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COMPANY DATA:
COMPANY CONFORMED NAME: ALLSTAR SYSTEMS INC
CENTRAL INDEX KEY: 0001020017
STANDARD INDUSTRIAL CLASSIFICATION: WHOLESALE-COMPUTER & PERIPHERAL EQUIPMENT & SOFTWARE [5045]
IRS NUMBER: 760515249
STATE OF INCORPORATION: DE
FISCAL YEAR END: 1231

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BUSINESS PHONE: 7137952000

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FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

(Mark One)

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

For the quarterly period ended September 30, 1998

OR

|_| 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: 333-09789

ALLSTAR SYSTEMS, INC.
(Exact name of Registrant as specified in its charter)

DELAWARE	76-0515249
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

6401 SOUTHWEST FREEWAY
HOUSTON, TEXAS 77074
(Address of principal executive offices) (Zip code)

(713) 795-2000
(Registrant's telephone number including area code)

Not applicable (Former name, former address, and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes _X_ No

APPLICABLE ONLY TO REGISTRANTS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

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 Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes ____ No ____

(APPLICABLE ONLY TO CORPORATE REGISTRANTS)

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Title	Outstanding
Common Stock $.01 par value per share	As of September 30, 1998, 4,522,911 shares outstanding

<PAGE>

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ALLSTAR SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and par value amounts)

	September 30, 1998	December 31, 1997 (Unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents		
Restricted cash	$	$ 280
Cash	1,431	1,301
Total cash and cash equivalents	1,431	1,581
Accounts receivable trade, net	28,671	23,759
Accounts receivable affiliates	655	434
Inventory	10,141	4,700
Deferred taxes	212	212
Other current asset	398	404
Total current assets	41,509	31,090
Property and equipment	2,281	2,013
Other assets	240	81
Total	$ 44,030	$ 33,184
	=======	=======
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Notes payable	$ 7,642	$ 1,572
Accounts payable	16,605	12,805
Accrued expenses	5,032	3,565
Income taxes payable	(13)	82
Deferred service revenue	233	242
Total current liabilities	29,494	18,266
Deferred Credit - Stock warrants	195	195
Total liabilities	29,694	18,461

Commitments and contingencies Stockholders' equity:

Preferred stock, $.01 par value, 5,000,000 shares authorized, no shares issued		
Common stock:		
$.01 par value, 50,000,000 shares authorized, 4,454,411 and 4,522,911 shares issued and outstanding on December 31, 1997 and September 30, 1998, respectively	45	45
Additional paid in capital	10,250	10,013
Unearned restricted stock	(270)	
Treasury stock(271,200 shares, at cost)	(834)	
Retained earnings	5,145	4,665
Total stockholders' equity	14,336	14,723
Total	$44,030	$33,184
	======	======

See notes to consolidated financial statements

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ALLSTAR SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except share and per share amounts)
(Unaudited)

	Three Months Ended September 30,	
	1998	1997
Total Revenue	$ 44,775	$ 31,914
Cost of sales and services	38,211	27,777
Gross Profit	6,564	4,137
Selling, general and administrative expenses	6,325	3,439
Operating income	239	698
Interest expense and other income (net)	95	82
Income before provision for income taxes	144	616
Provision for income taxes	57	236
Net income	$ 87	$ 380
	========	=========
Net income per share:		
Basic	$0.02	$0.09
	====	====
Diluted	$0.02	$0.09
	====	====
Weighted average shares outstanding:		
Basic	4,340,364	4,268,664

	=========	=========
Diluted	4,340,364	4,195,991
	=========	=========

	Nine Months Ended September 30,	
	1998	1997
	----	----
Total Revenue	$117,157	$ 90,745
Cost of sales and services	99,833	77,850
Gross Profit	17,324	12,895
Selling, general and administrative expenses	16,364	10,412
Operating income	960	2,483
Interest expense and other income (net)	175	680
Income before provision for income taxes	785	1,803
Provision for income taxes	305	701
Net income	480	$ 1,102
	=========	===========
Net income per share:		
Basic	$0.11	$0.34
	====	====
Diluted	$0.11	$0.34
	====	====
Weighted average shares outstanding:		
Basic	4,405,517	3,212,059
	=========	=========
Diluted	4,395,310	3,187,569
	=========	=========

See notes to consolidated financial statements

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<TABLE>
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ALLSTAR SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands, except share and per share amounts)
(Unaudited)

<S>	<C>	<C>
	Nine Months	
Nine Months		
	ended	
ended		
	September 30,	

September 30,	1998	1997
Net income	$ 480	$ 1,102
Adjustments to reconcile net income to net cash provided by (used in) operating activities		
Gain of disposal of assets		
Depreciation and amortization	573	384
Deferred taxes		190
Deferred offering costs	412	
Changes in assets and liabilities that provided (used) cash:		
Accounts receivable trade, net	(4,911)	(2,482)
Accounts receivable affiliates	(221)	(87)
Inventory	(5,441)	(143)
Other current assets	6	(176)
Other assets	(159)	
Accounts payable	3,800	809
Accrued expenses	1,466	325
Income taxes payable	(95)	(552)
Deferred service revenue	(9)	(112)
Net cash provided by (used in) operating activities	(4,511)	(330)
Cash flows from investing activities:		
Capital Expenditures	(842)	(467)

Net cash used in investing activities:	(842)	(467)
Cash flows from financing activities:		
Net proceeds from issurance of common stock	33	8,706
Purchase of treasury stock		(900)
Net increase (decrease) in notes payable	6,070	(7,021)
Net cash provided by (used in) financing activities:	5,203	1,685
Net increase (decrease) in cash and cash equivalents	(150)	888
Cash and cash equivalents at beginning of period	1,581	229
Cash and cash equivalents at end of period	$ 1,431	$ 1,117
	========	=======
Supplemental disclosures of cash flow information:		
Cash paid for interest	$ 254	$ 794
	=========	========
Cash paid for taxes	$ 401	$ 976
	=========	========

<FN>

See notes to consolidated financial statements

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</TABLE>

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ALLSTAR SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share amounts)

1. BASIS OF PRESENTATION

Allstar Systems, Inc. and subsidiaries ("Allstar"') is engaged in the sale and service of computer and telecommunications hardware and software products. Allstar's wholly owned subsidiary, Stratasoft, Inc. creates and markets software related to the integration of computer and telephone technologies. In January, 1997 Allstar formed IT Staffing Inc. to provide temporary and permanent placement services of technical personnel. In March, 1998 Allstar formed Allstar

Systems Rio Grande, Inc., a wholly owned subsidiary, to conduct operations in West Texas and New Mexico. All operations of the business are primarily conducted from offices located in Houston, Dallas, Austin, McAllen, San Antonio, and El Paso, Texas and in Albuquerque and Las Cruces, New Mexico. In addition, Allstar conducts sales of computer products through representatives located in Florida, Missouri and Oklahoma.

A substantial portion of Allstar's sales and services are authorized under arrangements with product manufacturers and Allstar's operations are dependent upon maintaining its approved status with such manufacturers. As a result of these arrangements and arrangements with its customers, gross profit could be limited by the availability of products or allowance for volume discounts. Furthermore, net income before income taxes could be affected by changes in interest rates, which underlie the credit arrangements, which are used for working capital.

The condensed consolidated financial statements presented herein at September 30, 1998 and for the three and nine months ended September 30, 1998 are unaudited; however, all adjustments which are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows for the periods covered have been made and are of a normal, recurring nature. Accounting measurements at interim dates inherently involve greater reliance on estimates than at year-end. The results of the interim periods are not necessarily indicative of results for the full year. The consolidated balance sheet at December 31, 1997 is derived from audited consolidated financial statements but does not include all disclosures required by generally accepted accounting principles. Although management believes the disclosures are adequate, certain information and disclosures normally included in the notes to the financial statements has been condensed or omitted as permitted by the rules and regulations of the Securities and Exchange Commission.

New Accounting Pronouncements. On January 1, 1998, Allstar adopted Statement of Financial Accounting Standards ("SFAS") No. 130, Reporting Comprehensive Income. Comprehensive income is a more inclusive financial reporting methodology that includes disclosure of certain financial information that historically has not been recognized in the presentation of net income. SFAS No. 130 requires the reporting of comprehensive income in addition to net income from operations. For the three and nine months ended September 30, 1998 and 1997, Allstar had no items of comprehensive income, and as a result Allstar's reported net income was the same as comprehensive income.

In March 1998, the Accounting Standards Executive Committee ("ACSEC") of the American Institute of Certified Public Accountants ('AICPA') reached a consensus on Statement of position ("SOP") No. 98-1, Accounting for the Cost of Computer Software Developed or Obtained for Internal Use, which provides guidance on accounting for the costs of computer software. SOP No. 98-1 is effective for fiscal years beginning after December 15, 1998. Management is evaluating what, if any, impact this SOP will have on Allstar upon implementation.

In April 1998, the ACSEC of the AICPA reached a consensus on SOP No. 98-5, Reporting on the Costs of Start-up Activities, which provides that the costs of such activities be expensed as incurred. SOP No. 98-5 is effective for fiscal years beginning after December 15, 1998. Management is evaluating what, if any, impact this SOP will have on Allstar upon implementation.

In March 1998, the Emerging Issues Task Force ("EITF") of the FASB reached a consensus on Issue No. 97-11, Accounting for the Internal Costs Relating to Real Estate Property Acquisitions, which requires that internal costs of

identifying and acquiring operating properties be expensed as incurred. Management is currently evaluating the impact this EITF, which was effective for transactions on or after March 20, 1998, will have on Allstar.

2. INCENTIVE STOCK PLANS

In September 1997 Allstar adopted the 1997 Incentive Stock Plan (the "Incentive Plan") and the 1997 Non-Employee Director Stock Option Plan (the "Director Plan"). Under the Incentive Plan, Allstar's Compensation Committee may grant up to 417,500 shares of common stock, which have been reserved for issuance, to certain key employees of Allstar. The Incentive Plan provides for the granting of incentive awards in the form of stock options, restricted stock, phantom stock, stock bonuses and cash bonuses in accordance with the provisions of the plan. Additionally, no shares may be granted after the tenth anniversary of the Incentive Plan's adoption. Allstar has reserved for issuance, under the Director Plan, 100,000 shares of common stock, subject to certain antidilution adjustments. The Director Plan provides for a one-time option by newly elected directors to purchase up to 5,000 common shares, after which each director is entitled to receive an option to purchase up to 2,000 common shares upon each date of re-election to Allstar's Board of Directors. Options granted under the Director Plan have an exercise price equal to the fair market value on the date of grant and generally expire ten years after the grant date. As of September 30, 1998, 28,000 stock option grants have been issued to directors under the Director Plan. The exercise price of 20,000 of the directors' options is $4.625 per share and 8,000 options have an exercise price of $3.69 per share. As of September 30, 1998 incentive stock options totaling 267,700 shares have been issued to employees. The exercise price of 80,000 of the stock option grants is $6.00 per share, 100,300 of the stock option grants have an exercise price of $4.625 per share and 87,400 options have an exercise price of $3.75 per share. The stock option grants will vest ratably over the five year period from the date of issuance. In addition, incentive awards in the form of restricted stock were granted for 14,286 shares which will vest ratably over the two year period ending July 7, 1999 and 63,500 shares which will vest ratably over the five-year period ending May 20, 2003.

3. LITIGATION

Allstar is party to litigation and claims which management believes are normal in the course of its operations; while the results of such litigation and claims cannot be predicted with certainty, Allstar believes the final outcome of such matters will not have a materially adverse effect on its results of operations or financial position.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

ALLSTAR SYSTEMS, INC.
MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is qualified in its entirety by, and should be read in conjunction with, the Company's Consolidated Financial Statements, including the Notes thereto.

OVERVIEW

The Company is engaged in the business of reselling computer hardware, business telephone systems and software products and providing related services. In addition, the Company derives revenue from providing IT Services to purchasers of Computer Products and other customers. The Company operates from offices in Houston, Austin, El Paso, McAllen, San Antonio and Dallas, Texas and in Albuquerque and Las Cruces, New Mexico. While all offices offer computer related products and services, certain offices do not offer telecommunications products and services. The Company develops and markets CTI Software through its wholly owned subsidiary Stratasoft, Inc. To date, most of the Company's revenue has been derived from Computer Products sales. During the quarter ended September 30, 1998, Computer Products totaled 85.4% of revenues while IT Services, Telecom Systems and CTI Software totaled 7.9%, 5.1% and 1.6% of revenues, respectively.

The Company's Computer Products division sells a wide variety of computer hardware and software products available from over 600 manufacturers. The Company's products include desktop and laptop computers, monitors, printers and other peripheral devices, operating system and application software, network products and mid-range host and server systems. The Company is an authorized reseller of products from a number of leading manufacturers of computer hardware, software and networking equipment.

Generally, Computer Products sales are made on a purchase order basis, with few on-going commitments to purchase from its customers. On certain occasions, large "roll-out" orders are received with delivery scheduled over a longer term, such as six to nine months, while normal orders are received and delivered to the customers usually within approximately thirty days of the receipt of the order. Because of this pattern of sales and delivery, the Company normally does not have a significant backlog of computer product sales.

IT Services are provided by the Company both in conjunction with and separately from its Computer Products sales. The Company typically prices its IT Services on a time and materials basis or under fixed fee service contracts, depending on customer preference and the level of service commitment required. In markets where the Company does not maintain branch offices, it often subcontracts for necessary technical personnel, particularly where required for larger scope or prolonged duration contracts. The Company's IT Services include information systems support, authorized warranty service, hardware repair and maintenance services, complex network diagnostic services, end user support services and software diagnostic services. The Company also offers complete outsourcing of a customer's computer and network management and technical support needs on a contract basis. In addition, the Company provides temporary and permanent staffing services.

To support and maintain the quality of these services and to maintain vendor accreditation necessary to resell and service its significant product lines, the Company's technical staff participates in various certification and authorization programs sponsored by hardware manufacturers and software suppliers. The Company's ability to attract and retain qualified professional and technical personnel is critical to the success of its IT Services business. The most significant portion of the costs associated with the delivery of IT Services are personnel costs. Therefore, in order to be successful, the Company's billable rates must be in excess of the personnel costs and its margin is dependent upon maintaining high utilization of its service personnel. In addition, the competition for high quality personnel has generally intensified causing the Company's, along with other IT Service providers, personnel costs to increase. The Company's costs of goods and services includes the personnel costs of its billable technical staff.

While the Company has service contracts with its larger customers, many of these contracts are project based or are terminable on relatively short notice.

Through the Telecom Systems division, the Company markets, installs and services business telephone systems, including large PBX systems and smaller "key systems"', along with a variety of related products including hardware and software products for data and voice integration, wide area connectivity and telephone system networking, wireless communications and video conferencing.

The Company develops and markets proprietary CTI Software, which integrates business telephone systems and networked computer systems, under the trade name "Stratasoft."' Basic products offered by the Company are typically customized to suit a customer's particular needs and are often bundled with computer hardware supplied by the Company at the customer's request. Stratasoft products include software for call center management, both in-bound and out-bound, as well as interactive voice response software.

The Company believes that each of its four separate businesses are complementary to each other and allow the Company to offer a broader range of integrated products and services in order to satisfy its customers' information and communication technology requirements than many of its competitors. The Company's strategy is to maintain and expand its relationships with its customers by satisfying a greater portion of these requirements.

A significant portion of the Company's selling, general and administrative expenses relate to personnel costs, some of which are variable and others of which are relatively fixed. The Company's variable personnel costs are substantially comprised of sales commissions, which are typically calculated based upon the Company's gross profit on a particular sales transaction and thus generally fluctuate with the Company's overall gross profit. The remainder of the Company's selling, general and administrative expenses are relatively more fixed and, while still somewhat variable, do not vary with increases in revenue as directly as do sales commissions.

Inacom Corp. ("Inacom") is the largest supplier of products sold by the Company. In August 1996, the Company renewed its long-term supply arrangement with Inacom and agreed to purchase at least 80% of its Computer Products from Inacom, but only to the extent that such products are made available within a reasonable period of time at reasonably competitive pricing. Inacom does not carry certain product lines sold by the Company and Inacom may be unable to offer reasonable product availability and reasonably competitive pricing from time to time on those product lines that it carries. The Company thus expects that less than 80% of its total purchases will be made from Inacom, and that any increase or decrease over historical levels in the percentage of products it purchases from Inacom under the Inacom agreement will not have any material impact on the Company's results of operations.

The Company manages its inventory in order to minimize the amount of inventory held for resale and the risk of inventory obsolescence and decreases in market value. The Company attempts to maintain a level of inventory required to reach only its near term delivery requirements by relying on the ready availability of products from its principal suppliers. Manufacturers of the Company's major products generally provide price protection, which reduces the Company's exposure to decreases in prices. In recent periods, the Company's Computer Product suppliers generally allowed for returns of excess inventory, which, on a limited basis, were made without material restocking fees. However, the Company's significant suppliers recently revised their policies to restrict the amount of returns allowed. It is expected that this change will increase the

Company's risks associated with inventory ownership. In particular, the Company will have greater risk associated with inventory obsolescence. In addition, certain manufacturers of computer products have generally become more restrictive with respect to price protection. This will increase the Company's risks, as they relate to the value of inventories. Each of these changes may cause a reduction of gross margins realized on the sale of computer products.

This Form 10-Q contains forward-looking statements that involve risks and uncertainties. The Company's actual results may differ significantly from the results discussed in the forward-looking statements. Such forward-looking statements include risks and uncertainties. Such risks and uncertainties, many of which are not within the control of the Company, may cause the actual results to differ materially from the results discussed in the forward looking statements, including, but not limited to, the Company's ability to execute and implement its plans and strategies and /or control the economic environment in which the Company operates.

The following table sets forth, for the periods indicated, certain financial data derived from the Company's consolidated statements of operations for the three months ended September 30, 1998 and 1997 and indicates the percentage of total revenue for each item.

<TABLE>
<CAPTION>

	Three Months ended September 30,			
	1998		1997	
<S>	<C>	<C>	<C>	<C>
	Amount	%	Amount	%
Revenue(1)				
Computer Products	$38,217	85 4	$27,767	87 0
IT Services	3,533	7 9	2,696	8 5
Telecom systems	2,302	5 1	801	2 5
CTI Software	723	1 6	650	2 0
	--------	---	--------	---
Total revenue	44,775	100 0	31,914	100 0
Gross Profit				
Computer Products	4,484	11 7	2,879	10 4
IT Services	1,127	31 9	843	31 3
Telecom Systems	549	23 9	183	22 8
CTI Software	404	55 9	232	35 7
	--------	---	--------	---
Total Gross Profit	6,564	14 7	4,137	13 0
Selling, general and administrative expense	6,325	14 1	3,439	10 8

	--------	---	--------	---
Operating income	239	0 5	698	2 2
Interest expense (net of other income)	95	0 2	82	0 3
	--------	---	--------	---
Income before provision for income taxes	144	0 3	616	1 9
Provision (benefit) for income taxes	57	0 1	237	0 7
	--------	---	--------	---
Net Income	$ 87	0 2	$ 380	1 2
	=======	===	========	===
Earnings per share	$0 02		$0 09	
	====		====	
Weighted average shares outstanding	4,340,364		4,268,664	
	=========		=========	

<FN>
(1) Percentages shown are percentages of total revenue, except gross profit percentages, which represent gross profit by each business unit as a percentage for each such unit.
</FN>
</TABLE>

Three Months Ended September 30, 1998 Compared To Three Months Ended September 30, 1997

TOTAL REVENUE. Total revenue increased by $12.9 million (40.3%) from $31.9 million in 1997 compared to $44.8 million in 1998. Revenue from Computer Products increased by $10.5 million (37.7%) from $27.8 million in 1997 to $38.2 million in 1998. Revenue from Computer Products as a percentage of total revenue decreased 1.6% from 87.0% in 1997 to 85.4% in 1998. Approximately $2.5 million of the increase in Computer Products from the prior period was realized in new offices while $7.9 million was realized in offices existing during the 1997 period. Revenue from IT Services increased $837,000 (31.0%) from $2.7 million in 1997 to $3.5 million in 1998 because of the continued expansion of its billable technical staff, together with the addition of new customers. Approximately one-half of the increase in IT Services revenue was realized in new offices with the other half being realized in offices existing in the 1997 period. Revenue from IT Services as a percentage of total revenue decreased from 8.5% in 1997 to 7.9% of total revenues in 1998 due to the higher rates of growth realized in Computer Products and Telecom Systems. Revenue from Telecom Systems increased by $1.5 million (187.4%) from $801,000 in 1997 to $2.3 million in 1998. The increase in Telecom Systems revenue was primarily the result of the Company's ability to obtain new orders for system installations from new customers. Revenue from Telecom Systems as a percentage of total revenue increased from 2.5% in 1997 to 5.1% in 1998. CTI Software revenue increased by $73,000 (11.2%) from $650,000 in 1997 to $723,000 in 1998. The increase in CTI Software revenues was due to the installation of a greater number of systems in 1998 than were installed in 1997. Revenue from CTI Software, as a percentage of total revenue, decreased from 2.0% in 1997 to 1.6% in 1998 because the growth rates of the

Company's other divisions were higher than the 11.2% increase achieved by CTI Software.

GROSS PROFIT. Gross profit increased by $2.4 million (58.6%) from $4.1 million in 1997 to $6.6 million in 1998 and gross margin increased from 13.0% in 1997 to 14.7% in 1998. The gross margin for Computer Products increased from 10.4% in 1997 to 11.7% in 1998, which was primarily the result of lower unit costs on the products purchased relative to their selling prices which reflects intensified competition among the Company's suppliers and the ability of the Company's sales force to obtain marginally higher prices in the 1998 period. While the Company's sales force has been able to increase the gross margin realized on Computer Products revenues, in certain instances, the Company has been providing a higher level of service to its customers. The increase in services provided has enhanced the margin realized while increasing the Company's selling, general and administrative costs. The gross profit from IT Services increased 33.8% from $843,000 in 1997 to $1.1 million in 1998. Gross margin increased slightly from 31.3% in 1997 to 31.9% in 1998. While the Company incurred higher rates of compensation for its billable technical staff during the 1998 period, the higher rates were offset by a greater utilization rate in 1998, resulting in a slight decrease in labor costs overall. The Company treats its costs associated with its technical staff as part of the cost of sales. When higher utilization rates are realized, cost of sales, expressed as a percentage of revenues, decreases. The wage costs of the Company's billable staff continue to be higher in the 1998 period compared to the 1997 period, due to the relative scarcity of qualified technical staff in the computing services industry. The gross profit for Telecom Systems sales increased $366,000 (200%) from 183,000 in 1997 to 549,000 in 1998. Gross margin improved nominally by 1.1% but continues to reflect less that industry norms for gross profit realization. The gross margin for CTI Software increased from 35.7% in 1997 to 55.9% in 1998 due to the company's ability to realize higher prices for its CTI products relative to the hardware and installation costs than in the 1997 period.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative expenses increased by $2.9 million (83.9%) from $3.4 million in 1997 to $6.3 million in 1998. As a percentage of total revenue, selling, general and administrative expenses increased from 10.8% in 1997 to 14.1% in 1998. Those components of selling, general and administrative expenses which increased significantly, as a percentage of revenues, were personnel related costs, general expenses related to opening new offices and expanding existing offices. In the 1998 period the Company operated offices in El Paso, San Antonio, McAllen and New Mexico which did not exist in the 1997 period. In addition, the Company has commenced selling through its direct sales representatives in Oklahoma, Missouri and Florida. Throughout 1998 and especially during the 1998 quarter, when compared to the 1997 period, the Company employed a significant number of new employees in its new offices, as well as increases in its Austin and Dallas office staffs. Since these employees generally receive compensation prior to the realization of significant revenues the amount of selling, general and administrative expenses increased both as to amount and as a percent of revenues. The Company also increased the number of administrative employees relative to the increases in revenues in order to enhance its ability to meet the requirements expected of revenue growth and increases in the number of employees and of the number of offices operated by the Company. Most notably, the Company upgraded its computing systems to enhance the speed and capacity of its systems. During the 1998 quarter the Company maintained a higher level of sales and administrative personnel than in the 1997 period. The costs of the personnel were greater, as a percentage of revenue, because the increase in personnel exceeded the increase in revenues realized.

The Company has opened the new offices and employed additional sales and administrative personnel with the expectation that revenues would be increased

commensurate with the increases in sales and administrative personnel. While revenues increased in excess of 40% and gross profit increased by over 58% over the prior year period, sales and administrative personnel costs increased by approximately 85% over the prior period. The Company believes that revenues will increase over time to restore the balance between the higher level of personnel costs and revenues. However, such forward looking statements include risks and uncertainties many of which are not within the control of the Company and which may cause actual results to differ materially from the expectations expressed in such statements. The risks and uncertainties, include but are not limited to, the Company's ability to realize such expectations in the highly competitive and rapidly changing businesses in which it is engaged, the Company's reliance upon its suppliers and product availability, the Company's reliance on its key customers and the establishment of new customer relationships to increase its revenues. There can be no assurance that the Company will realize revenues commensurate with its increases in selling and administrative expenses.

OPERATING INCOME. Operating income decreased by $459,000 (65.8%) from $698,000 in 1997 to $239,000 in 1998 due, principally, to higher selling, general and administrative expenses. Operating income decreased as a percentage of total revenue from 2.2% in 1997 to 0.5% in 1998. Contributing to the decrease in operating income were operating losses incurred in newly opened offices. The combined pretax losses incurred in the operation of newly opened offices were approximately $570,000 during the three months ended September 30, 1998, while similar losses were $65,000 in the 1997 period..

INTEREST EXPENSE (NET OF OTHER INCOME). Interest expense (net of other income) increased $13,000 from $82,000 during 1997 period compared to $95,000 in the 1998 period. This reflects a higher level of the Company's short-term debt during the 1998 period when compared to 1997 and lower interest rates during the 1998 period when compared to 1997.

NET INCOME. Net income, after a provision for income taxes totaling $57,000 (reflecting an effective tax rate of 38.5% in 1997 compared to 39.6% in 1998), decreased by $293,000 from $380,000 in 1997 to $87,000 in 1998.

The following table sets forth, for the periods indicated, certain financial data derived from the Company's consolidated statements of operations for the nine months ended September 30, 1998 and 1997 and indicates the percentage of total revenue for each item.

<TABLE>
<CAPTION>

<S>	Nine months ended September 30,			
	<C> 1998		<C> 1997	
	Amount	%	Amount	%
Revenue(1)				
Computer Products	$100,417	85.7	$78,620	86.6
IT Services	9,487	8.1	7,413	8.2
Telecom systems	5,192	4.4	3,038	3.4
CTI Software	2,061	1.8	1,674	1.8
Total revenue	117,157	100.0	90,745	100.0
Gross Profit				
Computer Products	11,724	11.7		

			8,602	10.9
IT Services	3,142	33.1	2,725	36.8
Telecom Systems	1,508	29.0	820	27.0
CTI Software	950	46.1	748	44.7
Total Gross Profit	17,324	14.8	12,895	14.2
Selling, general and administrative expense	16,364	14.0	10,412	11.5
Operating income	960	0.8	2,483	2.7
Interest expense (net of other income	175	0.1	680	0.7
Income before provision for income taxes	785	0.7	1,803	2.0
Provision (benefit) for income taxes	305	0.3	701	0.8
Net Income	$ 480	0.4	$ 1,102	1.2
Earnings per share	$0.11		$0.34	
Weighted average shares outstanding	4,405,517		3,212,059	

<FN>
(1) Percentages shown are percentages of total revenue, except gross profit percentages which represent gross profit by each business unit as a percentage for each such unit.
</FN>
</TABLE>

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Nine Months Ended September 30, 1998 Compared To Nine Months Ended September 30, 1997.

TOTAL REVENUE. Total revenue increased by $26.4 million (29.1%) from $90.7 million in 1997 compared to $117.2 million in 1998. Revenue from Computer Products increased by $21.8 million (27.7%) from $78.6 million in 1997 to $100.4 million in 1998. Revenue from Computer Products as a percentage of total revenue decreased 0.9% from 86.6% in 1997 to 85.7% in 1998. Approximately $5.0 million of the increase in Computer Products from the prior period was realized in new offices while $16.8 million was realized in offices existing during the 1997 period. Revenue from IT Services increased $2.1 million (28.0%) from $7.4 million in 1997 to $9.5 million in 1998 because of the continued expansion of its billable technical staff, together with the addition of new customers and the opening of new offices, approximately $800,000 of the increase between the 1997 period and the 1998 period was attributable to new offices. Revenue from IT Services as a percentage of total revenue decreased from 8.2% in 1997 to 8.1% of total revenues in 1998. Revenue from Telecom Systems increased by $2.2 million (70.9%) from $3.0 million in 1997 to $5.2 million in 1998. The increase in Telecom Systems revenue was primarily the result of the Company's ability to obtain new orders for system installations from new customers and the addition of sales personnel. Revenue from Telecom Systems as a percentage of total revenue increased from 3.4% in 1997 to 4.4% in 1998. CTI Software revenue increased by $387,000 (23.2%) from $1.6 million in 1997 to $2.1 million in 1998.

The increase in CTI Software revenues was the result of the addition of new customers and expanded marketing. Revenue from CTI Software, as a percentage of total revenue, remained at 1.8% in both periods.

GROSS PROFIT. Gross profit increased by $4.4 million (34.3%) from $12.9 million in 1997 to $17.3 million in 1998 and gross margin increased from 14.2% in 1997 to 14.8% in 1998. The gross margin for Computer Products increased from 10.9% in 1997 to 11.7% in 1998, which was primarily the result of lower unit costs on the products purchased relative to their selling prices which reflects intensified competition among the Company's suppliers and the ability of the Company's sales force to obtain marginally higher prices in the 1998 period. The gross profit from IT Services increased 15.3% from $2.7 million in 1997 to $3.1 million in 1998. Gross margin for IT Services decreased from 36.8% in 1997 to 33.1% in 1998. This decrease in gross margin was primarily attributable to a lower utilization rate, as well as, higher compensation rates for the Company's billable technical staff, leading to higher labor costs as a percent of revenue. The Company treats its costs associated with its technical staff as part of the cost of sales. Due to the relatively fixed nature of technical staff costs, when lower than expected revenues are realized, cost of sales, expressed as a percentage of revenues, increases proportionately. Additionally, the wage costs of the Company's billable staff are generally higher in the 1998 period compared to the 1997 period, due to the relative scarcity of qualified technical staff in the computing services industry. Gross profit for Telecom Systems increased $688,000 (83.9%) from $820,000 in the 1997 period to $1.5 million in 1998. The gross margin for Telecom Systems sales increased from 27.0% in 1997 to 29.0% in 1998, reflecting modest reduction in the installation costs, expressed as a percentage of revenues. The gross margin for CTI Software increased from 44.7% in 1997 to 46.1% in the 1998 due to improvement in the pricing of CTI software products.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative expenses increased by $6.0 million (57.2%) from $10.4 million in 1997 to $16.4 million in 1998. As a percentage of total revenue, selling, general and administrative expenses increased from 11.5% in 1997 to 14.0% in 1998. Those components of selling, general and administrative expenses which increased significantly, as a percentage of revenues, were commissions in Computer Products, personnel related costs, general expenses related to opening new offices and expanding existing offices and costs associated with the settlement of a law suit. The increase in commission expense in Computer Products was due to an increase in gross margin during the 1998 period versus the 1997 period and payments of "unearned commissions' in the form of minimum commissions guaranteed to newly hired sales personnel during their start-up period. During the 1998 period, when compared to the 1997 period, the Company employed a significant number of new employees in its San Antonio, El Paso and New Mexico offices, as well as increases in its Austin and Dallas office staffs. Since the new employees in all offices received compensation prior to the realization of significant revenues the amount of selling, general and administrative expenses increased both as to amount and as a percent of revenues. The Company also increased the number of administrative employees relative to the increases in revenues in order to enhance its ability to meet the requirements of revenue growth and increases in the number of offices operated by the Company. Most notably, the Company upgraded its computing systems to enhance the speed and capacity of its systems. During the upgrade significant overtime and other costs were incurred as the system change was implemented. Some of these excess costs may continue into subsequent periods. In addition, during the 1998 period the Company incurred costs related to the opening of offices in San Antonio, McAllen and El Paso, Texas and Albuquerque and Las Cruces, New Mexico without realizing revenues commensurate with those expenses.

OPERATING INCOME. Operating income decreased by $1.5 million (61.3%) from $2.5 million in 1997 to $960,000 in 1998 due to higher selling, general and administrative expenses. Operating income decreased as a percentage of total revenue from 2.7% in 1997 to 0.8% in 1998. Contributing to the decrease in operating income were operating losses incurred in newly opened offices. The combined pretax losses incurred in the operation of newly opened offices were approximately $553,000 compared to $65,000 during the 1997 period..

INTEREST EXPENSE (NET OF OTHER INCOME). Interest expense (net of other income) decreased $505,000 from $680,000 during 1997 period compared to $175,000 in the 1998 period. This reflects the reduced level of the Company's short-term debt during the 1998 period when compared to 1997. The reduction was accomplished by applying all of the net proceeds from the sale of common stock in July, 1997 to the repayment of the Company's debt.

NET INCOME. Net income, after a provision for income taxes totaling $305,000 (reflecting an effective tax rate of 38.9% in 1997 and 38.9% in 1998), decreased by $622,000 from $1.1 million in 1997 to $480,000 in 1998.

Liquidity and Capital Resources

The Company's working capital was $12.8 million and $12.0 million at December 31, 1997 and September 30, 1998, respectively. As of September 30, 1998, the Company had borrowing capacity under the Company's credit facility of $26.1 million of which $22.3 million was used under the Company's floor plan and revolving credit facility. Unused borrowing capacity at September 30, 1998 was $3.8 million.

Cash Flow

Operating activities used net cash totaling $4,511,000 during the nine months ended September 30, 1998. Operating activities used net cash during the nine months ended September 30, 1998 because of increases in inventories and accounts receivable which were partially offset by increases in accounts payable and accrued expenses. Net income and depreciation provided cash of $953,000 in the nine months ended September 30, 1998 versus $1.5 million in the 1997 period. The increase in inventories was primarily the result of increases in inventories staged for delivery to customers and inventories being stocked for certain customers. Of the $5.4 million increase during the nine months ended September 30, 1998, $3.2 million related to an increase in inventories staged for delivery to customers, $1.6 million of the increase relates to higher stocking requirements imposed by customers and the balance was due to a higher level of sales activities.

Investing activities used cash totaling $842,000 during the nine months ended September 30, 1998. The Company's investing activities that used cash during this period was primarily related to capital expenditures. During the next twelve months, the Company expects to incur capital expenditures, a majority of which is expected to be incurred for leasehold improvements and other capital expenditures in connection with the consolidation of its warehouse facilities into a single facility in the Dallas-Fort Worth area, the refurbishment of its Dallas branch office and the opening of branch offices. The actual amount and timing of such capital expenditures may vary substantially depending upon, among other things, the actual facilities selected, the level of expenditures required to render the facilities suitable for the Company's purposes and the terms of lease arrangements pertaining to the facilities.

Financing activities provided cash totaling $6.1 million from borrowing under the Company's credit facility during the nine months ended September 30,

1998. The Company expended $900,000 for the purchase of treasury stock to be used for employee incentive stock plans. The Company issued restricted shares to certain of its employees and charged expense and increased paid in capital for $33,000 during the nine months ended September 30, 1998 relating to the issuance of such shares.

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Asset Management

The Company had trade accounts receivable, net of allowance for doubtful accounts, of $28.7 million at September 30, 1998. The number of days' sales outstanding in trade accounts receivable was 53 days, which is slightly lower than the days outstanding of the prior quarter. The number of days outstanding continues to reflect, improved but still, slower than normal payment by the Company's customers during the three months ended September 30, 1998. Bad debt expense as a percentage of total revenue for the three months ended September 30, 1998 was 0.2%, which was 0.1% less than bad debt expense for the three months ended September 30, 1997. The Company's allowance for doubtful accounts, as a percentage of trade accounts receivable, was 1.0% at December 31, 1997 and 1.7% at September 30, 1998. Inventory turnover for the three and nine months ended September 30, 1998 was 12.6 times, and 16.4 times, respectively. The decline in inventory turnover during the three months ended September 30, 1998 was the result of having a high level of staged inventory as of September 30, 1998.

Current Debt Obligations

Historically, the Company has satisfied its cash requirements principally through borrowings under its lines of credit and through operations. The Company maintains a cash position sufficient to pay only its immediately due obligations and expenses. When the amount of cash available falls below its immediate needs, the Company requests advances under a credit facility provided by Deutsche Financial Services ("DFS Facility")

The total credit available under the DFS Facility is $30.0 million, subject to borrowing base limitations which are generally computed as a percentage of various classes of eligible accounts receivable and qualifying inventory. Credit available under the DFS Facility for floor plan financing of inventory from approved manufacturers (the "Inventory Line") is $20.0 million. Available credit under the DFS Facility, net of Inventory Line advances, is $10.0 million, which is used by the Company primarily to carry accounts receivable and for other working capital and general corporate purposes (the "Accounts Line"). Borrowings under the Accounts Line bear interest at the fluctuating prime rate minus 1.0% per annum. Under the Inventory Line, DFS pays the Company's inventory vendors directly, generally in exchange for negotiated financial incentives. Typically, the financial incentives received are such that DFS does not charge interest to the Company until 40 days after the transaction is financed, at which time the Company is required to either pay the full invoice amount of the inventory purchased from corporate funds or to borrow under the Accounts Line for the amount due to DFS. Inventory Line advances not paid within 40 days after the financing date bear interest at the fluctuating prime rate plus 5.0%. For purposes of calculating interest charges the minimum prime rate under the New DFS Facility is 7.00%. DFS may change the computation of the borrowing base and to disqualify accounts receivable upon which advances have been made and require repayment of such advances to the extent such disqualifications cause the Company's borrowings to exceed the reduced borrowing base.

The DFS Facility is collateralized by a security interest in substantially

all of the Company's assets, including its accounts receivable, inventory, equipment and bank accounts. Collections of the Company's accounts receivable are required to be applied through a lockbox arrangement to repay indebtedness to DFS; however, DFS has amended the lockbox agreement to make such arrangements contingent upon certain financial ratios. Provided the Company is in compliance with its debt to tangible net worth covenant, the Company has discretion over the use and application of the funds collected in the lockbox. If the Company exceeds that financial ratio, DFS may require that lockbox payments be applied to reduce the Company's indebtedness to DFS. If in the future DFS requires that all lockbox payments be applied to reduce the Company's indebtedness, the Company would be required to seek funding from DFS or other sources to meet substantially all of its cash needs.

The Company has a $2.0 million credit facility with IBM Credit Corporation (the " IBMCC Facility") for the purchase of IBM branded inventory from certain suppliers. Advances under the IBMCC Facility are typically interest free for 30 days after the financing date for transactions in which adequate financial incentives are received by IBMCC from the vendor. Within 30 days after the financing date, the full invoice amount for inventory financed through IBMCC is required to be paid by the Company. Amounts remaining outstanding thereafter bear interest at the fluctuating prime rate (but not less than 6.5%) plus 6.0%. IBMCC retains a security interest in the inventory financed. The IBMCC Facility is immediately terminable by either party by written notice to the other.

Under the DFS Facility the Company is required to maintain (i) a tangible net worth of $10.0 million, (ii) a ratio of debt minus subordinated debt to tangible net worth of 4 to 1 and (iii) a ratio of current tangible assets to current liabilities of not less than 1.4 to 1.

Both the IBMCC Facility and the DFS Facility prohibit the payment of dividends unless consented to by the lender.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On July 13, 1997, a former customer brought suit against the Company in the 152nd Judicial District Court of Harris County, Texas. The plaintiff alleges that the Company failed to provide and complete promised installation and configuration of certain computer equipment within the time promised by the Company. Based on these allegations, the plaintiff sued for breach of contract and other statutory violations, seeking actual monetary damages of approximately $3 million and treble damages under the Texas Deceptive Trade Practices Act. On September 17, 1998, the Company settled suit with the Company paying $70,000 to the plaintiff.

The Company is party to other litigation and claims which management believes are normal in the course of its operations; while the results of such litigation and claims cannot be predicted with certainty, The Company believes the final outcome of such matters will not have a materially adverse effect on its results of operations or financial position.

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.

Allstar Systems, Inc.

November 4, 1998 By: /s/ JAMES H. LONG

Date James H. Long, Chief Executive Officer

November 4, 1998 By: /s/ DONALD R. CHADWICK

Date Donald R. Chadwick, Chief Financial Officer

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