Predecessor Company's business included the small business and large enterprise sales channels.

The small business channel was the primary source of historical revenues, and provided small businesses with merchant services and digital marketing software, primarily marketed through workshops.

In March 2003, the Company stopped selling its products through seminars, and refocused on selling software and services through alternative distribution methods. In June 2003, the Company sold certain of the assets from its large enterprise operations to Silverpop Systems, Inc. After the sale, the Company changed its focus to software-based solutions for its small business customers.

Company revenues are derived from the production and delivery of rich media messages and licensing software. Production services include theme development, design and layout, special effects, hyperlink recommendations, hyperlink page design and creation, custom programming, reporting and sales cycle consultation.

The Company currently sells its products and services through a direct sales force and a small network of sales affiliates.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited Condensed consolidated financial statements of Avalon Digital Marketing Systems, Inc, ("AVALON" or the "Company") were prepared in accordance with U.S. generally accepted accounting principles (US GAAP) for interim financial information and with the instructions to Form 10-QSB. Accordingly, these financial statements do not include all of the information and footnote disclosures required by US GAAP for complete financial statements. In the opinion of management, the accompanying unaudited Condensed consolidated financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary to fairly present the Company's financial position as of March 31, 2005, its results of operations for the three months ended March 31, 2005 and 2004, the six months ended December 31, 2004, and the nine months ended March 31, 2004, and its cash flows for the three

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

months ended March 31, 2005, the six months ended December 31, 2004, and the nine months ended March 31, 2004. The results of operations for period ended March 31, 2005 may not be indicative of the results that may be expected for the year ending June 30, 2005. All periods prior to the fresh-start accounting applied on December 31, 2004, are considered the Predecessor Company and the period from January 1, 2005 through March 31, 2005 is considered the Successor Company (see Note 4).

Going Concern

Historically, the Company has incurred net losses and negative cash flows from operating activities. During the three months ended March 31, 2005, the Company had negative cash flows of \$197,231 from operating activities. At March 31, 2005, the Company had a deficit in working capital. The Company's ability to meet its obligations as they come due is dependent upon its ability to obtain additional financing as required, and ultimately to achieve and sustain profitability. These conditions raise substantial doubt about the Company's ability to continue as a going concern. The unaudited condensed consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

5

Avalon Digital Marketing Systems, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

The Company will continue to attempt to raise capital through private equity or debt offerings, as well as from institutional investors until internally generated profitability is achieved.

There can be no assurance that the Company will be successful in executing its plans to obtain additional debt or equity financing. If the Company is unable to obtain additional debt or equity financing, it may be unable to continue operating.

Fresh-start reporting

In accordance with SOP 90-7, the Company adopted fresh-start reporting as of the close of business on December 31, 2004. The consolidated balance sheet as of March 31, 2005 includes the effects of the allocations to the carrying value of assets or amounts and classifications of liabilities that were necessary when adopting fresh-start reporting.

The consolidated balance sheet reflects the implementation of the Plan as if the Plan had been effective on December 31, 2004. Reorganization adjustments have been reflected in the consolidated financial statements to reflect the discharge of debt and the adoption of fresh-start reporting in accordance with SOP 90-7.

In applying fresh-start reporting, the Company followed these principles:

- o Each liability existing as of the fresh-start reporting date has been stated at the present value of the amounts to be paid, determined at appropriate current interest rates. Deferred revenue was adjusted to reflect the fair value of future costs of contractual performance obligations plus a normal profit margin.
- o The Company is evaluating the fair value of property and

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

equipment assets and will reclass from the intangible upon final determination.

Principles of consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant inter-company account balances and transactions have been eliminated in consolidation.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentration of credit risk consist primarily of accounts receivable.

The Company performs ongoing credit evaluations of its customers and maintains reserves for potential credit losses.

In the normal course of business, the Company has historically sold certain of its receivables to financing companies. The Company's sales of receivables to financing companies include limited recourse provisions, which are deemed non-hedging derivatives pursuant to the provisions of the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging" ("SFAS No. 133"). 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 is based on historical recourse rates experienced by the Company. The fair value of the estimated receivable repurchase obligation at March 31, 2005 is \$111,949.

6

Avalon Digital Marketing Systems, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

Use of estimates

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

Revenue recognition

Revenue from the sale of products is recognized when the following four criteria are met: persuasive evidence of an arrangement exists; products are shipped and the customer takes ownership and assumes the risk of loss; the selling price is fixed or determinable; and collectibility is reasonably assured.

Revenue from lead generation or email delivery consulting is recognized when the consulting or production services are rendered and messages are delivered. Revenue from media sales is recognized upon placing advertisements. Revenue from other consulting is recognized as the services are rendered.

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

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.

Impairment of intangible assets

Intangible assets determined to have indefinite useful lives are not amortized. The Company tests such intangible assets with indefinite useful lives for impairment annually or more frequently if events or circumstances indicate that an asset might be impaired.

The reorganization value in excess of amounts allocable to identifiable assets was not amortized. The Company performed a test for impairment as of March 31, 2005 due to the operating loss and negative cash flows generated from operating activities during the quarter ended March 31, 2005. Based on the Company's impairment analysis as of March 31, 2005, which consisted of a cash flow projection analysis, the Company determined that the reorganization value in excess of amounts allocable to identifiable assets was fully impaired. Accordingly, the Company recorded an impairment expense of \$1,972,340. As of March 31, 2005, the net book value of the reorganization value in excess of amounts allocable to identifiable assets was \$0.

Stock-based compensation

The Company measures compensation expense for its equity incentive plan using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), and provides pro forma disclosures of net income as if the fair value based method prescribed by Statement of Financial Accounting Standards No. 123, "Accounting

7

Avalon Digital Marketing Systems, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

for Stock-Based Compensation" ("SFAS 123"), had been applied. Stock-based awards to non-employees are accounted for under the provisions of SFAS No. 123 and related pronouncements.

In December 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 148, "Accounting for Stock Based Compensation - Transition and Disclosure" ("SFAS No. 148"), which became effective for fiscal years ended after December 15, 2002. SFAS No. 148 requires that certain pro forma information be presented in the summary of significant accounting policies note to the consolidated financial statements, assuming the Company recognized its stock-based compensation using the fair value method.

The Company has not provided pro forma disclosures as defined by SFAS No. 148 because stock options and warrants granted prior to the fresh start are not applicable and the fair value of options granted subsequent to the fresh start accounting is near \$0.

Earnings 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

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

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 anti-dilutive.

Historical earning per share information has not been presented for the Predecessor Company. The Company does not believe that this information is relevant in any material respect for users of its financial statements because all existing equity interests of the Predecessor Company were eliminated (without a distribution) upon consummation of the Plan of Reorganization.

Recently issued Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets, which amends Accounting Principles Board (APB) Opinion No. 29, Accounting for Nonmonetary Transactions. The guidance in APB Opinion 29 is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in APB Opinion 29, however, included certain exceptions to that principle. SFAS 153 amends APB Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for fiscal periods beginning after June 15, 2005. We do not expect that the adoption of SFAS 153 will have a material impact on our financial position or results of operations.

On December 16, 2004, the Financial Accounting Standards Board ("FASB") published Statement of Financial Accounting Standards No.123 (Revised 2004), Share Based Payment ("SFAS 123R"). SFAS 123R requires that compensation cost related to share-based payment transactions be recognized in the financial statements. Share-based payment transactions within the scope of SFAS 123R include stock options, restricted stock plans, performance-based awards, stock appreciation rights, and employee share purchase plans. The provisions of SFAS 123R are effective as of the first interim period that begins after December 15, 2005. Accordingly, the Company will implement the revised standard in the first quarter of fiscal year 2006. Currently, the Company accounts for its share-based payment transactions under the provisions of APB 25, which does not necessarily require the recognition of compensation cost in the financial statements. Management is assessing the implications of this revised standard and the effect of the adoption of SFAS 123R will have on our financial position, results of operations, or cash flow.

Avalon Digital Marketing Systems, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

Reclassifications

Certain amounts in the prior period financial statements have been reclassified to be consistent with the current year presentation.

3. VOLUNTARY REORGANIZATION UNDER CHAPTER 11

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

Bankruptcy Proceedings

On September 5, 2003, the Company filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in the Bankruptcy Court. Under Chapter 11, certain claims against the Company in existence prior to the filing of the petition for relief under the Bankruptcy Code are stayed while the Company continues business operating as Debtor-In-Possession. Prior to the application of fresh-start reporting, the Company's consolidated balance sheet included the related balances subject to compromise described in the table below. However, the adoption of fresh-start reporting results in the settlement of such balances based on the estimated payment amounts pursuant to the Plan with the difference recorded as a reorganization gain in the consolidated statement of operations for the six months ended December 31, 2004.

Additional claims (liabilities subject to compromise) may arise resulting from rejection of executory contracts, including leases, and from the determination by the court (or agreed to by parties in interest) of allowed claims for contingencies and other disputed amounts. The Company continued to operate its business as Debtor-In-Possession through November 18, 2004. As a consequence of the bankruptcy filing, most litigation against the Company was stayed.

The Company filed the Plan on May 28, 2004 and the Plan was confirmed by the Bankruptcy Court on November 3, 2004, and was consummated on November 18, 2004. A summary of the significant provisions of the Plan is set forth below:

- o All common and preferred equity shares of the Company (and all stock options and warrants) were cancelled;
- o All debt securities of the Company were settled and cancelled;
- o Unexpired leases and executory contracts of the Company were assumed or rejected in accordance with the Plan;
- o The Company issued \$1.338 million principal amount of 3% Secured Convertible Promissory Notes due 2007;
- o Pursuant to the Plan, approximately 1.1 million shares of new Company common stock were issued to settle the claims of general unsecured creditors, 73,483 shares of new Company common stock were issued to the former shareholders of the Company. Additionally, approximately 6.2 million shares of new Company common stock have been authorized and reserved relating to convertible promissory notes and new warrants issued by the Company on December 9, 2004 in connection with the Company's emergence from bankruptcy;
- o 293,933 shares of new Company common stock were authorized and reserved for issuance to the secured creditor of the Predecessor Company. Warrants representing these 293,933 shares of Company common stock were issued on December 13, 2004.
- o Total payments of approximately \$903,000 in cash were made in December, 2004, pursuant to the Plan, to settle certain claims against the Company and administrative expenses related to the Bankruptcy Proceedings; and
- o The distribution provisions of the Plan allow the Company to settle and discharge the allowed claims of certain classes of creditors in cash and stock, as described above.

Avalon Digital Marketing Systems, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

Plan of Reorganization

The following briefly summarizes the classification and treatment of claims and equity interests under the Plan:

Claims estimated to be fully recoverable

- o Administrative expenses and other priority claims, secured tax claims and other secured claims are to be paid in cash.
- o Obligations incurred in the ordinary course of business during the pendency of the Chapter 11 cases or approved by the Bankruptcy Court and pre-existing obligations assumed by the Company will be paid in full when due.

Claims having an estimated recovery of less than 100%

- o Company general unsecured claims are to be settled and discharged by the payment of \$245,000 in cash to a trust established for the benefit of creditors (the "Creditors Trust"), by transferring certain litigation rights and claims to the Creditors Trust (which transfer has occurred) and by the distribution of approximately 127 shares of common stock of the Successor Company for each \$1,000 of allowed claim and cash equal to 2.31% of the allowed claim.
- o Company's common stockholders are to receive approximately 1 share of common stock in the Successor Company for approximately each 132 shares of common stock held in the Predecessor Company.

Claims receiving no compensation

- o Company subordinated claims will receive no distribution.

Dividends or Stock Repurchases

- o No amounts are being distributed in cash in the form of dividends or stock repurchases.

Liabilities Subject To Compromise

Liabilities subject to compromise represent the liabilities of the Company incurred prior to the Petition Date, except those that will not be impaired under the Plan. Liabilities subject to compromise consisted of the following at December 31, 2004:

Pre-petition accounts payable and accrued liabilities	\$ 7,148,241
Notes payable	2,187,289
Other liabilities	743,805

Total liabilities subject to compromise	\$ 10,079,335
	=====

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

For the amounts reported as liabilities subject to compromise in the table above, the Company will reconcile recorded pre-petition liabilities with the actual claims filed by creditors. In some individual instances and in total, claims filed by creditors are in excess of the amounts recorded by the Company's debtors. The Company has recorded an estimate of allowed claims based on the reconciliation work that has been completed to date. However, given the size and complexity of the Chapter 11 cases, there is some uncertainty as to the ultimate liability that will be negotiated with creditors for these pre-petition claims, and, the final liability upon completion of the reconciliation and negotiation with claimants at a future date may be significantly higher or lower than management's current estimate. The Company's debtors and the Creditors Trust intend to contest claims to the extent they exceed the amounts the Company's debtors believe are due and to the extent an objection would have a material effect on pro-rata distribution.

During the six months ended December 31, 2004, the Predecessor Company made adjustments to liabilities subject to compromise for additional liabilities recognized under the Plan. The following table identifies the changes in the Predecessor Company's liabilities subject to compromise prior to the adoption of fresh-start reporting on December 31, 2004:

10

Avalon Digital Marketing Systems, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

Liabilities subject to compromise as of June 30, 2004	\$ 9,449,617
Additions:	
Additional liabilities	629,718

Liabilities subject to compromise as of December 31, 2004	\$ 10,079,335
	=====

No interest expense related to pre-petition debt has been accrued following the Petition Date as none of the allowed claims against the Company has underlying collateral in excess of the principal amount of debt.

Reorganization items, net

Following the filing of the Chapter 11 cases, the Company commenced a comprehensive reorganization process, together with its financial and legal advisors, to review and analyze its businesses, contracts and leases to determine if any of these owned assets should be divested and which contracts and leases should be rejected or assumed during the Chapter 11 cases.

Reorganization items consisted primarily of \$8,254,042 related to the effects of the plan of reorganization and fresh-start reporting,

Included in reorganization items, net for the six months ended December 31, 2004 was the Company's gain recognized from the effects of the Plan. The gain results from the difference between the Company's carrying value of remaining pre-petition liabilities, minority interests and common stock subject to compromise and the amounts to be distributed pursuant to the Plan. The gain from the effects of the Plan and the application of fresh-start reporting is comprised of the following:

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

Discharge of liabilities subject to compromise	\$ 10,079,335
Discharge of common stock subject to compromise	8,539
Issuance of new common stock	(930,234)
Amounts settled in cash	(903,598)

Gain from the effects of the Plan	\$ 8,254,042
	=====

4. FRESH-START REPORTING

In accordance with SOP 90-7, the Company adopted fresh-start reporting as of the close of business on December 31, 2004. The consolidated balance sheet as of March 31, 2005 includes the effects of the allocations to the carrying value of assets or amounts and classifications of liabilities that were necessary when adopting fresh-start reporting. As discussed below, these allocation adjustments recorded to the carrying amounts of assets and liabilities are subject to adjustment as estimated valuations are finalized.

The consolidated balance sheet included in this Quarterly Report on Form 10-QSB reflects the implementation of the Plan as if the Plan had been effective on December 31, 2004. Reorganization adjustments have been reflected in the consolidated financial statements to reflect the discharge of debt and the adoption of fresh-start reporting in accordance with SOP 90-7.

These estimates of fair value were recorded as of December 31, 2004. However, as these estimates are finalized, the allocations of fair value in the Company's balance sheet could result in additional adjustments to the fair value of assets or present value of estimated liabilities during the allocation period while the Company continues to obtain information necessary to complete its final allocation. These adjustments could result from additional information related to the assumptions and estimates used in determining the fair value of long-lived assets. Potential allocation adjustments to the Company's assets include estimates used for the fair value of contracts, property, plant and equipment.

11

Avalon Digital Marketing Systems, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

In applying fresh-start reporting, the Company followed these principles:

- o Each liability existing as of the fresh-start reporting date has been stated at the present value of the amounts to be paid, determined at appropriate current interest rates. Deferred revenue was adjusted to reflect the fair value of future costs of contractual performance obligations plus a normal profit margin.
- o The Company is evaluating the fair value of property, plant and equipment assets and will reclass from the intangible upon final determination.

The following table identifies the adjustments recorded to the Company's December 31, 2004 consolidated balance sheet as a result of implementing the Plan and applying fresh-start reporting (in millions):

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

	Predecessor Company December 31, 2004	Adjustments to Record Confirmation of Plan	
	-----	Debt Discharge	Exchang of Stoc -----
Assets			
Current assets:			
Cash	\$ 1,273,986	\$ (903,598)	
Receivables, net:			
Contract	87,650		
Trade	15,538		
Retainages	28,700		
Prepaid assets	31,100		

Total current assets	1,436,974		
Fixed assets, net	190,605		
Identifiable intangible assets, net	-		
Reorganization value in excess of amounts allocable to identifiable assets	-		
Deposits	1,250		

Total assets	\$ 1,628,829		

Liabilities and Shareholders' Deficit			
Liabilities not subject to compromise:			
Current liabilities:			
Accounts payable and accrued liabilities	\$ 281,774		
Deferred revenue	-		
Notes payable	1,367,573		
Estimated receivable repurchase obligation	116,815		
Deferred taxes	-		

Total current liabilities	1,766,162		
Liabilities subject to compromise	10,079,335	(10,079,335)	
Commitments and contingencies (Notes 15)			
Preferred stock subject to compromise	1,000		(1,000)
Shareholders' deficit:			
Common stock - new (Successor)	-	118	
Common stock - old (Predecessor)	8,713		(8,713)
Additional paid-in capital	22,620,080	931,291	
Retained deficit	(32,846,463)	9,175,738	(921,600)

Total shareholders' deficit	(10,216,670)		

Total liabilities and shareholders' deficit	\$ 1,628,827		

Avalon Digital Marketing Systems, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

5. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities consisted of the following at March 31, 2005:

Accounts payable	\$ 46,948
Accrued payroll and payroll taxes	30,106
Accrued vacation	59,775
Accrued interest	10,033
Other accrued liabilities	57,304

	\$ 204,166
	=====

6. NOTES PAYABLE

Liabilities Not Subject to Compromise

On November 30, 2004, in conjunction with the Plan of Reorganization, the Company issued a secured promissory note in the amount of \$29,760 to a former secured creditor affiliated with two current employees of the Company. Interest on the note accrues at a rate of 6% per annum. The entire balance is to be repaid in three equal monthly installments beginning December 17, 2004. The secured promissory note was repaid in full prior to March 31, 2005.

On December 13, 2004, the Company issued two secured convertible promissory notes in the amounts of \$822,763 and \$514,950. These notes were issued in conjunction with an investment relating to the Company's emergence from bankruptcy. The notes convert into 5,143,795 shares of Company common stock. Unless converted, the notes automatically mature and principal is due and payable on December 13, 2007. Interest on the notes is payable in common stock and accrues at a rate of 3% per annum, increasing to a rate of 8% in the event of default. Accrued interest on the notes is payable quarterly on the last day of each three-month period beginning on December 13, 2004. As of March 31, 2005, accrued interest on the notes totaled \$10,033.

On March 8, 2005, the Company issued a promissory note to the Law Debenture Trust Company of New York in the amount of \$45,000 for services to be rendered associated with the Plan of Reorganization and review and approval of Company's unsecured claims. \$15,000 remains outstanding under this note.

7. COMMITMENTS AND CONTINGENCIES

Operating leases

The Company leases office space in Provo, Utah from a related party under a non-cancelable lease agreement. The original term of the lease was thirty-six months commencing on September 1, 2001 and terminating on August 31, 2004. On November 15, 2004, the Company exercised its Renewal Option under the original lease. The Renewal Option requires monthly lease payments ranging from \$6,100 to \$6,415 over the lease term expiring on November 30, 2007.

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

Legal claims

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 "Liabilities subject to compromise" and "Accounts payable and accrued liabilities" in the accompanying consolidated balance sheet at March 31, 2005 and June 30, 2004. The Company is working with the creditors to reach settlements and payment terms that are acceptable. As a consequence of the bankruptcy filing, most litigation regarding non-payment of liabilities against the Company has been stayed.

In July, 2004, the Company received a notice from the Utah Department of Consumer Protection (the "Department") indicating that a former subsidiary of the Company (which had subsequently been merged into the Company) had incurred a fine in the amount of \$44,000, which resulted in the Company being placed on the Consumer Watch List. The Department has asserted that this fine may not be discharged by the Plan or the Company's bankruptcy proceedings. The Company is in discussions with the Department and the State of Utah regarding the dischargability of this fine.

13

Avalon Digital Marketing Systems, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

8. RELATED PARTY TRANSACTIONS

Secured Promissory Notes

On November 30, 2004, in conjunction with the Plan of Reorganization, the Company issued a secured promissory note in the amount of \$29,760 to a former secured creditor affiliated with two current employees of the Company. Interest on the note accrues at a rate of 6% per annum. The entire balance is to be repaid in three equal monthly installments beginning December 17, 2004. The secured promissory note was repaid in full prior to March 31, 2005.

On February 14, 2005, the Company made a loan in the form of a secured promissory note to Hubbard Acquisition Corp. in the amount of \$125,000. The Company's largest secured creditor is affiliated with Hubbard Acquisition Corp. The loan was collateralized by a Note and Warrant Purchase and Security Agreement previously executed by the Company. Additionally, the loan was personally guaranteed by an individual affiliated with the Company's largest secured creditor. The principal amount of the loan was repaid in April, 2005.

Sales Commission

An investor affiliated with a significant shareholder and who is a director provides sales lead generation services for the Company for which commissions were paid. Commissions paid for the quarter and nine months ended March 31, 2005 totaled approximately \$4,044 and \$20,678, respectively.

Office Lease

The Company leases office space from a related party under a three year

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

lease agreement commencing September 1, 2001 (Note 7).

9. SHAREHOLDERS' EQUITY

Common Stock

Under the Plan, all equity securities of the Company were cancelled as of November 18, 2004. Also under the Plan, approximately 1.1 million shares of new Company common stock shares were authorized to be issued to settle the claims of general unsecured creditors, 73,483 shares of new Company common stock were authorized to be issued to the former shareholders of the Company. Additionally, approximately 6.2 million shares of new Company common stock have been authorized and reserved relating to convertible promissory notes and new warrants issued by the Company on December 9, 2004 in connection with the Company's emergence from bankruptcy.

Options

On January 14, 2005, the Board of Directors approved and reserved for issuance 1 million shares of Company common stock to be issued upon exercise of stock options. These options have an exercise price of \$0.01 with one-fourth vesting upon issuance and the remainder vesting equally in January 2006, 2007 and 2008. Additionally, the Board of Directors issued approximately 850,000 options to employees and members of the Board of Directors.

Warrants

Under the Plan, all equity securities of the Company, including all outstanding warrants, were cancelled as of November 18, 2004. In connection with the consummation of the Plan, the Company issued 1,028,761 warrants to certain former creditors of the Company and to investors in the Company's convertible notes issued December 9, 2004. As of December 31, 2004, all of these warrants were outstanding with exercise prices ranging from \$.0001 to \$.00011 per share, and with expiration dates in 2011. The Company has reserved sufficient shares of common stock to meet its stock option and warrant obligations.

14

Avalon Digital Marketing Systems, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

10. SUBSEQUENT EVENTS

In April 2005, Hubbard Acquisition Corp., under a certain Settlement Agreement with the Company, repaid the \$125,000 loan made on February 14, 2005. Additionally, the Company was compensated for legal fees and other costs associated with reviewing a joint venture proposal made by Hubbard Acquisition Corp. In addition to the repayment of the loan, Hubbard Acquisition Corp. issued a promissory note to the Company for \$33,500. This promissory note was to be repaid on or before April 16, 2005. Currently the note is in default and has not been repaid.

In April 2005, Tyler Thompson, former CEO of the Company, was replaced by a new CEO appointed by the Board of Directors. This appointment triggered the Change in Control Agreement by and between the Company and Mr. Thompson. Based on such agreement, if Mr. Thompson is terminated or voluntarily resigns within ninety days following the diminution of his duties, he is entitled to receive a severance payment equal to eighteen months of his total compensation.

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

The following discussion should be read together with Company consolidated financial statements and related notes included elsewhere in this quarterly report on Form 10-QSB.

Overview

On September 5, 2003 (the "Petition Date"), Avalon Digital Marketing Systems, Inc. (the "Company") filed a voluntary petition for reorganization under Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code") in the United States Bankruptcy Court for the District of Utah, Central Division (the "Bankruptcy Court"). The Company recently emerged from Chapter 11 Bankruptcy by obtaining confirmation of its Plan, which has become effective, and received a concurrent debt infusion of approximately \$1.3 million. The Bankruptcy Court entered an order on November 3, 2004 confirming the Company's First Amended Plan of Reorganization Pursuant to Chapter 11 of the United States Bankruptcy Code (the "Plan"). The Plan became effective on November 18, 2004, with the closing of the financing and related confirmation matters effective December 9, 2004.

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 Company currently sells its products and services through a direct sales force and a small network of sales affiliates.

Critical accounting policies

Fresh-start reporting

For the period subsequent to the Petition Date, the accompanying consolidated financial statements have been prepared in accordance with the American Institute of Public Accountant's Statement of Position 90-7, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code" ("SOP 90-7"). Accordingly, all pre-petition liabilities subject to compromise have been segregated in the consolidated balance sheet and classified as liabilities subject to compromise at the estimated amounts of allowable claims. Liabilities not subject to compromise are separately classified as current and non-current. Interest has not been accrued on debt subject to compromise subsequent to the Petition Date. Reorganization items include the expenses, realized gains and losses, and provisions for losses resulting from the reorganization under the Bankruptcy Code, and are reported separately as reorganization items in the Company's consolidated statement of operations. Cash used for reorganization items is disclosed separately in the consolidated statement of cash flows.

Estimated receivable repurchase obligation

In the normal course of business the Company sells its receivables to financing companies. The Company's sales of receivables to financing companies include limited 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

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

method, and the fair value estimate was based on historical recourse rates experienced by the Company. The fair value of the recourse obligation at March 31, 2005 is \$111,949. Increases and decreases in the recourse liability are recorded as reductions and increases of revenue, respectively.

Revenue recognition

Revenue from the sale of products is recognized when the following four criteria are met: persuasive evidence of an arrangement exists; products are shipped and the customer takes ownership and assumes the risk of loss; the selling price is fixed or determinable; and collectibility is reasonably assured.

Revenue from lead generation or email delivery consulting is recognized when the consulting or production services are rendered and messages are delivered. Revenue from media sales is recognized upon placing advertisements. Revenue from other consulting is recognized as the services are rendered.

16

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.

Intangible assets

Intangible assets determined to have indefinite useful lives are not amortized. The Company tests such intangible assets with indefinite useful lives for impairment annually or more frequently if events or circumstances indicate that an asset might be impaired. Intangible assets determined to have definite lives are amortized on a straight-line basis over their useful lives. The Company reviews such intangible assets with definite lives for impairment to ensure they are appropriately valued if conditions exist that may indicate the carrying value may not be recoverable. Such conditions may include an economic downturn in a geographic market or a change in the assessment of future operations.

The reorganization value in excess of amounts allocable to identifiable assets was not amortized. The Company performed a test for impairment as of March 31, 2005 due to the operating loss and negative cash flows generated from operating activities during the quarter ended March 31, 2005. Based on the Company's impairment analysis as of March 31, 2005, which consisted of a cash flow projection analysis, the Company determined that the reorganization value in excess of amounts allocable to identifiable assets was fully impaired. Accordingly, the Company recorded an impairment expense of \$1,972,340. As of March 31, 2005, the net book value of the reorganization value in excess of amounts allocable to identifiable assets was \$0.

Stock-based compensation

The Company measures compensation expense for its equity incentive plan using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), and provides pro forma disclosures, when applicable, of net income as if the fair value based method prescribed by Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"), had been applied. Stock-based awards to non-employees are accounted for under the provisions of SFAS No. 123 and related pronouncements.

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

Recent accounting pronouncements

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets, which amends Accounting Principles Board (APB) Opinion No. 29, Accounting for Nonmonetary Transactions. The guidance in APB Opinion 29 is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in APB Opinion 29, however, included certain exceptions to that principle. SFAS 153 amends APB Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for fiscal periods beginning after June 15, 2005. We do not expect that the adoption of SFAS 153 will have a material impact on our financial position or results of operations.

On December 16, 2004, the Financial Accounting Standards Board ("FASB") published Statement of Financial Accounting Standards No.123 (Revised 2004), Share Based Payment ("SFAS 123R"). SFAS 123R requires that compensation cost related to share-based payment transactions be recognized in the financial statements. Share-based payment transactions within the scope of SFAS 123R include stock options, restricted stock plans, performance-based awards, stock appreciation rights, and employee share purchase plans. The provisions of SFAS 123R are effective as of the first interim period that begins after December 15, 2005. Accordingly, the Company will implement the revised standard in the first quarter of fiscal year 2006. Currently, the Company accounts for its share-based payment transactions under the provisions of APB 25, which does not necessarily require the recognition of compensation cost in the financial statements. Management is assessing the implications of this revised standard and the effect of the adoption of SFAS 123R will have on our financial position, results of operations, or cash flow.

17

The Company needs additional financing

The Company is in the process of emerging from bankruptcy protection under Chapter 11 of the Bankruptcy Code. The Company has paid, and will continue to incur costs associated with the recent bankruptcy process. As a result of the use of many of the Company's resources to settle debts as part of its bankruptcy proceedings and the related costs associated with emerging from bankruptcy protection, the Company has a significant need for addition capital.

Pursuant to the terms of the Plan, on December 9, 2004, the Company issued Secured Convertible Promissory Notes (the "Secured Notes") payable in the aggregate principal amount of \$1,337,813. The Secured Notes are payable upon maturity and mature on December 13, 2007. The Company also issued warrants to purchase 734,828 shares of the Company's common stock in connection with the issuance of the Secured Notes.

In addition, the Company's liquidity is significantly impacted by credit and collection issues. Prior to its bankruptcy, the Company generated large balances of receivables and, depending on the quality of the credit and cash needs, certain of the receivables were sold, at a discount, to financing sources. Receivables that were not sold were retained and billing and collecting administration were outsourced. A large portion of the Company's customers prior to its bankruptcy had sub-prime credit. Accordingly, many of the receivables generated by these customers had high credit risk.

At March 31, 2005, the Company had a cash overdraft of \$13,983, which

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

requires that it seek immediate additional capital. As of March 31, 2005, total assets were \$400,606 and total liabilities were \$1,667,911.

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 Company's view, recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheet is dependent upon its continued operations, which in turn is dependent upon its 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 it be unable to continue in existence.

Results of operations

In recent months, the Company has maintained Axis(TM), a 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 customers to make the best use of them, should contribute to the Company's revenue going forward.

Throughout the bankruptcy process, The Company has been actively engaged in the development of a new, enterprise level software application. This application, Point Blank, is an enterprise email marketing system that manages the entire life-cycle of strategic email marketing campaigns, from list management to design and execution, to reporting. Combining robust creation and delivery features with event-driven content and campaign logic, the software delivers individually customized messaging to each recipient without sacrificing the economic and marketing advantages of email. Point Blank is offered as an ASP product, allowing global access via the Web, and providing full third-party data and program access through a web services interface. These new products should allow the Company to shift its reliance away from the sources of revenue generated prior to its bankruptcy filing. Clients of the Company prior to its bankruptcy generally entered into long-term installment contracts to pay for the products and services they purchased, and the Company experienced high rates of payment default in these contracts.

Quarterly revenues totaled \$239,381, a 44% decrease from the same quarter in the previous year. Revenues for the nine months ended March 31, 2005 decreased to \$778,108 from \$1,544,947 for the nine months ended March 31, 2004, a 50% decrease. The decreases are primarily the result of management's plan to reduce its dependency on the lower quality revenues typically produced prior to the Company's bankruptcy filing, and a shift in the overall direction of the Company by developing its own, proprietary, digital marketing software application.

18

Gross profit decreased from \$396,885 for the three months ended March 31, 2004 to \$232,442 for the three months ended March 31, 2005. Gross profit decreased from \$1,388,633, or 90% of revenues for the nine months ended March 31, 2004 to \$740,298, or 95% of revenues, for the nine months ended March 31, 2005.

Selling, general and administrative expenses decreased from \$553,278, or 128% of revenues, and \$1,991,007, or 129% of revenues, for the quarter and nine months ended March 31, 2004, respectively, to \$451,911, or 189% of revenues, and \$1,518,548, or 195% of revenues, for the quarter and nine months

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

ended March 31, 2005, respectively. These decreases were associated with a reduction in workforce and scaled back operations during bankruptcy.

Company intangible assets with definite lives for impairment to ensure they are appropriately valued if conditions exist that may indicate the carrying value may not be recoverable. Such conditions may include an economic downturn in a geographic market or a change in the assessment of future operations of reorganization value in excess of amounts allocable to identifiable assets. The Company performed a test for impairment as of March 31, 2005 due to the operating loss and negative cash flows generated from operating activities during the quarter ended March 31, 2005. Based on the Company's impairment analysis as of March 31, 2005, which consisted of a cash flow projection analysis, the Company determined that the reorganization value in excess of amounts allocable to identifiable assets was fully impaired. Accordingly, the Company recorded an impairment expense of \$1,972,340. As of March 31, 2005, the net book value of the reorganization value in excess of amounts allocable to identifiable assets was \$0.

Bad debt expense decreased from \$3,157 and \$34,085 for the quarter and nine months ended March, 31, 2004, respectively, to \$0 and \$11,827 for the quarter and nine months ended March 31, 2005, respectively. The decrease resulted primarily from a reduction in defaults on contracts receivable of the Company pertaining to contracts receivable previously sold to financing companies. The Company has decreased its dependence on long-term contracts receivable for revenues generated prior to the Company's bankruptcy filing, and therefore expects bad debt expense to decrease on both an absolute and relative basis in future quarters.

The Company incurred a loss from operations of \$2,191,809 and \$2,762,417 for the quarter and nine months ended March, 31, 2005, respectively, compared to a loss from operations of \$159,550 and \$885,959 for the same periods from 2004. The loss resulted from a number of factors, including the factors discussed in the foregoing paragraphs and the following factors:

- o The decrease in lead-source revenues and bad debt expense;
- o Reduction in new sales due to perceived instability during bankruptcy;
- o Increases in costs related to the bankruptcy completed during the year; and
- o Impairment of the reorganization value in excess of amounts allocable to identifiable assets.

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

Liquidity and sources of capital

In conjunction with its recent Plan of Reorganization and emergence from Chapter 11 bankruptcy, on December 9, 2004, the Company issued Secured Convertible Promissory Notes payable in the amount of \$1,337,813 and due in 2007. Additionally, the Company has paid, and will continue to incur costs associated with the recent bankruptcy process.

At March 31, 2005, the Company had a cash overdraft of \$13,983, which requires that it seek immediate additional capital. As of March 31, 2005, total assets were \$400,606 and total liabilities were \$1,667,911.

The accompanying consolidated financial statements have been prepared

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

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 Company's view, recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheet is dependent upon its continued operations, which in turn is dependent upon its 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 it be unable to continue in existence.

19

During the nine months ended March 31, 2005, the Company used \$1,082,999 of cash from operating activities and used \$157,382 of cash in investing activities and generated \$1,189,852 in cash from financing activities. During the nine months ended March 31, 2004, the Company generated \$253,393 of cash from operating activities, used \$911 of cash in investing activities and used \$115,774 of cash in financing activities. Liquidity is significantly impacted by credit and collection issues and the continued costs and fees associated with the recent bankruptcy process.

The Company needs additional capital to continue operations in the near term. Additional capital may come from the sale of certain assets of the Predecessor Company or other available means, which may include debt and/or equity financings. Assurance cannot be given 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 unable to raise additional capital and/or reach agreement with its creditors to convert convertible debt into equity, Company operations will be severely harmed.

Certain of the matters and subject areas discussed in this quarterly report on Form 10-QSB contain "forward-looking statements" that are subject to a number of risks and uncertainties, many of which are beyond the Company's control. All statements, other than statements of historical fact included in this report regarding 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 the Company believes that the expectations reflected in the forward-looking statements are reasonable, it can give no assurance that such expectations will prove to be correct. Important factors that could cause its actual results to differ materially from its expectations are described below and in other Company filings with the SEC.

Risk Factors

The Company needs additional financing

At March 31, 2005, the Company had a cash overdraft of \$13,983, which requires that it seek immediate additional capital. As of March 31, 2005, total assets were \$400,606 and total liabilities were \$1,667,911.

Implementation of the Company's business plan will require access to additional capital. Failure to obtain sufficient financing will restrict the Company's ability to implement its business plan and materially adversely affect its business. The Company believes that its current cash and cash equivalents, together with cash flows expected to be generated from the Company's future

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

operations, will not be sufficient to fund the Company's operating needs for the next 12 months. Therefore, the Company requires additional financing in an amount that cannot be determined at this time to enable it to finance unanticipated working capital requirements and to develop or enhance existing products or services, among others. In addition, if the Company is unable to fund its operations at its current levels, and if customers and vendors become concerned about its business prospects, they may decide not to conduct business with it, or may conduct business with it on terms that are less favorable than those customarily extended by them. In that event, Company revenues would decrease and its business will suffer significantly.

THERE CAN BE NO ASSURANCE THAT ANY ADDITIONAL FINANCING WILL BE AVAILABLE ON ACCEPTABLE TERMS, IF AT ALL. IF UNSUCCESSFUL IN RAISING ADDITIONAL FUNDS, THE COMPANY'S LIQUIDITY POSITION WILL BE MATERIALLY AND ADVERSELY AFFECTED AND IT COULD BE REQUIRED TO MAKE DRASTIC COST REDUCTIONS, WHICH WOULD NEGATIVELY IMPACT ITS OPERATIONS.

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

20

Recent actions of the Company may negatively impact its ability to achieve its business objectives

In order to manage liquidity and cash positions, over the past year the Company has had to implement certain cost cutting measures, including significant reductions in force. After these staff reductions, as of March 31, 2005, the Company had 14 full time employees. Although these cost cutting measures improved its short-term cash requirements, they may negatively impact its ability to grow its business and achieve its business objectives.

Limited operating history makes evaluation of its business difficult

The Company has a limited operating history on which to base its evaluation of current business and prospects. The Company's current business plan is significantly changed from its business plan prior to its bankruptcy filing, with less reliance on long-term contracts and the Predecessor Company's product offerings. The very limited operating history using its new business plan makes it difficult to predict future results, and there are no assurances that its revenues will increase, or that it will achieve or maintain profitability or generate sufficient cash from operations in future periods.

Company's ability to achieve and sustain profitability would be adversely affected if it:

- o fails to effectively market and sell its services;
- o fails to develop new and maintain existing relationships with clients;
- o fails to continue to develop and upgrade its technology and network infrastructure;

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

- o fails to respond to competitive developments;
- o fails to introduce enhancements to its existing products and services to address new technologies and standards; or
- o fails to attract and retain qualified personnel.

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

The Company is not sure if the market will accept its product offerings

The Company is in the process of developing and marketing new software products and related services. The Company's ability to succeed will depend on the effectiveness of its marketing and sales efforts of these new products, market acceptance of these current and future product offerings and the reliability of its networks and the services it offers to its clients. The Company operates in a market that 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 its 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 the Company expects, its growth will be slower than expected.

The Company may make acquisitions of complementary technologies or businesses, which may disrupt its business and be dilutive to its existing stockholders

The Company intends 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 its own. Although it attempts 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. The Company cannot guarantee that it will successfully identify attractive acquisition candidates, complete and finance additional acquisitions on favorable terms, or integrate the acquired businesses or assets into its own. Any of these factors could materially harm its business or its operating results in a given period.

21

Network and system failures could adversely impact its business.

The performance, reliability and availability of the Company's websites and network infrastructure is critical to its reputation and ability to attract and retain clients. Its 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. Services

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

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 its services.

The Company is also dependent upon web browsers, Internet service providers and online service providers to provide Internet user's access to its clients, users and websites. Users may experience difficulties due to system failures or delays unrelated to its systems. These difficulties may hurt audio and video quality or result in intermittent interruptions in broadcasting and thereby slow its growth.

Circumvention of Company security measures and viruses could disrupt its business

Despite the implementation of security measures, Company 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 its operations. Service providers have occasionally experienced interruptions in service as a result of the accidental actions of users or intentional actions of hackers. The Company may have to spend significant capital to protect against security breaches or to fix problems caused by such breaches. Although it has 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 its business.

The Company may be unable to collect its receivables and retainages in amounts previously estimated

In accordance with United States generally accepted accounting principles, the Company has established reserves against its retainages and receivables. It believes that the established reserves adequately allow for the estimated uncollectible portion of the retainages and receivables. However, it 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 its ability to successfully implement the objectives of its business plan. There can be no assurance that it will be able to collect retainages and receivables in sufficient amounts. Failure to collect adequate amounts of retainages and receivables could materially adversely affect its business and results of operations.

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. The Company expects competition to persist and intensify and the number of competitors to increase significantly in the future. Should it seek in the future to attempt to expand the scope of its Internet services and product offerings, it 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 it to anticipate which companies are likely to offer competitive products and services in the future.

If the Company does not respond to technological change, it could lose or fail to develop customers

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

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

22

The evolving nature of the Internet could render the Company's existing systems obsolete. Company success will depend, in part, on its ability to:

- o develop and enhance technologies useful in its business;
- o develop new services and technology that address the increasingly sophisticated and varied needs of its current and prospective clients; and
- o 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, the Company's business. Furthermore, it may not use new technologies effectively or adapt its systems to client requirements or emerging industry standards on a timely basis. Its ability to remain technologically competitive may require substantial expenditures and lead time. If it is unable to adapt to changing market conditions or user requirements in a timely manner, it will lose clients.

The Company could face liability for Internet content

As a distributor of Internet content, the Company faces potential liability for negligence, copyright, patent or trademark infringement, defamation, indecency and other claims based on the content of its broadcasts. Such claims have been brought, and sometimes successfully pressed, against Internet content distributors. The Company's general liability insurance may not be adequate to indemnify it for all liability that may be imposed. Although it generally requires its clients to indemnify it 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 its business.

The Company's stock price has been and may continue to be volatile

The trading price of the Company's common stock has been and is likely to continue to be highly volatile. Its stock price could be subject to wide fluctuations in response to factors such as:

- o the average daily trading volume of its common stock;
- o actual or anticipated variations in quarterly operating results and its need for additional financing to fund its continuing operations;
- o announcements of technological innovations, new products or services by it or its competitors;

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

- o the addition or loss of strategic relationships or relationships with its key customers;
- o conditions or trends in the Internet, streaming media, media delivery, and online commerce markets;
- o changes in the market valuations of other Internet, online service, or software companies;
- o announcements by it or its competitors of significant acquisitions, mergers, strategic partnerships, joint ventures, or capital commitments;
- o sales of its common stock and legal or regulatory developments;
- o additions or departures of key personnel;
- o its failure to obtain additional financing on satisfactory terms, or at all; and
- o general market conditions.

The historical volatility of the Company's stock price may make it more difficult for investors in its 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, has 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 the Company's stock price, regardless of its operating performance.

Failure to satisfy the Nasdaq SmallCap Market listing requirements may result in the Company's common stock not being listed on the Nasdaq SmallCap Market, which could have an adverse impact on its stock price.

23

In connection with its bankruptcy proceedings and related matters, the Company's common stock was delisted from the NASDAQ SmallCap Market. The Company's common stock is quoted on the Pink Sheets on an unsolicited trading basis. As a result, there is currently no regular public trading market for the Company's common stock. The Company is making every effort to comply with the Nasdaq SmallCap Listing requirements, but the Company cannot ensure that it will meet the requirements in a timely manner or that an active trading market will exist for its common stock in the future. The Company's failure to obtain the relisting of its common stock on the NASDAQ SmallCap Market could have an ongoing material adverse effect on the liquidity of the Company's common stock and result in a corresponding material reduction in the price of the common stock.

Future sales of the Company's common stock may depress its stock price.

Sales of a substantial number of shares of Company common stock in the public market, or the appearance that such shares are available for sale, could adversely affect the market price for its common stock. As of December 31, 2004, the Company had 1,175,725 shares of common stock outstanding. A significant number of these shares are not publicly traded but may be available for immediate resale to the public through private transactions. The Company also has reserved shares of its common stock as follows:

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

- o 1,028,761 shares are reserved for issuance upon the exercise of warrants; and
- o 5,143,795 shares are reserved for issuance upon the conversion of convertible notes.

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

Company efforts to protect its intellectual property rights may not sufficiently protect it and it may incur costly litigation to protect its rights

The Company marks its software with copyright notices, and intends to file copyright registration applications where appropriate. It intends to file several federal trademark registration applications for trademarks and service marks it uses. There can, however, be no assurance that any patents, copyright registrations, or trademark registrations applied for by the Company will be issued, or if issued, will sufficiently protect its proprietary rights.

The Company also relies substantially on certain technologies that are not patentable or proprietary and are therefore available to its competitors. In addition, many of the processes and much of its technology is dependent upon its technical personnel, whose skill, knowledge and experience are not patentable. To protect its rights in these areas, the Company requires all employees, significant consultants and advisors to enter into confidentiality agreements under which they agree not to use or disclose Company confidential information as long as that information remains proprietary. It also requires that its employees agree to assign to it all rights to any inventions made during their employment relating to its activities, and not engage in activities similar to that of the Company during the term of their employment. There can be no assurance, however, that these agreements will provide meaningful protection for Company 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, the Company may be exposed to competitors who independently develop substantially equivalent technology or otherwise gain access to its trade secrets, knowledge or other proprietary information.

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

The Company's intellectual property may be misappropriated or infringed upon. Consequently, litigation may be necessary in the future to enforce its intellectual property rights, to protect its 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 the Company's intellectual property. Additionally, it 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.

The Company's technology may infringe on the rights of others

Even if the patents, copyrights and trademarks the Company applies for are granted, they do not confer on the Company 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, the Company may be required to stop making, using, or marketing one or more of its products or to obtain licenses from and pay

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

royalties to others, which could have a significant and material adverse effect on it. There can be no assurance that the Company will be able to obtain or maintain any such license on acceptable terms or at all.

24

The Company 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 Company business, then the Company may be forced to litigate infringement claims that could result in substantial costs to it. In addition, if it 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 the Company, it 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 it. An adverse outcome in litigation or privity proceedings could require it to license disputed rights from third parties or to cease using such rights. Any litigation regarding its proprietary rights could be costly, divert management's attention, result in the loss of certain of its proprietary rights, require it to seek licenses from third parties and prevent it from selling its services, any one of which could have a negative financial impact. In addition, inasmuch as the Company broadcasts content developed by third parties, its exposure to copyright infringement actions may increase because it must rely upon such third parties for information as to the origin and ownership of such licensed content. The Company generally obtains representations as to the origin and ownership of such licensed content and generally obtains 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 it.

The length of the sales cycle increases Company costs

Many of the Company's potential customers conduct extensive and lengthy evaluations before deciding whether to purchase or license its products. In the Company's experience to date it has seen the sales cycle range from a few days up to six months. While the potential customer is making this decision, it continues to incur salary, travel and other similar costs of following up with these accounts. Therefore, the risk associated with a lengthy sales cycle is that the Company 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 it. Any significant change in customer buying decisions or sales cycles for Company products could have a material adverse effect on its business, results of operations, and financial conditions.

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

The Company has distributed email messages globally. To date, the Company has 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 the Company cannot assure 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:

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

- 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
- o 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 future Company business, financial condition, or results of operations.

Company is subject to risks associated with governmental regulation and legal uncertainties

The Company is 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

25

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 Company products and services, and may affect the growth of the Internet. Such laws or regulations may therefore harm Company business.

The Company does 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:

- o limit the growth of the Internet;
- o create uncertainty in the marketplace that could reduce demand for Company products and services;
- o increase Company's cost of doing business;
- o expose the Company to significant liabilities associated with content distributed or accessed through its products or services, and with its provision of products and services, and with the features or performance of its products;

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

- o lead to increased product development costs, or otherwise harm Company business; or
- o decrease the rate of growth of the Company user base and limit its ability to effectively communicate with and market to its user base.

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

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

Company 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, Company products occasionally send information to servers at the Company. Many of the services the Company provides also require that users provide information to it. The Company posts privacy policies concerning the use and disclosure of its user data. Any failure by the Company to comply with its posted privacy policies could impact the market for its products and services, subject it to litigation, and harm its 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:

- o provide parents notice of their information practices;
- o obtain verifiable parental consent before collecting a child's personal information, with certain limited exceptions;
- o give parents a choice as to whether their child's information will be disclosed to third parties;
- o provide parents access to their child's personal information and allow them to review it and/or have it deleted;
- o 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
- o maintain the confidentiality, security, and integrity of information collected from children.

26

The Company does not knowingly collect and disclose personal information from such minors, and therefore believes that it is 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 the Company to potential liability, which in turn would harm its business.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company does not believe that it currently has material exposure to interest rate, foreign currency exchange rate or other relevant market risks.

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

Interest Rate and Market Risk. Company exposure to market risk for changes in interest rates relates primarily to the Company's investment profile. As of March 31, 2005, the Company's investment portfolio consisted primarily of cash and cash equivalents, substantially all of which were held at one financial institution. The Company does not use derivative financial instruments in its investment portfolio.

Foreign Currency Exchange Risk. The Company does not believe that it currently has material exposure to foreign currency exchange risk because of the relative insignificance of its foreign relationships. The Company intends to assess the need to use financial instruments to hedge currency exposures on an ongoing basis.

The Company does not use derivative financial instruments for speculative trading purposes.

Item 4. CONTROLS AND PROCEDURES

(a) Evaluation of disclosure controls and procedures.

We maintain disclosure controls and procedures as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Our disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures.

As required by Rule 13a-15(b) of the Exchange Act, we conducted an evaluation, under the supervision of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of March 31, 2005. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of March 31, 2005 in ensuring that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms.

(b) Changes in internal controls

There were no significant changes in the Company's internal controls over financial reporting or in other factors that could significantly affect these internal controls subsequent to the date of their most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

27

PART II

OTHER INFORMATION

Item 1. Legal Proceedings

The Company recently emerged from Chapter 11 Bankruptcy with the confirmation of its First Amended Plan of Reorganization Pursuant to Chapter 11 of the United States Bankruptcy Code (the "Plan") on November 3, 2004. The Plan became effective on November 18, 2004, with the closing of the financing and related confirmation matters effective December 9, 2004. However, under the Plan, the Bankruptcy Court retained jurisdiction over certain matters, including

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

matters relating to claim objections and specific matters relating to the implementation and consummation of the Plan. In management's opinion, the matters over which the Bankruptcy Court has retained jurisdiction are not expected to have a material adverse impact on the Company's financial position or results of operations.

In July, 2004, the Company received a notice from the Utah Department of Consumer Protection (the "Department") indicating that a former subsidiary of the Company (which had subsequently been merged into the Company) and the Company will be placed on the "Buyers Beware List" for the State of Utah until such time that the Company has no complaints filed with the Division for a period of 90 days and the Company pays the \$44,000 assessed by the Department in connection with an earlier judgment obtained by the Department. The Department has asserted that this fine may not be discharged by the Plan or the Company's bankruptcy proceedings. The Company is in discussions with the Department and the State of Utah regarding the dischargability of this fine and the Company's listing on the Buyer Beware List.

Item 2. Changes in Securities and Use of Proceeds

During the quarter ended March 31, 2005, the Company authorized the following equity securities in transactions not registered under the Securities Act:

1,028,761 shares of new Company common stock have been authorized and reserved relating to new warrants issued by the Company on December 9, 2004 in connection with the Company's emergence from bankruptcy;

Each of the foregoing issuances was 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

None

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

None.

Item 5. Other Information

None.

Item 6. Exhibits

31.1 Certification of Registrant's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Registrant's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Registrant's Chief Executive Officer pursuant to

Edgar Filing: AVALON DIGITAL MARKETING SYSTEMS INC - Form 10QSB

18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Quarterly Report on Form 10-QSB and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company.

32.2 Certification of Registrant's Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Quarterly Report on Form 10-QSB and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of this Company.

29

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.

Date: June 2, 2005

/s/ DANIEL D. WALTER

Daniel D. Walter
Chief Executive Officer
(Principal Executive Officer)

Date: June 2, 2005

/s/ MATTHEW A. GREENE

Matthew A. Greene
Chief Financial Officer, Secretary, and Treasurer
(Principal Financial and Accounting Officer)

30