CONVERSION SERVICES INTERNATIONAL INC
Form 10QSB
May 19, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

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FORM 10-QSB

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

For the Quarterly Period Ended March 31, 2005

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 0-30420

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CONVERSION SERVICES INTERNATIONAL, INC.
(Exact name of small business user as specified in its charter)

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| | |
|---|---|
| Delaware | 20-1010495 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

100 Eagle Rock Avenue, East Hanover, New Jersey 07936
(Address of principal executive office)

Issuer's telephone number: (973) 560-9400

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: as of May 13, 2005, 788,474,038 shares of common stock, par value $0.001, were outstanding.

Conversion Services International, Inc. and Subsidiaries
Form 10-QSB

Index

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONVERSION SERVICES INTERNATIONAL, INC.
AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEET
MARCH 31, 2005
(Unaudited)

| | |
|---|---|
| ASSETS | |
| CURRENT ASSETS | |
| Cash | $ 1,2 |
| Accounts receivable, net of allowance for doubtful accounts of $259,147 | 3,6 |
| Accounts receivable from related parties; (Note 16) | 7 |
| Prepaid expenses | 2 |
| TOTAL CURRENT ASSETS | 5,9 |
| PROPERTY AND EQUIPMENT, at cost, net; (Note 3) | 5 |
| OTHER ASSETS | |
| Restricted cash | 4,2 |
| Goodwill | 4,6 |
| Intangible assets, net of accumulated amortization of $1,191,031; (Note 4) | 3,3 |
| Deferred financing costs, net of accumulated amortization of $222,653; (Note 5) | 6 |
| Discount on debt issued, net of accumulated amortization of $1,582,659; (Note 6) | 5,9 |
| Equity investments | 1 |
| Other assets | |

| | |
|---|---|
| | 19,2 |
| Total Assets | $ 25,7 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | |
| CURRENT LIABILITIES | |
| Line of credit; (Note 7) | $ 3,7 |
| Current portion of long-term debt | 1 |
| Accounts payable and accrued expenses | 3,3 |
| Short term note payable, (Note 8) | 7 |
| Related party short term note payable; (Note 16) | 2 |
| Deferred revenue | 1,7 |
| TOTAL CURRENT LIABILITIES | 10,0 |
| LONG-TERM DEBT, net of current portion; (Note 9) | 5,0 |
| Total Liabilities | 15,0 |
| MINORITY INTEREST | 1 |
| COMMITMENTS AND CONTINGENCIES; (Note 15) | |
| STOCKHOLDERS' EQUITY | |
| Common stock, $0.001 par value, 1,000,000,000 shares authorized; 781,010,668 issued and outstanding | 7 |
| Additional paid in capital | 46,0 |
| Accumulated deficit | (36,2 |
| Accumulated other comprehensive income | |
| Total Stockholders' Equity | 10,5 |
| Total Liabilities and Stockholders' Equity | $ 25,7 |

See Notes to Condensed Consolidated Financial Statements.



CONVERSION SERVICES INTERNATIONAL, INC.
AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | Three months ended March 31, | |
|---|---|---|
| | 2005 | 2004 |
| | | (Restated) |

| | | |
|---|---|---|
| REVENUE: | | |
| Services | $ 5,015,293 | $ 4,234,471 |
| Related party services | 1,096,402 | 969,887 |
| Software | 293,368 | -- |
| Support and maintenance | 432,005 | -- |
| Other | 35,470 | 57,679 |
| | 6,872,538 | 5,262,037 |
| COST OF REVENUE: | | |
| Services | 3,528,596 | 3,073,240 |
| Related party services | 1,011,858 | 756,624 |
| Software | 44,450 | -- |
| Support and maintenance | 13,068 | -- |
| Other | -- | 9,436 |
| | 4,597,972 | 3,839,300 |
| GROSS PROFIT | 2,274,566 | 1,422,737 |
| OPERATING EXPENSES | | |
| Selling and marketing | 1,527,223 | 581,425 |
| General and administrative | 1,940,135 | 1,412,952 |
| Research and development | 241,676 | -- |
| Depreciation and amortization | 431,456 | 50,244 |
| | 4,140,490 | 2,044,621 |
| LOSS FROM OPERATIONS | (1,865,924) | (621,884) |
| OTHER INCOME (EXPENSE) | | |
| Equity in income (losses) from investments | 43,292 | (1,602) |
| Other income (expense) | (2,191) | 6,551 |
| Interest income | 24,192 | 443 |
| Interest expense | (1,364,854) | (32,553) |
| | (1,299,561) | (27,161) |
| LOSS BEFORE INCOME TAXES (BENEFIT) AND MINORITY INTEREST | (3,165,485) | (649,045) |
| INCOME TAXES (BENEFIT) | -- | (215,600) |
| LOSS BEFORE MINORITY INTEREST | (3,165,485) | (433,445) |
| MINORITY INTEREST | 30,702 | -- |
| NET LOSS | $ (3,134,783) | $ (433,445) |
| Basic | $ (0.00) | $ (0.00) |
| Diluted | $ (0.00) | $ (0.00) |

Shares used to compute net loss per share:

| | | |
|---|---|---|
| Basic | 772,974,953 | 572,700,000 |
| Diluted | 772,974,953 | 572,700,000 |

See Notes to Condensed Consolidated Financial Statements.

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CONVERSION SERVICES INTERNATIONAL, INC.
AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Three months en |
|---|---|
| | 2005 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | |
| Net loss | $(3,134,783) |
| Adjustments to reconcile net loss to net cash used in operating activities: | |
| Depreciation and amortization of leasehold improvements | 55,680 |
| Amortizaton of intangible assets | 279,889 |
| Amortization of discount on debt | 661,054 |
| Amortization of relative fair value of warrants issued | 331,737 |
| Amortization of deferred financing costs | 95,886 |
| Deferred taxes | -- |
| Compensation expense for stock options and stock issued | 15,794 |
| Allowance for doubtful accounts | 35,412 |
| Write-off deferred loan costs | -- |
| Loss on disposal of equipment | -- |
| (Income) loss from equity investments | (43,724) |
| Minority interest in Evoke Software Corporation | (30,702) |
| Changes in operating assets and liabilities: | |
| (Increase) decrease in accounts receivable | 637,075 |
| Increase in accounts receivable from related parties | (1,730) |
| Decrease in prepaid expenses | 46,345 |
| Increase in due from stockholders | -- |
| (Increase) decrease in other assets | (66,667) |
| Increase (decrease) in accounts payable and accrued expenses | (463,431) |
| Increase in deferred revenue | 455,875 |
| Net cash used in operating activities | (1,126,290) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | |
| Acquisition of property and equipment | (20,367) |
| Investment in DeLeeuw Associates, net of cash acquired | -- |
| Net cash used in investing activities | (20,367) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | |
| Cash overdraft | -- |
| Net advances under line of credit | 51,220 |
| Line of credit repayment | -- |
| Issuance of convertible line of credit notes | -- |

| | |
|---|---|
| Deferred loan costs in connection with line of credit / long term debt | -- |
| Principal payments on long-term debt | -- |
| Proceeds from sale of Company common stock | 1,250,000 |
| Principal payments on capital lease obligations | (31,165) |
| Principal payments on stockholder loans | (8,363) |
| Restricted cash | 59,183 |
| Net cash provided by financing activities | 1,320,875 |
| Effect of exchange rate changes on cash and cash equivalents | 2,808 |
| NET INCREASE IN CASH | 177,026 |
| CASH, beginning of period | 1,028,146 |
| CASH, end of period | $ 1,205,172 |

See Notes to Condensed Consolidated Financial Statements.



CONVERSION SERVICES INTERNATIONAL, INC.
AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Three months e |
|---|---|
| | 2005 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | |
| Cash paid for interest | $ 11,388 |
| Cash paid for income taxes | -- |

SUPPLEMENTAL DISCLOSURE OF NON-CASH ACTIVITIES:

During the three months ended March 31, 2005 and 2004, the Company entered into various capital lease arrangements for computer and trade show equipment in the amount of $13,378 and $64,749, respectively

On March 4, 2004, the Company acquired DeLeeuw Associates, Inc. The following assets and liabilities were obtained as a result of the acquisition

| | |
|---|---|
| Acquired accounts receivable | $ -- |
| Acquired approved vendor status | -- |
| Acquired tradename | -- |
| Acquired goodwill | -- |
| Acquired investment in limited liability company | -- |
| Acquired liabilities | -- |

See Notes to Condensed Consolidated Financial Statements.

CONVERSION SERVICES INTERNATIONAL, INC.
AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 - Accounting Policies

Organization and Business

Conversion Services International, Inc. ("CSI") was incorporated in the State of Delaware and has been conducting business since 1990. CSI and its subsidiaries (together the "Company") are principally engaged in the information technology services industry in the following areas: strategic consulting, business intelligence, data warehousing and data management, on credit, to its customers principally located in the northeastern United States.

Basis of Presentation

The accompanying financial statements have been prepared by the Company and are unaudited. The results of operations for the three months ended March 31, 2005 are not necessarily indicative of the results to be expected for any future period or for the full fiscal year. In the opinion of management, all adjustments (consisting of normal recurring adjustments unless otherwise indicated) necessary to present fairly the financial position, results of operations and cash flows at March 31, 2005, and for all periods presented, have been made. Footnote disclosure has been condensed or omitted as permitted in interim financial statements.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its subsidiaries, Doorways, Inc., DeLeeuw, Evoke Software Corporation (formerly known as Evoke Asset Purchase Corp.), LEC Corporation of NJ and CSI Sub Corp. (DE). All intercompany transactions and balances have been eliminated in the consolidation. Investments in business entities in which the Company does not have control, but has the ability to exercise significant influence (generally 20-50% ownership), are accounted for by the equity method.

Revenue recognition

Services

Revenue from consulting and professional services is recognized at the time the services are performed on a project by project basis. For projects charged on a time and materials basis, revenue is recognized based on the number of hours worked by consultants at an agreed-upon rate per hour. For large services projects where costs to complete the contract could reasonably be estimated, the Company undertakes projects on a fixed-fee basis and recognizes revenues on the percentage of completion method of accounting based on the evaluation of actual costs incurred to date compared to total estimated costs. Revenues recognized in excess of billings are recorded as costs in excess of billings. Billings in excess of revenues recognized are recorded as deferred revenues until revenue recognition criteria are met. Reimbursements, including those relating to travel and other out-of-pocket expenses, are included in revenues, and an equivalent amount of reimbursable expenses are included in cost of services and are immaterial.

Software

Revenue from software licensing and maintenance and support are recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is reasonably assured. The Evoke software is delivered by the Company either directly to the customer or to a distributor on an order by order basis. The software is not sold with any right of return privileges and, as a result, a returns reserve is not applicable. The Company recognizes net license revenues based upon the residual method after all licensed software product has been delivered as prescribed by Statement of Position 98-9, "Modification of SOP No. 97-2 with Respect to Certain Transactions." The Company recognizes maintenance revenues over the term of the maintenance contract. The maintenance rates for both license agreements with and without stated renewal rates are based upon the price when sold separately. Vendor-specific objective evidence of the fair value of maintenance for license agreements that do not include stated renewal rates is determined by reference to the price paid by the Company's customers when maintenance is sold separately (i.e. the prices paid by customers in connection with renewals).

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The percentage-of-completion method of accounting is not applicable for the Company's software sales.

Business Combinations

Business combinations are accounted for in accordance with SFAS No. 141, "Business Combinations" ("SFAS 141"), which requires the purchase method of accounting for business combinations be followed and in accordance with EITF No. 99-12 "Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination" ("EITF 99-12"). In accordance with SFAS 141, the Company determines the recognition of intangible assets based on the following criteria: (i) the intangible asset arises from contractual or other rights; or (ii) the intangible is separable or divisible from the acquired entity and capable of being sold, transferred, licensed, returned or exchanged. In accordance with SFAS 141, the Company allocates the purchase price of its business combinations to the tangible assets, liabilities and intangible assets acquired based on their estimated fair values. The excess purchase price over those fair values is recorded as goodwill. Additionally, in accordance with EITF 99-12, the Company values an acquisition based upon the market price of its common stock for a reasonable period before and after the date the terms of the acquisition are agreed to and announced.

Research and development costs

The Company incurs research and development costs related to software upgrades and the development of new versions of its Evoke Axio software product. Research and development costs are charged to expense as incurred. Such costs amounted to $241,676 and $0 during the three months ended March 31, 2005 and 2004, respectively.

Accounts receivable

The Company carries its accounts receivable at cost less an allowance for doubtful accounts. On a periodic basis, the Company evaluates its accounts receivable and adjusts the allowance for doubtful accounts, when deemed necessary, based upon its history of past write-offs and collections, contractual terms and current credit conditions.

Property and equipment

Property and equipment are stated at cost and includes equipment held under capital lease arrangements. Depreciation, which includes amortization of leasehold improvements, is computed principally by an accelerated method and is based on the estimated useful lives of the various assets ranging from three to seven years. Leasehold improvements are amortized over the shorter of the asset life or the remaining lease term on a straight-line basis. When assets are sold or retired, the cost and accumulated depreciation are removed from the accounts and any gain or loss is included in operations.

Expenditures for maintenance and repairs have been charged to operations. Major renewals and betterments have been capitalized.

Goodwill and intangible assets

Goodwill and intangible assets are accounted for in accordance with SFAS No. 142 "Goodwill and Other Intangible Assets" ("SFAS 142"). Under SFAS 142, goodwill and indefinite lived intangible assets are not amortized but instead are reviewed annually for impairment, or more frequently if impairment indicators arise. Separable intangible assets that are not deemed to have an indefinite life will continue to be amortized over their estimated useful lives. The Company tests for impairment whenever events or changes in circumstances indicate that the carrying amount of goodwill or other intangible assets may not be recoverable, or at least annually at December 31 of each year. These tests are performed at the reporting unit level using a two-step, fair-value based approach. The first step compares the fair value of the reporting unit with its carrying amount, including goodwill. If the fair value of the reporting unit is less than its carrying amount, a second step is performed to measure the amount of impairment loss. The second step allocates the fair value of the reporting unit to the Company's tangible and intangible assets and liabilities. This derives an implied fair value for the reporting unit's goodwill. If the carrying amount of the reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized equal to that excess. In the event that the Company determines that the value of goodwill or other intangible assets have become impaired, the Company will incur a charge for the amount of the impairment during the fiscal quarter in which the determination is made.



Goodwill represents the amounts paid in connection with the acquisitions of Scosys and DeLeeuw. Additionally, as part of the Scosys, DeLeeuw and Evoke acquisitions, the Company acquired identifiable intangible assets.

Acquired software is amortized on a straight-line basis over an estimated useful life of three years. Acquired contracts are amortized over a period that approximates the estimated life of the contracts, based upon the estimated annual cash flows obtained from those contracts, generally five to six years. The approved vendor status intangible asset is being amortized over an estimated life of forty months.

Deferred financing costs

The Company capitalizes costs associated with the issuance of debt instruments. These costs are amortized on a straight-line basis over the term of the related debt instruments, which currently range from one to three years.

Discount on debt

The Company has allocated the proceeds received from convertible debt instruments between the underlying debt instrument and the detachable warrants and has recorded the discount on the debt instrument due to a beneficial conversion feature as a deferred charge. This deferred charge is being amortized to interest expense over the life of the related debt instruments, which currently range from one to five years.

Stock compensation

The Company follows Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") in accounting for its employee stock options. Under APB 25, because the exercise of the Company's employee stock option equals the market price of the underlying stock on the date of grant, no compensation expense is recognized in the Company's consolidated statements of operations. The Company is required under Statement of Financial Accounting Standards (SFAS) 123, "Accounting for Stock-Based Compensation", which established a fair value based method of accounting for stock compensation plans with employees and others to disclose pro forma financial information regarding option grants made to its employees.

The Company follows EITF No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" ("EITF 96-18") in accounting for stock options issued to non-employees. Under EITF 96-18, the equity instruments should be measured at the fair value of the equity instrument issued. During the three months ended June 30, 2004, the Company granted 650,000 stock options to non-employee recipients. In compliance with EITF 96-18, the fair value of these options was determined using the Black-Scholes option pricing model. The Company is recording the fair value of these options as expense over the three year vesting period of the options. Compensation expense of $15,794 and zero was included in the reported results for the three months ended March 31, 2005 and 2004, respectively.

Had the Company determined compensation cost based upon the fair value at the grant date for its stock options under SFAS No. 123, the Company's net loss would have changed to the pro forma amounts indicated below:

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| | | Three months ended March 31, 2005 | Three months ended March 31, 2004 |
|---|---|---|---|
| Net loss: | | | |
| As reported | | $ (3,134,783) | $ (433,445) |
| Less: Compensation expense per SFAS 123 | | (382,646) | (7,385) |
| Pro forma | | $ (3,517,429) | $ (440,830) |
| Net loss per share: | | | |
| As reported | | | |
| | Basic | $ (0.00) | $ (0.00) |
| | Diluted | (0.00) | $ (0.00) |
| Pro forma | | | |
| | Basic | $ (0.00) | (0.00) |
| | Diluted | (0.00) | (0.00) |

There were no options granted prior to 2004. The per share weighted average fair value of stock options granted during 2004 was $0.16 per share on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

| | |
|---|---|
| Expected dividend yield | 0.0% |
| Risk-free interest rate | 2.5% |
| Expected volatility | 148.0% |
| Expected option life (years) | 3.0 |

Pro forma information regarding net loss and net loss per share is required by SFAS 123, as amended by SFAS 148, and has been determined as if the Company had accounted for its employee stock options under the fair-value method. The Black-Scholes option pricing model used in this valuation was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. Option valuation models require the input of highly subjective assumptions. The Company's stock-based compensation has characteristics significantly different from those of traded options, and changes in the assumptions used can materially affect the fair value estimate.

Concentrations of credit risk

Financial instruments which potentially subject the Company to concentrations of credit risk are cash and accounts receivable arising from its normal business activities. The Company routinely assesses the financial strength of its customers, based upon factors surrounding their credit risk, establishes an allowance for doubtful accounts, and as a consequence believes that its accounts receivable credit risk exposure beyond such allowances is limited. At March 31, 2005, one customer, LEC, a related party, comprised approximately 17.6% of the Company's accounts receivable balance.

The Company maintains its cash with a high credit quality financial institution. Each account is secured by the Federal Deposit Insurance Corporation up to $100,000.

Income taxes

The Company accounts for income taxes, in accordance with SFAS No. 109, "Accounting for Income Taxes" ("SFAS 109") and related interpretations, under an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's financial statements or tax returns. In estimating future tax consequences, the Company generally considers all expected future events other than enactments of changes in the tax laws or rates.

The Company records a valuation allowance to reduce the deferred tax assets to the amount that is more likely than not to be realized. The Company's current valuation allowance primarily relates to benefits from the Company's NOL's.



Derivatives

The Company accounts for derivatives in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133") and related interpretations. SFAS 133, as amended, requires companies to recognize all derivative instruments as either assets or liabilities in the balance sheet at fair value. At December 31, 2004, the Company had not entered into any transactions which were considered hedges under SFAS 133. The accounting for changes in the fair value of a derivative instrument depends on: (i) whether the derivative has been designated and qualifies as part of a hedging relationship, and (ii) the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, a company must designate the hedging instrument based upon the exposure being hedged as either a fair value hedge, cash flow hedge or hedge of a net investment in a foreign operation.

Foreign Currency Translation

Local currencies are the functional currencies for Evoke's foreign subsidiaries. Assets and liabilities are translated using the exchange rates in effect at the balance sheet date. Income and expenses are translated at the average exchange rates during the period. Translation gains and losses not reflected in earnings are reported as a component of stockholders' equity.

Reclassification

Certain amounts in prior periods have been reclassified to conform to the 2005 financial statement presentation.

Use of estimates

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

Note 2: Recent Pronouncements

In December 2004, the FASB issued SFAS No. 123 (revised 2004) "Share-Based Payment" ("SFAS No. 123R") that addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for (a) equity instruments of the company or (b) liabilities that are based on the fair value of the company's equity instruments or that may be settled by the issuance of such equity instruments. SFAS No. 123R addresses all forms of share-based payment awards, including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. SFAS No. 123R eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25, "Accounting for Stock Issued to Employees", that was provided in Statement 123 as originally issued. Under SFAS No. 123R, companies are required to record compensation expense for all share based payment award transactions measured at fair value. This statement is effective for quarters ending after December 15, 2005. The Company has not yet determined the impact of applying the various provisions of SFAS No. 123R.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets -- An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions (SFAS 153). SFAS 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, Accounting for Nonmonetary Transactions, and replaces it with an exception for exchanges that do not have commercial substance. SFAS 153 specifies that 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 the fiscal periods beginning after June 15, 2005 and is required to be adopted by the Company in the third quarter of 2005. The Company is currently evaluating the effect that the adoption of SFAS 153 will have on its consolidated results of operations and financial condition but does not expect it to have a material impact.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs: an amendment of ARB No. 43, Chapter 4," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after

June 15, 2005. We do not believe the provisions of SFAS No. 151, when applied, will have an impact on our financial position or results of operations.



Note 3 - Property and equipment

Property and equipment consisted of the following:

| | March 31, 2005 |
|---|---|
| Computer equipment | $ 980,212 |
| Furniture and fixtures | 202,376 |
| Leasehold improvements | 221,219 |
| | 1,403,807 |
| Accumulated depreciation | (839,110) |
| | $ 564,697 |

Depreciation and amortization expense related to property and equipment totaled $56,000 and $16,600 for the three months ended March 31, 2005 and 2004, respectively.

Note 4 - Intangible assets

Intangibles acquired have been assigned as follows:

| | March 31, 2005 | Amortization period |
|---|---|---|
| Customer contracts | $ 1,876,424 | 5 - 6 years |
| Approved vendor status | 538,814 | 40 months |
| Computer software | 1,381,000 | 3 years |
| Tradename | 722,000 | Indefinite |
| Proprietary rights and rights to the name of Scosys, Inc. | 20,000 | Indefinite |
| | 4,538,238 | |
| Accumulated amortization | (1,191,031) | |
| | $ 3,347,207 | |

The estimated amortization expense for the next five years related to other finite-lived intangible assets is estimated to be as follows:

| | Amortization of Intangible assets |
|---|---|
| 2006 | $ 1,092,457 |

| | |
|---|---|
| 2007 | 941,324 |
| 2008 | 379,960 |
| 2009 | 115,897 |
| 2010 | 69,831 |
| Thereafter | 5,738 |
| | $ 2,605,207 |



Note 5 - Deferred financing costs

The Company has incurred and capitalized financing costs in connection with two financing transactions consummated during 2004. These costs were deferred and are being amortized over the life of the related financing agreement. The following illustrates the components of the deferred financing costs:

| | March 31, 2005 |
|---|---|
| Laurus Master Fund | $ 766,270 |
| Sands Brothers | 127,039 |
| | $ 893,309 |
| Accumulated amortization | (222,653) |
| | $ 670,656 |

Note 6 - Discount on debt

The Company has allocated the proceeds received from convertible debt instruments between the underlying debt instrument and the detachable warrants and has recorded the discount on the debt instrument due to a beneficial conversion feature as a deferred charge. This deferred charge is being amortized to interest expense over the life of the related debt instruments, which currently range from one to five years. The following illustrates the components of the discount on debt:

| | March 31, 2005 | Amortization period |
|---|---|---|
| Laurus Master Fund | $ 5,621,630 | 3 years |
| Sands Brothers | 454,545 | 1 year |
| Taurus Advisory Group | 1,500,000 | 5 years |
| | 7,576,175 | |
| Accumulated amortization | (1,582,659) | |
| | $ 5,993,516 | |

Note 7 - Line of credit

The Company has a revolving line of credit with Laurus Master Fund, Ltd. ("Laurus"), whereby the Company has access to borrow up to $6.0 million based upon eligible accounts receivable. This revolving line, effectuated through a $2.0 million convertible minimum borrowing note and a $4.0 million revolving note, provides for advances at an advance rate of 90% against eligible accounts receivable, with an annual interest rate of prime rate (as reported in the Wall Street Journal, which was 5.75% as of March 31, 2005) plus 1%, and maturing in three years. The Company has no obligation to meet financial covenants under the $2.0 million convertible minimum borrowing note or the $4.0 million revolving note. These notes will be decreased by 1.0% for every 25% increase above the fixed conversion price prior to an effective registration statement and 2.0% thereafter up to a minimum of 0.0%. This line of credit is secured by substantially all the corporate assets. Both the $2.0 million convertible minimum borrowing note and the $4.0 million revolving note provide for conversion at the option of the holder of the amounts outstanding into the Company's common stock at a fixed conversion price of $0.14 per share. In the event that the Company issues common stock or derivatives convertible into Company common stock for a price less than the aforementioned fixed conversion price, then the fixed conversion price is reset using a weighted average dilution calculation.

Additionally, in exchange for a secured convertible term note bearing interest at prime rate (as reported in the Wall Street Journal) plus 1%, Laurus has made available to the Company an additional $5.0 million to be used for acquisitions. The Company has no obligation to meet financial covenants under the $5.0 million secured convertible term note (See Note 9 to the Condensed Consolidated Financial Statements). This note is convertible into Company common stock at a fixed conversion price of $0.14 per share. In the event that the Company issues Company common stock or derivatives convertible into Company common stock for a price less than the fixed conversion price, then the fixed conversion price is reset to the lower price on a full-ratchet basis. This note matures in three years. This cash will be restricted for use until approved acquisition targets identified by the Company are approved by Laurus.

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The Company issued Laurus a common stock purchase warrant that provides Laurus with the right to purchase 12.0 million shares of the Company's common stock. The exercise price for the first 6.0 million shares acquired under the warrant is $0.29 per share, the exercise price for the next 3.0 million shares acquired under the warrant is $0.31 per share, and the exercise price for the final 3.0 million shares acquired under the warrant is $0.35 per share. The common stock purchase warrant expires on August 16, 2011.

As of March 31, 2005, approximately $3.8 million was outstanding under the revolving line of credit. The interest rate on the revolving line and the acquisition note was 6.75% as of March 31, 2005.

Under the Laurus agreement, the Company was obligated to ensure that the shares provided for issuance under the agreement were properly registered by December 19, 2004. As a result of the Company's Registration statement not being declared effective prior to this date, and not being effective as of March 31, 2005, the Company is incurring liquidated damages to Laurus. As a result, the Company has accrued $0.25 million for payment of these penalties through March 31, 2005.

Note 8 - Short Term Notes Payable

In September 2004, the Company issued to Sands Brothers Venture Capital LLC, Sands Brothers Venture Capital III LLC and Sands Brothers Venture Capital IV LLC (collectively, "Sands") three subordinated secured convertible promissory notes equaling $1.0 million (the "Notes"), each with an annual interest rate of 8% expiring September 22, 2005. The Notes are secured by substantially all corporate assets, but subordinate to Laurus. The Notes are convertible into shares of the Company's common stock at the election of Sands at any time following the consummation of a convertible debt or equity financing with gross proceeds of $5 million or greater (a "Qualified Financing"). The Company also issued Sands three common stock purchase warrants (the "Warrants") providing Sands with the right to purchase 6.0 million shares of the Company's common stock. The exercise price of the shares of the Company's common stock issuable upon exercise of the Warrants shall be equal to a price per share of common stock equal to forty percent (40%) of the price of the securities issued pursuant to a Qualified Financing. If no Qualified Offering has been consummated by September 8, 2005, then Sands may elect to exercise the Warrants at a fixed conversion price of $0.14 per share. The latest that the Warrants may expire is September 8, 2008.



Note 9 - Long term debt

Long-term debt consisted of the following:

| | March 31 2005 |
|---|---|
| Secured convertible term note with a maturity date of August 16, 2007 unless converted into common stock at the note holder's option. The initial conversion price is $0.14 per share. Interest accrues at a rate of prime plus one percent. As of March 31, 2005, the interest rate on this note was 6.75%. See note 7 - Line of credit, for further description of this transaction. | $ 5,000,00 |
| Convertible line of credit note with a maturity date of June 6, 2009 unless converted into common stock at the Company or the note holder's option. Interest accrues at 7% per annum. The original conversion price to shares of common stock is equal to 75% of the average trading price for the prior ten trading days. In September 2004, the price was reset to $0.105 per share. A warrant to purchase 4,166,666 shares of Company common stock was also issued. The exercise price of the warrant is $0.14 per share and the warrant expires on June 6, 2009. An allocation of the relative fair value of the warrant and the debt instrument was performed. The relative fair value of the warrant was determined to be $500,000 and is being amortized to interest expense over the life of the note. A discount on debt issued of $1,500,000 was recorded in September 2004 based on the reset conversion terms. | 2,000,00 |
| Notes payable under capital lease obligations payable to various finance companies for equipment at varying rates of interest, ranging from 18% to 32% as of March 31, 2005, and have maturity dates through 2008. | 206,64 |
| | 7,206,64 |
| Relative fair values ascribed to warrants associated with the above debt agreements. This amount is being accreted to the debt instrument over the term of the related debt agreements, which range from three to five years. | (2,032,62 |
| Subtotal | 5,174,01 |
| Less: Current portion of long-term debt, including obligations under capital leases of $129,890. | (129,89 |
| | $ 5,044,12 |

==========

Future annual payments of long-term debt is as follows:

| Years Ending March 31, | |
|---|---|
| 2006 | $ 129,89 |
| 2007 | 5,069,61 |
| 2008 | 7,13 |
| 2009 | 2,000,00 |
| | $ 7,206,64 |

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Obligations under Capital Leases

The Company has entered into various capital leases that are collateralized by computer equipment and a trade show booth with an original cost of approximately $368,000.

The following schedule lists future minimum lease payments under the capital leases with their present value as of March 31, 2005:

| Years Ending March 31, | |
|---|---|
| 2006 | $164,113 |
| 2007 | 77,663 |
| 2008 | 7,726 |
| | 249,502 |
| Less: Amount representing interest | (42,860) |
| | $206,642 |

During the three months ended March 31, 2005 and 2004, the Company recorded depreciation expense related to equipment under capital leases of approximately $25,100 and $4,700, respectively.

Note 10 - Income Taxes

The Company's provision for income taxes is based on estimated effective annual income tax rates. The provision may differ from income taxes currently payable because certain items of income and expense are recognized in different periods for financial statement purposes than for tax return purposes.

The Company evaluates the amount of deferred tax assets that are recorded against expected taxable income over its forecasting cycle which is currently two years. As a result of this evaluation, the Company has recorded a valuation allowance of $12.6 million and zero for the three months ended March 31, 2005 and 2004, respectively. This allowance was recorded because, based on the weight of available evidence, it is more likely than not that some, or all, of the deferred tax asset may not be realized.

During 2005 and 2004, the Company's effective tax rate is estimated to be approximately 40%. This rate is based upon the statutory federal income tax rate of 34% plus a blended rate for the various states in which the Company incurs income tax liabilities, net of the federal income tax benefit for state taxes paid, of 6%.

Note 11 - Common Stock

On November 8, 2004, the Company entered into a Stock Purchase Agreement (the "Agreement") with a private investor, CMKX-treme, Inc. Pursuant to the Agreement, CMKX-treme, Inc. agreed to purchase 12.5 million shares of common stock for a purchase price of $1.75 million. Under the terms of the Agreement, CMKX-treme, Inc. initially purchased 3,571,428 shares of common stock for $0.5 million, and it was required to purchase the remaining 8,928,572 shares of common stock for $1.25 million by December 31, 2004. On March 17, 2005, CMKX-treme, Inc. remitted final payment for the remaining 8,928,572 shares.

Note 12 - Stock Based Compensation

The 2003 Incentive Plan ("2003 Plan") authorizes the issuance of up to 100,000,000 shares of common stock for issuance upon exercise of options. It also authorizes the issuance of stock appreciation rights. The options granted may be a combination of both incentive and nonstatutory options, generally vest over a three year period from the date of grant, and expire ten years from the date of grant.

To the extent that CSI derives a tax benefit from options exercised by employees, such benefit will be credited to additional paid-in capital when realized on the Company's income tax return. There were no tax benefits realized by the Company during 2005 or 2004.

The following summarizes the stock option transactions under the 2003 Plan during 2005:

| | Share | Weighted average exercise price |
|---|---|---|
| Options outstanding at December 31, 2004 | 41,265,981 | $ 0.15 |
| Options granted | -- | -- |
| Options exercised | -- | -- |
| Options canceled | (775,000) | 0.21 |
| Options outstanding at March 31, 2005 | 40,490,981 | $ 0.15 |



The following table summarizes information concerning outstanding and exercisable Company common stock options at March 31, 2005:

| Range of exercise prices | Options outstanding | Weighted average exercise price | Weighted average remaining contractual life | Options exercisable | Weighted average exercise price |
|---|---|---|---|---|---|
| $0.055 | 8,900,981 | $ 0.055 | 9.4 | 8,900,981 | $ 0.055 |
| $0.165 - $0.23 | 31,590,000 | 0.180 | 9.2 | 6,400,000 | 0.165 |

| | |
|---|---|
| 40,490,981 | 15,300,981 |

Note 13 - Loss Per Share

Basic loss per share is computed on the basis of the weighted average number of common shares outstanding. Diluted loss per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options using the "treasury stock" method.

Basic and diluted loss per share were determined as follows:

| | For the three months ended March 31, | |
|---|---|---|
| | 2005 | 2004 |
| | | (Restated) |
| Net loss available for common stockholders (A) | $ (3,134,783) | $ (433,445) |
| Weighted average outstanding shares of common stock (B) | 772,974,953 | 572,700,000 |
| Common stock and common stock equivalents (C) | 772,974,953 | 572,700,000 |
| Loss per share: | | |
| Basic (A/B) | $ (0.00) | $ (0.00) |
| Diluted (A/C) | $ (0.00) | $ (0.00) |

For the three months ended March 31, 2005, 40,490,981 shares attributable to outstanding stock options were excluded from the calculation of diluted loss per share because the effect was antidilutive. There were no stock options outstanding during 2003. Additionally, the effect of 22,166,666 warrants which were issued on June 7, 2004, August 16, 2004 and September 22, 2004 were excluded from the calculation of diluted loss per share for the three months ended March 31, 2005 because the effect was antidilutive.

Note 14 - Major Customers

During the three months ended March 31, 2005, the Company had sales to one major customer, LEC, a related party (16.0%), which totaled approximately $1,096,000. Amounts due from this customer included in accounts receivable was approximately $783,000 at March 31, 2005. As of March 31, 2005, LEC accounted for approximately 17.6% of the Company's accounts receivable balance.

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During the three months ended March 31, 2004, the Company had sales to one major customer, LEC, a related party (18.4%), which totaled approximately $970,000. Amounts due from this customer included in accounts receivable was approximately $823,000 at March 31, 2004. As of March 31, 2004, LEC accounted for approximately 19.1% of the Company's accounts receivable balance.

See Note 16 "Related Party Transactions" in the Notes to the Condensed Consolidated Financial Statements for further discussion.

Note 15 - Commitments and Contingencies

Legal Proceedings

On June 29, 2004, Viant Capital LLC commenced legal action against the Company in the United States District Court for the Southern District of New York. Through an agreement with Viant, Viant had the exclusive right to obtain private equity transactions on behalf of the Company from February 18 to May 17, 2004. Viant alleges that it is owed a fee of approximately $450,000 relating to the Company's loan from a private investor in May 2004. Management believes that this loan does not qualify as a private equity transaction and it intends to vigorously defend the Company. The Company has estimated the probable loss related to this suit to be the agreed upon contract signing fee of $75,000 and has recorded a liability for this amount. This suit was settled on April 28, 2005 for an immaterial amount.

Lease Commitments

The Company's corporate headquarters are located at 100 Eagle Rock Avenue, East Hanover, New Jersey 07936, where it operates under an amended lease agreement expiring December 31, 2010. Our monthly rent with respect to our East Hanover, New Jersey facility is $26,290. In addition to minimum rentals, the Company is liable for its proportionate share of real estate taxes and operating expenses, as defined. DeLeeuw Associates, LLC has an office at Suite 1460, Charlotte Plaza, 201 South College Street, Charlotte, North Carolina 28244. DeLeeuw leases this space which has a stated expiration date of December 31, 2005. Our monthly rent with respect to our Charlotte, North Carolina facility is $2,831. Evoke leases offices in the following locations: Riata Corporate Park Building VII, 12357-III Riata Trace Parkway, Austin, Texas; 1900 13th Street, Boulder, Colorado; and Am Soldnermoos 17, D-85399 Hallbergmoos, Germany. The expiration dates for these leases are July 2006, July 2006 and May 2005. Monthly rentals for these offices are $22,872, $5,284 and $2,000, respectively.

Rent expense, including automobile rentals, totaled approximately $205,539 and $78,784 for the three months ended March 31, 2005 and 2004, respectively.

The Company is committed under several operating leases for automobiles that expire during 2007.

Note 16 - Related Party Transactions

For the three months ended March 31, 2005 and 2004, the Company invoiced LEC $1,096,000 and $970,000, respectively, for the services of consultants subcontracted to LEC by the Company. As of March 31, 2005 and 2004, the Company had accounts receivable due from LEC of approximately $783,000 and $823,000, respectively. There are no known collections problems with respect to LEC. We feel confident in the collectibility of these accounts receivable as the majority of its billing is derived from Fortune 100 clients. The collection process is slow as these clients require separate approval on their own internal systems, which extends the payment cycle.

On November 8, 2004, Mr. Newman entered into a stock purchase agreement with a private investor, CMKX-treme, Inc. Pursuant to the agreement, CMKX-treme, Inc. agreed to purchase 2,833,333 shares of common stock for a purchase price of $250,000. As of March 31, 2005, the shares have not been issued to CMKX-treme, Inc. because the investor has not yet remitted payment for the shares.

On November 8, 2004, Mr. Peipert entered into a stock purchase agreement with a private investor, CMKX-treme, Inc. Pursuant to the agreement, CMKX-treme, Inc. agreed to purchase 5,666,667 shares of common stock for a purchase price of $500,000. As of March 31, 2005, the shares have not been issued to CMKX-treme, Inc. because the investor has not yet remitted full payment for the shares.

On November 10, 2004, the Company and Dr. Michael Mitchell, the former President, Chief Executive Officer and sole director of LCS, executed a one-year consulting agreement whereby Dr. Mitchell would perform certain consulting services on behalf of the Company. Dr. Mitchell will receive an aggregate amount of $250,000 as compensation for services provided to the Company. As of March 31, 2005, an aggregate amount of $150,000 has been paid to Dr. Mitchell for services provided under this consulting agreement.

As of December 14, 2004, Scott Newman, our President, Chief Executive Officer and Chairman, had loaned the Company $200,000, and Glenn Peipert, our Executive Vice President, Chief Operating Officer and Director, had loaned the Company $125,000. The unsecured loans by Mr. Newman and Mr. Peipert each accrue interest at a simple rate of 3% per annum, and each has a term expiring on January 1, 2006. As of March 31, 2005, approximately $177,000 and $123,000 remained outstanding to Messrs. Newman and Peipert, respectively.

As of March 30, 2005, Messrs. Newman, Peipert and Robert C. DeLeeuw have agreed to personally support our cash requirements to enable us to fulfill our obligations through May 1, 2006, to the extent necessary, up to a maximum amount of $2.5 million. Mr. Newman personally guaranties up to $1.4 million, Mr. Peipert guaranties up to approximately $0.7 million and Mr. DeLeeuw personally guaranties approximately $0.4 million. We believe that our reliance on such commitment is reasonable and that Messrs. Newman, Peipert and DeLeeuw have sufficient liquidity and net worth to honor such commitment. We believe that this written commitment provides us with the legal right to request and receive such advances. Any loan by Messrs. Newman, Peipert and DeLeeuw to the Company would bear interest at 3% per annum.

Note 17 - Segment Information

The Company has two reportable segments: services and software, which includes support and maintenance. The services segment includes the Company's information technology services offerings in the following areas: data warehousing, business intelligence, management consulting and professional services to its customers principally located in the northeastern United States. The Company's acquisitions of the assets of Scosys, Inc., DeLeeuw Associates, Inc. and the equity adjustment related to its equity investment in Leading Edge Communications Corporation have all been included in the services business segment. The Company maintains offices for its services business in East Hanover, New Jersey and Charlotte, North Carolina.

The software segment resulted from the Company's acquisition of substantially all the assets of Evoke Software Corporation ("Evoke") on June 28, 2004. Evoke is a provider of data discovery, profiling and quality management software. Evoke's headquarters are in East Hanover, New Jersey and it maintains development offices in Austin, Texas and Denver, Colorado. Additionally, Evoke has sales offices in England and Germany.

The Company considers all revenues and expenses to be of an operating nature and, accordingly, allocates them to industry segments regardless of the profit center in which recorded. Corporate office expenses are allocated to certain segments based on resources allocated. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies.

The Company considers reportable segments as business units that offer different products and are managed separately.

| | As of and for the three months en | | | |
|---|---|---|---|---|
| | 2005 | | | |
| | Services | Software | Consolidated | Service |
| | | | | (Restat |
| Net revenues from external customers | $ 6,245,117 | $ 627,421 | $ 6,872,538 | $ 5,262, |
| Segment net loss | (2,062,049) | (1,072,734) | (3,134,783) | (433, |
| Interest income | 24,192 | -- | 24,192 | |
| Interest expense | 875,417 | 489,437 | 1,364,854 | 32, |
| Depreciation and amortization | 192,830 | 238,626 | 431,456 | 50, |
| Total segment assets | 24,072,826 | 1,683,920 | 25,756,746 | 23,357, |



Geographic Information

| | For the three months ended March 31, | |
|---|---|---|
| | 2005 | 2004 |
| Revenues: | | |
| United States | $ 6,717,990 | $ 5,262,037 |
| International | 154,548 | -- |
| | $ 6,872,538 | $ 5,262,037 |

| | As of March 31, | |
|---|---|---|
| | 2005 | 2004 |
| Long-lived assets: | | |
| United States | $ 562,573 | |
| International | 2,124 | -- |
| | $ 564,697 | $ -- |

Note 18 - Pro Forma Results of Operations

The following unaudited statement of income reflects the pro-forma consolidated results of Conversion Services International, Inc. and DeLeeuw Associates, LLC for the three months ended March 31, 2004 as if the entities had been consolidated for the entire three month period.

| | For the three months ended March 31, 2004 |
|---|---|
| Revenues | $ 6,356,816 |
| Net Loss | $ (456,399) |

| | |
|---|---|
| Net Loss per share | $ (0.00) |

Note 19 - Subsequent Events

In April 2005, Glenn Peipert loaned $250,000 to the Company, which had been received as partial payment from CMKX-treme related to his sale of stock which was disclosed in Note 16 - related party transactions. Such loan bears interest at 3% per annum and is due May 1, 2006.

On May 6, 2005, Joseph Santiso was elected to the Board of Directors of the Company. Mr. Santiso founded and is President of The BCI Group. Mr. Santiso and present director Lawrence K. Reisman will comprise the newly formed Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee.

On May 9, 2005, Laurus Master Fund. Ltd. elected to convert $1,000,000 of the principal amount outstanding under the minimum borrowing note dated August 16, 2004 into shares of common stock of the Company at a conversion price of $0.14 per share. As a result of this conversion, the Company issued 7,142,857 shares of common stock to Laurus.

In May 2005, a compensation plan was approved for independent members of the Company's Board of Directors. This plan provides for a $10,000 per year payment to each independent director with 50% being paid in cash and 50% in Company common stock, a $1,000 payment for each meeting attended in person, a $500 payment for each meeting attended via telephone, a $500 payment for each committee meeting attended, and an annual option grant to be determined by the Board of Directors.



Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview of our Business

Management's Discussion and Analysis contains statements that are forward-looking. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of factors discussed in "Risk Factors" and elsewhere in this report. The Company undertakes no duty to update any forward-looking statement to conform the statement to actual results or changes in the Company's expectations.

Conversion Services International, Inc. provides professional services to the Global 2000 as well as mid-market clientele relating to strategic consulting, data warehousing, business intelligence and data management and, as a result of its acquisition of Evoke Software Corporation, the sale of software which is used to survey and quantify the quality of data. This software is a tool that is used to identify problems with company data prior to being transferred into a data warehouse. The Company's services based clients are primarily in the financial services, pharmaceutical, healthcare and telecommunications industries, although it has clients in other industries as well. The Company's clients are primarily located in the northeastern United States. The Company delivers value to its clients, utilizing a combination of business acumen, technical proficiency, experience and a proven set of "best practices" methodologies to deliver cost effective services. The Company is committed to being a leader in data warehousing and business intelligence consulting, enabling it to be a valuable asset and trusted advisor to its customers.

The Company began operations in 1990. Its services were originally focused on e-business solutions and data warehousing. In the late 1990s, the Company strategically repositioned itself to capitalize on its data warehousing expertise in the fast growing business intelligence/data warehousing space. The Company became a public company via its merger with a wholly owned subsidiary of LCS Group, Inc., effective January 30, 2004.

The Company's core strategy includes capitalizing on the already established in-house strategic consulting, business intelligence/data warehousing ("BI/DW") technical expertise and its seasoned sales force. This is expected to result in organic growth through the addition of new customers. In addition, this foundation will be leveraged as the Company pursues targeted strategic acquisitions.

Revenues for the Company are categorized by strategic consulting, business intelligence, data warehousing, data management, and software and support and maintenance. They are reflected in the chart below as a percentage of overall revenues:

| Category of Services | Percentage of Revenues for the three months ended March 31, 2005 | 2004 |
|---|---|---|
| Strategic Consulting | 38.6% | 18.5% |
| Business Intelligence | 20.6% | 26.7% |
| Data Warehousing | 16.1% | 15.9% |
| Data Management | 14.7% | 38.9% |
| Software & Support | 9.5% | 0.0% |
| Other | 0.5% | 0.0% |

Strategic consulting revenues were 38.6% of total revenues for the three months ended March 31, 2005, increasing by 20.1% of total revenues as compared to 18.5% for the comparable prior year period. The Company acquired DeLeeuw Associates, whose revenue base is entirely in the strategic consulting category of services, in March 2004. During the three months ended March 31, 2005, DeLeeuw revenues were $2.2 million, or 84.2% of strategic consulting revenues as compared to $0.4 million for the three months ended March 31, 2004, representing an increase of $1.8 million.

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The Deleeuw Associates acquisition increased the Company's revenue base and, as a result, the percentage of revenues contributed by each of the other services categories were impacted by the increase in the strategic consulting category. Business intelligence service revenues were approximately $1.4 million for both of the three month periods ended March 31, 2005 and 2004. Data warehousing revenues were $1.1 million for the three months ended March 31, 2005, an increase of $0.2 million, or 22.2%, from $0.9 million for the three months ended March 31, 2004. The Company intends to continue to focus on increasing revenues in these two categories during 2005.

Data management revenues were $1.2 million for the three months ended March 31, 2005, a decrease of $0.9 million, or 42.9%, from $2.1 million for the three months ended March 31, 2004. This category of services is less profitable to the Company than the other service categories and, as a result, is being de-emphasized and the Company's resources are being focused on the more profitable service categories.

Software and support and maintenance revenues increased from zero for the three months ended March 31, 2004 to 9.5% of revenues for the three months ended March 31, 2005. This is attributable to revenues from licensing and supporting the Evoke Axio Software which was acquired by the Company in June 2004.

The Company derives a majority of its revenue from professional services engagements. Its revenue depends on the Company's ability to generate new business, in addition to preserving present client engagements. The general domestic economic conditions in the industries the Company serves, the pace of technological change, and the business requirements and practices of its clients and potential clients directly affect this. When economic conditions decline, companies generally decrease their technology budgets and reduce the amount of spending on the type of information technology (IT) consulting the Company provides. The Company's revenue is also impacted by the rate per hour it is able to charge for its services and by the size and chargeability, or utilization rate, of its professional workforce. During periods of economic decline and reduced client spending, competition for new engagements increases, and it becomes more difficult to maintain its billing rates and sustain appropriate utilization rates. If the Company is unable to maintain its billing rates or sustain appropriate utilization rates for its professionals, its overall profitability may decline. The Company is beginning to see improvements in economic conditions, which have recently led to increased spending on consulting services in certain vertical markets, particularly in financial services, which is serviced by the Company's strategic consulting service category.

As the Company continues to see increases in client spending and improvements in economic conditions, it will continue to focus on a variety of growth initiatives in order to improve its market share and increase revenue. Moreover, as the Company achieves top line growth, the Company will concentrate its efforts on improving margins and driving earnings to the bottom line. The Company intends to improve margins by limiting its use of outside consultants, complementing its service offerings with higher level management consulting opportunities, continuously evaluating the size of its workforce in order to balance the Company's skill base with the market demand for services.

In addition to the conditions described above for growing the Company's current business, the Company will continue to grow through acquisition. One of the Company's objectives is to make acquisitions of companies offering services complementary to the Company's lines of business will accelerate the Company's business plan at lower costs than it would generate internally and also improve its competitive positioning and expand the Company's offerings in a larger geographic area. The service industry is very fragmented, with a handful of large international firms having data warehousing and/or business intelligence divisions, and hundreds of regional boutiques throughout the United States. These smaller firms do not have the financial wherewithal to scale their businesses or compete with the larger players, and the Company believes that the service industry as a whole is ready for consolidation. The Company will continue to aggressively pursue these firms, adding new geographies, areas of expertise and verticals to its current business. These acquisitions will likely be consummated with a combination of cash and stock. Although the Company has approximately $4.3 million to fund acquisitions via its financing transaction with Laurus Master Fund, Ltd., some of these acquisitions may hinge upon future financings.

During the three month period ended March 31, 2005, one of the Company's clients, LEC, a related party, accounted for approximately 16.0% of total revenues. For the three months ended March 31, 2004, two of our clients, LEC (18.4%) and Verizon Wireless (15.4%), accounted collectively for approximately 33% of our total revenues.

The Company's most significant costs are personnel expenses, which consist of consultant fees, benefits and payroll-related expenses.

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Results of Operations

The following table sets forth selected financial data for the periods indicated:

| | Selected Statement of Operations Data for the three months Ended March 31, 2005 | 2004 |
|---|---|---|
| Net sales | $ 6,872,538 | $ 5,262,037 |
| Gross profit | 2,274,566 | 1,422,737 |
| Net loss | (3,134,783) | (433,445) |
| Net loss per share: | | |
| Basic | $ (0.00) | $ (0.00) |
| Diluted | $ (0.00) | $ (0.00) |

| | Selected Statement of Financial Position Data for the three months ended March 31, 2005 |
|---|---|
| Working capital | $(4,111,092) |
| Total assets | 25,756,746 |
| Long-term debt | 5,044,126 |
| Total stockholders' equity | 10,572,785 |

Three Months Ended March 31, 2005 and 2004

Revenue

The Company's revenues are primarily comprised of billings to clients for consulting hours worked on client projects. Revenues for the three months ended March 31, 2005 were $6.9 million, an increase of $1.6 million, or 30.6%, over revenues of $5.3 million for the three months ended March 31, 2004.

Services

Revenues from services for the three months ended March 31, 2005 were $5.0 million, an increase of $0.8 million, or 18.4%, over revenues of $4.2 million for the three months ended March 31, 2004. DeLeeuw Associates, which was acquired by the Company in March 2004, contributed $1.9 million of the 2005 services revenue increase as compared to the prior year. Partially offsetting this increase is a reduction in revenues from services of $1.1 million relating to a decrease in the number of consultants in the ongoing business. Exclusive of DeLeeuw Associates, the number of consultants decreased by approximately 29.0% for the three months ended March 31, 2005 compared to the same period for the prior year. The decline in the number of consultants was attributable to both the conversion of our consultants to full time employees of our clients and a reduction in consultants due to resignations.

Related party services

Revenues from related parties for the three months ended March 31, 2005 were $1.1 million, an increase of $0.1 million over revenues of $1.0 million for the three months ended March 31, 2004. The increase is primarily attributed to the hiring of four consultants, during the summer of 2004, under the independent contractor agreement executed by the Company and LEC in November 2003. Additionally, five part-time employees were replaced with full-time employees which also contributed to the revenue increase.

Software

Software revenues are derived from the sale of software licenses pertaining to the licensing of our Evoke Axio data profiling software. The assets of Evoke were acquired by the Company in June 2004 and, as a result, the Company has only included revenues since July 2004. Revenues from software for the three months ended March 31, 2005 were $0.3 million as compared to zero for the three months ended March 31, 2004.



Support and maintenance

Revenues from support and maintenance for the three months ended March 31, 2005 were $0.4 million as compared to zero in the prior year. This increase in revenues is attributable to support and maintenance revenues derived from the Evoke Axio Software which was acquired by the Company in June 2004.

Cost of revenue

Cost of revenue primarily includes payroll and benefits costs for the Company's consultants as well as the cost of software that is sold or licensed by the company. Cost of revenue was $4.6 million, or 66.9% of revenue for the three months ended March 31, 2005, compared to $3.8 million, or 73.0% of revenue for the three months ended March 31, 2004, representing an increase of $0.8 million, or 19.8%, as compared to the prior year.

Services

Cost of revenue for services was $3.5 million, or 70.4% of services revenue for the three months ended March 31, 2005, compared to $3.1 million, or 72.6% of services revenue for the three months ended March 31, 2004 representing an increase of $0.4 million, or 14.8%. Cost of revenue for DeLeeuw Associates generated a $1.1 million increase in cost of revenues for services as compared to the prior year. Partially offsetting this increase was a reduction in cost of services resulting from the reduction in consultants on billing.

Related party services

Cost of revenue for related party services was $1.0 million, or 92.3% of related party services revenue for the three months ended March 31, 2005, compared to $0.8 million, or 78.0% of related party services revenue for the three months ended March 31, 2004. The increased cost in 2005 reflects the cost of full-time higher level consultants hired for specialized work, but at lower gross margins than normal.

Software

Cost of revenue for software includes production costs related to the Evoke Axio software product. Evoke was acquired by the Company in June 2004. Cost of revenue for software was $44,000, or 15.2% of software revenue for the three months ended March 31, 2005, compared to zero for the three months ended March 31, 2004. In 2005, cost of software revenue related to the cost of the Evoke Software revenues.

Support and maintenance

Cost of revenue for support and maintenance includes costs associated with resolving customer inquiries. Cost of revenue for support and maintenance was $13,000, or 3.0% of support and maintenance revenue for the three months ended March 31, 2005, as compared to zero for the prior year. The increase in cost of support and maintenance is entirely attributable to Evoke Software which was acquired by the Company in June 2004.

Gross Profit

Gross profit was $2.3 million, or 33.1% of revenue for the three months ended March 31, 2005, compared to $1.4 million, or 27.0% of revenue for the three months ended March 31, 2004.

As a percentage of total gross profit for the three months ended March 31, 2005 and 2004, services contributed 65.4% and 81.6%, respectively, related party services contributed 3.7% and 15.0%, respectively, software contributed 10.9% and zero, respectively, support and maintenance 18.4% and zero, respectively, and other contributed 1.6% and 3.4%, respectively.

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Services

Gross profit from services was $1.5 million for the three months ended March 31, 2005, an increase of $0.3 million, or 28.0%, as compared to $1.2 million for the three months ended March 31, 2004. As a percent of services revenues, gross profit of 29.6% for the three months ended March 31, 2005 represented an increase of 2.2% points as compared to 27.4% of services revenues for the three months ended March 31, 2004. The increase in the gross margin percentage is the result of recording a full quarter of the higher margin DeLeeuw business during the three months ended March 31, 2005 versus only several weeks in 2004. The DeLeeuw business provided approximately $0.8 million of increased gross profit during the three months ended March 31, 2005. Partially offsetting this increase is an offsetting reduction in gross profit resulting from having fewer billable consultants combined with the cost of having consultants on the payroll that were not billable to clients during the current year period as compared to the comparable period in the prior year.

Related party services

Gross profit for related party services was $85,000 , or 7.7% of related party services revenue for the three months ended March 31, 2005, compared to $0.2 million, or 22.0% of related party services revenue for the three months ended March 31, 2004. The decline in the related party services gross profit percentage is due to the increased costs of the full-time employees hired by Company as compared to the part-time employees and the reduced billing rates being realized on these consultants during the three months ended March 31, 2005.

Software

Gross profit resulting from software was $0.2 million, or 84.8% of software revenue for the three months ended March 31, 2005, compared to zero for the three months ended March 31, 2004. During the three months ended March 31, 2005, the Company deferred approximately $0.6 million of license revenue that is being recognized over the life of the related support and maintenance agreements.

Support and maintenance

Gross profit for support and maintenance was $0.4 million, or 97.0% of support and maintenance revenue for the three months ended March 31, 2005, as compared to zero in the prior year. The gross profit for support and maintenance is attributable to the Company's acquisition of Evoke Software in June 2004.

Selling and marketing

Selling and marketing expenses include payroll, employee benefits and other headcount-related costs associated with sales and marketing personnel and advertising, promotions, tradeshows, seminars and other programs. Selling and marketing expenses were $1.5 million, or 22.2% of revenue for the three months ended March 31, 2005, representing an increase of $0.9 million as compared to $0.6 million, or 11.0% of revenue for the three months ended March 31, 2004. $0.7 million of this increase relates to increased payroll expense, $0.1 million relates to increased marketing expenses, and the remaining $0.1 million relates to other various increases. $0.2 million of the increase in payroll is the result of the acquisition of DeLeeuw Associates in March 2004, $0.2 million of the increase is the result of the acquisition of Evoke in June 2004, and the remaining $0.3 million of increased payroll expense primarily relates to salaries and commissions for the ongoing CSI business.

General and administrative

General and administrative costs include payroll, employee benefits and other headcount-related costs associated with the finance, legal, facilities, certain human resources and other administrative headcount, and legal and other professional and administrative fees. General and administrative costs were $1.9 million, or 28.2% of revenue for the three months ended March 31, 2005 compared to $1.4 million, or 26.9% of revenue for the three months ended March 31, 2004. $0.5 million of the increase in general and administrative expenses during the three months ended March 31, 2005 is attributed to the costs of operating Evoke subsequent to the June 2004 acquisition. Additionally, a $0.2 million increase is attributed to professional fees related to legal, accounting and consulting fees primarily due to work related to the Company's public filing and financing efforts. These increases were partially offset by $0.1 million of recruiting costs incurred during the three months ended March 31, 2004 that did not recur in 2005.

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Research and Development

Research and development costs primarily include the payroll, employee benefits and other headcount-related costs associated with the employees working on the development of upgrades and new versions of the Evoke Axio software product. Research and development costs were $0.2 million, or 3.5% of revenue compared to zero for the comparative periods in the prior year. The research and development department was obtained in association with the Evoke acquisition which was completed in June 2004.

Depreciation and amortization

Depreciation expense is recorded on the Company's property and equipment which is generally depreciated over a period between three to seven years. Amortization of leasehold improvements is taken over the shorter of the estimated useful life of the asset or the remaining term of the lease. The Company amortizes deferred financing costs utilizing the effective interest method over the term of the related debt instrument. Acquired software is amortized on a straight-line basis over an estimated useful life of three years. Acquired contracts are amortized over a period of time that approximates the estimated life of the contracts, based upon the estimated annual cash flows obtained from those contracts, generally five to six years. Depreciation and amortization expenses were $0.4 million for the three months ended March 31, 2005 compared to $0.1 million for the three months ended March 31, 2004. The $0.3 million increase in depreciation and amortization during the three months ended March 31, 2005, as compared to the prior year period, is attributed to $0.2 million of amortization of the acquired Evoke and DeLeeuw Associates intangible assets during the quarter and $0.1 million of increased depreciation for the assets acquired from Evoke in June 2004 and for new assets purchased during the past year.

Interest Expense

The Company incurs interest expense on loans from financial institutions, from capital lease obligations related to the acquisition of equipment used in its business, and on the outstanding convertible line of credit notes. Amortization of the discount on debt issued of $0.7 million for the three months ended March 31, 2005 is also recorded as interest expense. Total interest expense recorded was $1.4 million for the three months ended March 31, 2005 compared to $33,000 for the three months ended March 31, 2004. This increase relates to the interest and penalties associated with the Laurus and Sands financing transactions described below in the liquidity and capital resources section.

Other income (expense)

The Company recorded interest income of $24,000 and other income of approximately $41,000 for the three months ended March 31, 2005, compared to interest income of $400 and other income of $5,000 for the three months ended March 31, 2004. The Company recorded equity income from its investments in DeLeeuw International (Turkey) and LEC of approximately $43,000 for the three months ended March 31, 2005.

Income Taxes

The Company evaluates the amount of deferred tax assets that are recorded against expected taxable income over its forecasting cycle which is currently two years. As a result of this evaluation, the Company has recorded a valuation allowance of $12.6 million as of March 31, 2005. This allowance was recorded because, based on the weight of available evidence, it is more likely than not that some, or all, of the deferred tax asset may not be realized.

A $215,600 income tax benefit was recorded during the three months ended March 31, 2004.

LIQUIDITY AND CAPITAL RESOURCES

Cash totaled $1.2 million as of March 31, 2005 compared to $1.0 million as of December 31, 2004. The Company's cash balance is primarily derived from customer remittances, bank and other borrowings, and acquired cash and is used for general working capital needs.

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Working capital deficit is ($4.1 million) as of March 31, 2005 compared to ($3.0 million) as of December 31, 2004. The Company's working capital position has deteriorated during the current quarter primarily due to losses incurred by the Company. The losses generated by the Company have resulted in the need for the Company to raise $1.25 million through the sale of Company stock.

Cash used by operations during the three months ended March 31, 2005 was $1.1 million, unchanged from the comparable period in 2004. While sequential quarter revenues increased by $0.4 million to $6.9 million during the three months ended March 31, 2005 from $6.5 million for the three months ended December 31, 2004, accounts receivable declined by $0.6 million primarily due to increased collection efforts by the Company. Days sales outstanding have declined to 58 days for the current quarter from 72 days in the prior quarter. Deferred revenue increased by $0.5 million primarily due to the deferral of the revenue recognition for Evoke software licenses invoiced in the current quarter. These sources of cash were offset by a reduction in accounts payable and accrued expenses of $0.5 million due to payments which were accrued at December 31, 2004, but paid during the current quarter, relating to $0.4 million of payroll and $0.1 million of other miscellaneous payments. The remaining use of cash relates to the losses generated by the Company during the current period. Cash based losses (net loss plus non cash expenses) were $1.7 million during the three months ended March 31, 2005.

Cash used by investing activities was $20,000 during the three months ended March 31, 2005 was for the purchases of computer equipment for the Company.

Cash provided by financing activities was $1.3 million during the three months ended March 31, 2005. $1.25 million was raised through the sale of Company common stock and $0.1 million was provided by the release of restricted cash, partially offset by principal payments on capital lease obligations.

There are currently no material commitments for capital expenditures.

The Company expects to incur costs, in 2005, of approximately $125,000 in order to improve its internal controls surrounding financial reporting and disclosure. No costs were incurred during the three months ended March 31, 2005.

As of March 31, 2005 and December 31, 2004, the Company had accounts receivable due from LEC of approximately $0.8 million. There are no known collections problems with respect to LEC.

For the three months ended March 31, 2005 and 2004, we invoiced LEC $1.1 million and $1.0 million, respectively, for the services of consultants subcontracted to LEC by us. We feel confident in the collectibility of these accounts receivable as the majority of its billing is derived from Fortune 100 clients. The collection process is slow as these clients require separate approval on their own internal systems, which extends the payment cycle.

The Company has a revolving line of credit with Laurus Master Fund, Ltd. ("Laurus"), whereby the Company has access to borrow up to $6.0 million based upon eligible accounts receivable. This revolving line, effectuated through a $2.0 million convertible minimum borrowing note and a $4.0 million revolving note, provides for advances at an advance rate of 90% against eligible accounts receivable, with an annual interest rate of prime rate (as reported in the Wall Street Journal, which was 5.75% as of March 31, 2005) plus 1%, and maturing in three years. We have no obligation to meet financial covenants under the $2.0 million convertible minimum borrowing note or the $4.0 million revolving note. These notes will be decreased by 1.0% for every 25% increase above the fixed conversion price prior to an effective registration statement and 2.0% thereafter up to a minimum of 0.0%. This line of credit is secured by substantially all the corporate assets. Both the $2.0 million convertible minimum borrowing note and the $4.0 million revolving note provide for conversion at the option of the holder of the amounts outstanding into the Company's common stock at a fixed conversion price of $0.14 per share. In the event that the Company issues common stock or derivatives convertible into Company common stock for a price less than the aforementioned fixed conversion price, then the fixed conversion price is reset using a weighted average dilution calculation.

Additionally, in exchange for a secured convertible term note bearing interest at prime rate (as reported in the Wall Street Journal) plus 1%, Laurus has made available to the Company an additional $5.0 million to be used for acquisitions. We have no obligation to meet financial covenants under the $5.0 million secured convertible term note (See Note 9 to the Condensed Consolidated Financial Statements). This note is convertible into Company common stock at a fixed conversion price of $0.14 per share. In the event that the Company issues Company common stock or derivatives convertible into Company common stock for a price less than the fixed conversion price, then the fixed conversion price is reset to the lower price on a full-ratchet basis. This note matures in three years. This cash will be restricted for use until approved acquisition targets identified by the Company are approved by Laurus.



The Company issued Laurus a common stock purchase warrant that provides Laurus with the right to purchase 12.0 million shares of the Company's common stock. The exercise price for the first 6.0 million shares acquired under the warrant is $0.29 per share, the exercise price for the next 3.0 million shares acquired under the warrant is $0.31 per share, and the exercise price for the final 3.0 million shares acquired under the warrant is $0.35 per share. The common stock purchase warrant expires on August 16, 2011.

As of March 31, 2005, approximately $3.8 million was outstanding under the revolving line of credit. The interest rate on the revolving line and the acquisition note was 6.75% as of March 31, 2005.

On May 9, 2005, Laurus Master Fund, Ltd. elected to convert $1,000,000 of the principal amount outstanding under the minimum borrowing note dated August 16, 2004 into shares of common stock of the Company at a conversion price of $0.14 per share. As a result of this conversion, the Company issued 7,142,857 shares of common stock to Laurus. This conversion provided the Company with additional borrowing capacity under its line of credit.

Under the Laurus agreement, the Company was obligated to ensure that the shares provided for issuance under the agreement were properly registered by December 19, 2004. As a result of the Company's Registration statement not being declared effective prior to this date, the Company is incurring liquidated damages to Laurus. As a result, the Company has accrued $254,000 for payment of these penalties through March 31, 2005.

In September 2004, the Company issued to Sands Brothers Venture Capital LLC, Sands Brothers Venture Capital III LLC and Sands Brothers Venture Capital IV LLC (collectively, "Sands") three subordinated secured convertible promissory notes equaling $1.0 million (the "Notes"), each with an annual interest rate of 8% expiring September 22, 2005. The Notes are secured by substantially all corporate assets, but subordinate to Laurus. The Notes are convertible into shares of the Company's common stock at the election of Sands at any time following the consummation of a convertible debt or equity financing with gross proceeds of $5 million or greater (a "Qualified Financing"). The Company also issued Sands three common stock purchase warrants (the "Warrants") providing Sands with the right to purchase 6,000,000 shares of the Company's common stock. The exercise price of the shares of the Company's common stock issuable upon exercise of the Warrants shall be equal to a price per share of common stock equal to forty percent (40%) of the price of the securities issued pursuant to a

Qualified Financing. If no Qualified Offering has been consummated by September 8, 2005, then Sands may elect to exercise the Warrants at a fixed conversion price of $0.14 per share. The latest that the Warrants may expire is September 8, 2008.

The following is a summary of the debt instruments outstanding as of March 31, 2005:

| Lender | Type of facility | Outstanding as of March 31, 2005 (not including interest) (all numbers approximate) | Rema (if |
|---|---|---|---|
| Laurus Master Fund, Ltd. | Convertible Line of Credit | $3,800,000 | $0 |
| Laurus Master Fund, Ltd. | Convertible Term note | $4,251,000 | $0 |
| Sands Brothers Venture Capital LLC | Convertible Promissory Note | $50,000 | $0 |
| Sands Brothers Venture Capital III LLC | Convertible Promissory Note | $850,000 | $0 |
| Sands Brothers Venture Capital IV LLC | Convertible Promissory Note | $100,000 | $0 |
| Taurus Advisory Group, LLC investors | Convertible Promissory Note | $2,000,000 | $0 |
| Scott Newman | Promissory Note | $177,000 | $0 |
| Glenn Peipert | Promissory Note | $123,000 | $0 |
| TOTAL | | $11,351,000 | $0 |



The Company had generated losses during 2004 and these losses have continued during the three months ended March 31, 2005. To that extent, the Company has experienced continued negative cash flow which created a liquidity issue for the Company during 2004. To address this issue, the following financings were effectuated:

In November 2004, the Company entered into a Stock Purchase Agreement (the "Agreement") with a private investor, CMKX-treme, Inc. Pursuant to the Agreement, CMKX-treme, Inc. agreed to purchase 12.5 million shares of common stock for a purchase price of $1.75 million. Under the terms of the Agreement, CMKX-treme, Inc. initially purchased 3,571,428 shares of common stock for $0.5 million, and it was required to purchase the remaining 8,928,572 shares of common stock for $1.25 million by December 31, 2004. As of March 17, 2005, CMKX-treme, Inc. remitted final payment for the remaining 8,928,572 shares.

As of March 30, 2005, Messrs. Newman, Peipert and Robert C. DeLeeuw have agreed to personally support our cash requirements to enable us to fulfill our obligations through May 1, 2006, to the extent necessary, up to a maximum amount of $2.5 million. Mr. Newman personally guaranties up to $1.4 million, Mr. Peipert guaranties up to $0.7 million and Mr. DeLeeuw personally guaranties $0.4 million. We believe that our reliance on such commitment is reasonable and that Messrs. Newman, Peipert and DeLeeuw have sufficient liquidity and net worth to honor such commitment. We believe that this written commitment provides us with the legal right to request and receive such advances. Any loan by Messrs. Newman, Peipert and DeLeeuw to the Company would bear interest at 3% per annum.

The Company has completed various financing transactions through the issuance of common stock, as well as the issuance of notes and warrants convertible into our common stock, while a registration statement was on file with the Securities and Exchange Commission but had not yet been declared effective. Those transactions were with the following entities:

| | | |
|---|---|---|
| o | Taurus Advisory Group, LLC | $ 4.0 million |
| o | Laurus Master Fund, Ltd. | $11.0 million |
| o | Sands Brothers International Ltd. (3 affiliated entities) | $ 1.0 million |

Even though all stockholders, noteholders and warrantholders have been advised of their rights to rescind those financing transactions and they each have agreed to waive their rights to rescind those transactions, there is a remote possibility that each of those transactions could be reversed. In such an event, the Company could be adversely affected and may have an obligation to fund such rescissions.

The Company believes existing cash, borrowing capacity under the line of credit or alternative financing sources, the funding to be provided by the principal stockholders', and funds generated from operations should be sufficient to meet operating requirements over the upcoming twelve month period. We may raise additional funds through debt or equity transactions in order to fund expansion, to develop new or enhanced products and services, to respond to competitive pressures, or to acquire complementary businesses or technologies. There is no assurance, however, that additional financing will be available, or if available, will be available on acceptable terms. Any decision or ability to obtain additional financing through debt or equity investment will depend on various factors, including, among others, revenues, financial market conditions, strategic acquisition and investment opportunities, and developments in the Company's markets. The sale of additional equity securities or future conversion of convertible debt would result in additional dilution to the Company's stockholders.

Off-balance sheet arrangements

The Company does not have any transactions, agreements or other contractual arrangements that constitute off-balance sheet arrangements.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Revenue recognition

Our revenue recognition policy is significant because revenues are a key component of our results from operations. In addition, revenue recognition determines the timing of certain expenses, such as incentive compensation. We follow very specific and detailed guidelines in measuring revenue; however, certain judgments and estimates affect the application of the revenue policy. Revenue results are difficult to predict and any shortfall in revenues or delay in recognizing revenues could cause operating results to vary significantly from quarter to quarter and could result in future operating losses or reduced net income.

Services

Revenue from consulting and professional services is recognized at the time the services are performed on a project by project basis. For projects charged on a time and materials basis, revenue is recognized based on the number of hours worked by consultants at an agreed-upon rate per hour. For large services projects where costs to complete the contract could reasonably be estimated, the Company undertakes projects on a fixed-fee basis and recognizes revenues on the percentage of completion method of accounting based on the evaluation of actual costs incurred to date compared to total estimated costs. Revenues recognized in excess of billings are recorded as costs in excess of billings. Billings in excess of revenues recognized are recorded as deferred revenues until revenue recognition criteria are met. Reimbursements, including those relating to travel and other out-of-pocket expenses, are included in revenues, and an equivalent amount of reimbursable expenses are included in cost of services.

Software

Revenue from software licensing and maintenance and support are recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is reasonably assured. The Evoke software is delivered by the Company either directly to the customer or to a distributor on an order by order basis. The software is not sold with any right of return privileges and, as a result, a returns reserve is not applicable. License fee revenue is recognized by the Company in the period in which delivery occurs. Maintenance and support revenue is recorded in revenue on a pro rata basis over the term of the maintenance and support agreement. Deferred revenue is recorded when customers are invoiced for software maintenance and support. The revenue is recognized over the term of the maintenance and support agreement.

The Company licenses software and provides a maintenance and support agreement to customers. These items are invoiced as separate items and vendor-specific objective evidence is determined for the maintenance and support, generally by identifying in the contract the cost of the maintenance and support to the customer in subsequent renewal periods.

The percentage-of-completion method of accounting is not applicable for the Company's software sales.

Business Combinations

We are required to allocate the purchase price of acquired companies to the tangible and intangible assets acquired and liabilities assumed based on their estimated fair values. Such a valuation requires us to make significant estimates and assumptions, especially with respect to intangible assets. Critical estimates in valuing certain intangible assets include, but are not limited to, future expected cash flows from customer contracts, customer lists, distribution agreements and acquired developed technologies, and estimating cash flows from projects when completed and discount rates. Our estimates of fair value are based upon assumptions believed to be reasonable, but which are inherently uncertain and unpredictable and, as a result, actual results may differ from estimates. These estimates may change as additional information becomes available regarding the assets acquired and liabilities assumed. Additionally, in accordance with EITF 99-12, the Company values an acquisition based upon the market price of its common stock for a reasonable period before and after the date the terms of the acquisition are agreed to and announced.

Impairment of Goodwill, Intangible Assets and Other Long-Lived Assets

We evaluate our identifiable goodwill, intangible assets, and other long-lived assets for impairment on an annual basis and whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable based on expected undiscounted cash flows attributable to that asset. Future impairment evaluations could result in impairment charges, which would result in an expense in the period of impairment and a reduction in the carrying value of these assets.



Allowances for Doubtful Accounts

We make judgments regarding our ability to collect outstanding receivables and provide allowances for the portion of receivables when collection becomes doubtful. Provisions are made based upon a specific review of all significant outstanding invoices. For those invoices not specifically reviewed, provisions are provided at differing rates, based upon the age of the receivable. In determining these percentages, we analyze our historical collection experience and current economic trends. If the historical data we use to calculate the allowance provided for doubtful accounts does not reflect the future ability to collect outstanding receivables, additional provisions for doubtful accounts may be needed and our future results of operations could be materially affected.

Stock-based Compensation

We issue stock options to our employees and provide our employees the right to purchase ordinary shares under employee stock purchase plans. We account for our stock-based compensation plans under the intrinsic value method of accounting as defined by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") and related interpretations. For equity instruments under fixed plans, APB 25 does not require that any amount of expense to be recorded in the statement of income; however, SFAS No. 123, "Accounting for Stock-Based Compensation" does require disclosure of these amounts in a pro forma table to the financial statements. In determining this disclosure the value of an option is estimated using the Black Scholes option valuation model. This model requires the input of highly subjective assumptions and a change in our assumptions could materially affect the fair value estimate, and thus the total calculated costs associated with the grant of stock options or issuance of stock under employee stock purchase plans. In addition, in disclosing the fair-value cost of stock-based compensation, we estimate that we will be able to obtain a 40% tax benefit on these costs. There is the potential that this tax benefit will not be obtained to this extent or at all, which directly impacts the level of expenses associated with stock-based compensation. We expect our accounting policies, regarding stock-based compensation to be materially affected by our adoption of SFAS123R, which is described under "Recent Pronouncements." We have not yet determined what the impact of the adoption of SFAS123R will be on our compensation philosophy.

Deferred Income Taxes

Determining the consolidated provision for income tax expense, income tax liabilities and deferred tax assets and liabilities involves judgment. We record a valuation allowance to reduce our deferred tax assets to the amount of future tax benefit that is more likely than not to be realized. We have considered future taxable income and prudent and feasible tax planning strategies in determining the need for a valuation allowance. A valuation allowance is maintained by the Company due to the impact of the current years net operating loss (NOL). In the event that we determine that we would not be able to realize all or part of our net deferred tax assets, an adjustment to the deferred tax assets would be charged to net income in the period such determination is made. Likewise, if we later determine that it is more likely than not that the net deferred tax assets would be realized, then the previously provided valuation allowance would be reversed. Our current valuation allowance relates predominately to benefits derived from the utilization of our NOL's.

Recent Pronouncements

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("SFAS") No. 123R, "Share-Based Payment, an Amendment of SFAS No. 123 and 95". This final standard replaces the existing requirements under SFAS 123 and APB 25 and requires that all forms of share-based payments to employees, including employee stock options and employee stock purchase plans, be treated the same as other forms of compensation by recognizing the related cost in the statements of income. SFAS 123R eliminates the ability to account for stock-based compensation transactions using APB 25 and requires instead that such transactions be accounted for using a fair-value based method. SFAS 123R is effective for interim or annual periods beginning after June 15, 2005 and allows companies to restate the full year of 2005 to reflect the impact of expensing under SFAS 123R as reported in the footnotes to the financial statements for the first half of 2005. . The transitional provisions of SFAS 123R allow companies to select either a modified-prospective or modified-retrospective transition method which effectively impacts in which periods actual expense will be reported in the statements of income. We are in the process of determining the transitional method we will apply. We have not determined how SFAS123R will modify, if at all, our compensation philosophy in general or for stock option grants in particular. We cannot currently estimate the amount of stock-based compensation expense which will be related to stock option grants or the issue of warrants in 2005 and thereafter.



ISSUES AND UNCERTAINTIES

This Quarterly Report on Form 10-QSB contains statements that are forward-looking. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of issues and uncertainties such as those referenced below and elsewhere in this report, which, among others, should be considered in evaluating the Company's financial outlook.

For further information, refer to the Company's 2004 Annual Report filed with the Securities and Exchange Commission on Form 10-KSB on April 13, 2005.

Item 3. Controls and Procedures

Evaluation of disclosure controls and procedures.

Under the supervision and with the participation of our management, including our chief executive officer and our chief financial officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Securities Exchange Act of 1934 Rule 13a-15(e) as of the end of the period covered by this report. Based on that evaluation, and as a result of comments received in February 2005 from the Staff of the SEC pertaining to our Registration Statement on Form SB-2/A, File No. 333-115243 (the "Registration Statement"), our chief executive officer and our chief financial officer have concluded that a material weakness exists with regard to the valuation and purchase accounting of our recent acquisitions, including the inability to prepare financial statements and footnotes in accordance with SEC rules and regulations.

In connection with our acquisitions of DeLeeuw Associates, Inc. and Evoke Software Corporation, we misapplied generally accepted accounting principles whereby we did not value the acquisitions and record the resulting purchase accounting in accordance with SFAS 141 and EITF 99-12. As a result, we were required in March 2005 to restate our financial statements for the quarters ended March 31, 2004, June 30, 2004 and September 30, 2004. Management now believes and has determined that the disclosure controls and procedures for these three quarters were not effective.

In light of the need for these restatements and the material weakness in our valuation and purchase accounting for recent acquisitions, commencing in the first quarter of our 2005 fiscal year, we are beginning to undertake a review of our disclosure, financial information and internal controls and procedures regarding these areas for future acquisitions. This review will include efforts by our management and directors, as well as the use of additional outside resources, as follows:

o Senior accounting personnel and our chief financial officer will continue to review any future acquisition or divestiture in order to evaluate, document and approve its accounting treatment in accordance with SFAS 141 and EITF 99-12;

o We will augment, as necessary, such procedures by obtaining concurrence with independent outside accounting experts prior to finalizing financial reporting for such transactions; and

o We will incorporate the applicable parts of the action plan described in the next paragraph.

In conjunction with the measures outlined below, we believe these actions will strengthen our internal control over our valuation and purchase accounting of future acquisitions, and this material weakness should be resolved. Management does not anticipate any extra cost from this change in its valuation and purchase accounting of future acquisitions.

In addition, we previously identified two internal control matters. Neither relates to the subject matter of the material weakness described above, yet combined with the above-referenced material weakness, constitute in the aggregate a material weakness in our internal control over financial reporting. These internal control matters, identified in October 2004 by Friedman LLP, our independent registered public accounting firm, are summarized as follows:

o Lack of certain internal controls over period-end financial reporting related to the identification of transactions, primarily contractual, and accounting for them in the proper periods; and



o Accounting and reporting for our complex financing transactions related to the beneficial conversion features and the determination of the fair value of warrants in such transactions.

Management is establishing an action plan that it believes will correct the aggregated material weaknesses described above. Our estimated costs related to the correction of these material weaknesses is approximately $0.125 million, most notably related to our conversion to the Great Plains accounting system during the third quarter of 2004. The conversion to the Great Plains accounting system required inconsequential modifications to our transaction processing systems. The effect of the migration to this system has been to provide a better audit trail than our previous system. The batch processing of transactions provides the ability for review of transactions prior to being posted in the accounting system. Further, the ability to close and lock periods to prevent changes to prior periods provides greater reliability of the data and the financial statements (resulting from the financial statements being prepared directly by the accounting system as opposed to using spreadsheets, which have greater potential for error). Finally, this system has the ability to provide comparative financial statements to expectations, which drives variance reporting. As a result of this system change, there were changes in our internal control over financial reporting starting in the third quarter of 2004, as we have redesigned the organization structure to drive more focus on our internal control environment. Other measures included in our action plan are as follows:

o We have formed a Disclosure Committee consisting of our chief executive officer, chief operating officer, senior vice president of sales, general counsel and controller, chaired by our chief financial officer. The Disclosure Committee is comprised of these key members of senior management who have knowledge of significant portions of our internal control system, as well as the business and competitive environment in which we operate. One of the key responsibilities of each Disclosure Committee member is to review quarterly reports, annual reports and registration statements to be filed with the SEC as each progress through the preparation process. Open lines of communication to financial reporting management exist for Disclosure Committee members to convey comments and suggestions;

o A process to be established whereby material agreements are reviewed by the legal, accounting and sales departments and an executive management member that includes determination of appropriate accounting and disclosure;

o Our accounting and legal departments are now working more closely and in conjunction to accurately account for period-end financial reporting and complex financing transactions;

o We are constantly assessing our existing environment and continue to make further changes, as appropriate, in our finance and accounting organization to create clearer segregation of responsibilities and supervision, and to increase the level of technical accounting expertise including the use of outside accounting experts;

o There will be closer monitoring of the preparation of our monthly and quarterly financial information. We are in the process of instituting regular quarterly meetings to review each department's significant activities and respective disclosure controls and procedures and to have such in place by the end of the second quarter of 2005;

o Department managers have been tasked with tracking relevant non-financial operating metrics and other pertinent operating information and communicating their findings to a member of the Disclosure Committee; and

o We will conduct quarterly reviews of the effectiveness of our disclosure controls and procedures, and we have enhanced our quarterly close process to include detailed analysis in support of the financial accounts, and improved supervision over the process.

We believe that we will satisfactorily address the control deficiencies and material weakness relating to these matters by the end of the second quarter of 2005, although there can be no assurance that we will do so.

At the same time as we continue our efforts to improve our internal control environment, management of the Company is still in the process of implementing the above procedures and controls, including review and evaluation, to mitigate recognized weaknesses specifically for the preparation of the financial statements for the periods covered by this Quarterly Report on Form 10-QSB. Management believes that these procedures and controls are not yet effective in ensuring the proper collection, evaluation and disclosure of the financial information for the periods covered by this. Based on the foregoing, our chief executive officer and our chief financial officer concluded that our disclosure controls and procedures were not yet effective at a reasonable assurance level as of the date of this Quarterly Report.

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Management, including our chief executive officer and our chief financial officer, does not expect that our disclosure controls and internal controls will prevent all error or all fraud, even as the same are improved to address any deficiencies and/or weaknesses. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control.

Changes in internal control over financial reporting.

Our company also maintains a system of internal controls. The term "internal controls," as defined by the American Institute of Certified Public Accountants' Codification of Statement on Auditing Standards, AU Section 319, means controls and other procedures designed to provide reasonable assurance regarding the achievement of objectives in the reliability of our financial reporting, the effectiveness and efficiency of our operations and our compliance with applicable laws and regulations. In connection with the preparation of the Registration Statement, our management identified certain weaknesses in our internal control procedures and in our valuation and purchase accounting of our acquisitions in 2004. Our management and Board have adopted corrective measures as described in the third and fourth paragraphs of this Controls and Procedures section above. The following measures have materially affected our internal control over financial reporting since our last Quarterly Report:

o Senior accounting personnel and our chief financial officer will continue to review any future acquisition or divestiture in order to evaluate, document and approve its accounting treatment in accordance with SFAS 141 and EITF 99-12;

o We will augment, as necessary, such procedures by obtaining concurrence with independent outside accounting experts prior to finalizing financial reporting for such transactions;

o We have formed a Disclosure Committee consisting of our chief executive officer, chief operating officer, senior vice president of sales, general counsel and controller, chaired by our chief financial officer. The

Disclosure Committee is comprised of these key members of senior management who have knowledge of significant portions of our internal control system, as well as the business and competitive environment in which we operate. One of the key responsibilities of each Disclosure Committee member is to review quarterly reports, annual reports and registration statements to be filed with the SEC as each progress through the preparation process. Open lines of communication to financial reporting management exist for Disclosure Committee members to convey comments and suggestions;

o Our accounting and legal departments are now working more closely and in conjunction to accurately account for period-end financial reporting and complex financing transactions;

o There will be closer monitoring of the preparation of our monthly and quarterly financial information. We are in the process of instituting regular quarterly meetings to review each department's significant activities and respective disclosure controls and procedures and to have such in place by the end of the second quarter of 2005; and

o Department managers have been tasked with tracking relevant non-financial operating metrics and other pertinent operating information and communicating their findings to a member of the Disclosure Committee.



PART II. OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934

31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934

32.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(b)/15d-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350

32.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(b)/15d-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350

(b) Reports on Form 8-K:

None.



SIGNATURE

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.

CONVERSION SERVICES INTERNATIONAL, INC.

By: /s/ Scott Newman
-----------------------------------------
Name: Scott Newman
Title: President and Chief Executive Officer
(Principal Executive Officer and Duly Authorized Officer)

May 19, 2005

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