CONVERSION SERVICES INTERNATIONAL INC
Form 10QSB/A
April 13, 2005

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

FORM 10-QSB/A
Amendment No. 1

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

For the Quarterly Period Ended June 30, 2004

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

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

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

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 August 20, 2004, 766,129,715 of common stock, par value $0.001, were outstanding.

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

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Explanatory Note

This Amendment No. 1 to this Quarterly Report on Form 10-QSB for the quarter ended June 30, 2004 was filed in order to restate the consolidated financial statements as of and for the three and six months ended June 30, 2004 to revise the accounting treatment related to the purchase accounting for the Company's acquisitions of DeLeeuw Associates, Inc. and Evoke Software Corporation, to revise the accounting for a deferred tax liability recorded in connection with the DeLeeuw Associates acquisition, and certain merger costs associated with the reverse merger with LCS Group, Inc. See Note 1, Restatement of Financial Statements.

Part 1 has been amended herein to reflect this change. This amendment does not otherwise update information in the original filing to reflect facts or events occurring subsequent to the date of the original filing. All information contained in this amendment and the original filing is subject to updating and supplementing as provided in periodic reports subsequent to the original filing date of this Form 10-QSB with the Securities and Exchange Commission.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONVERSION SERVICES INTERNATIONAL, INC.
AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET
JUNE 30,2004
(Unaudited)

(Restated)

ASSETS	
CURRENT ASSETS	
Cash	$ 553,338
Restricted cash	83,375
Accounts receivable, net of allowance for doubtful accounts of $140,375	3,989,165
Accounts receivable from related parties - See note 7	786,232
Prepaid expenses	255,674
Costs in excess of billings	26,428
Deferred tax asset	687,576
TOTAL CURRENT ASSETS	6,381,788
PROPERTY AND EQUIPMENT, at cost, net	627,959
OTHER ASSETS	
Due from stockholders, including accrued interest of $24,330	206,354
Goodwill	27,197,882
Intangible assets, net of accumulated amortization of $184,991	5,503,823
Deferred financing costs	515,365
Equity investments	122,688
Other assets	13,420
	33,559,532
Total Assets	$ 40,569,279
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES	
Line of credit	$ 2,041,125
Current portion of long-term debt	68,137
Accounts payable and accrued expenses	3,632,446
Deferred revenue	1,303,287
TOTAL CURRENT LIABILITIES	7,044,995
LONG-TERM DEBT, net of current portion	2,099,618
DEFERRED TAXES	36,900
Total Liabilities	9,181,513
MINORITY INTEREST	199,400
COMMITMENTS AND CONTINGENCIES	-
STOCKHOLDERS' EQUITY	
Common stock, $0.001 par value, 1,000,000,000 shares authorized; 766,129,715 issued and outstanding	766,130
Additional paid in capital	32,158,114
Accumulated deficit	(1,735,878)
Total Stockholders' Equity	31,188,366

Total Liabilities and Stockholders' Equity	$ 40,569,279

See Notes to Consolidated Financial Statements.

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

	Three Months Ended June 30,		Six Months Ended	
	2004	2003	2004	2
	(Restated)		(Restated)	
REVENUE	$ 6,516,028	$ 3,660,323	$ 11,778,065	$ 7
COST OF SERVICES	4,379,625	2,501,926	8,218,925	5
GROSS PROFIT	2,136,403	1,158,397	3,559,140	2
OPERATING EXPENSES				
Selling and marketing	785,943	309,786	1,367,368	
General and administrative	1,782,127	678,305	3,195,079	1
Depreciation and amortization	102,108	50,528	152,352	
	2,670,178	1,038,619	4,714,799	1
INCOME (LOSS) FROM OPERATIONS	(533,775)	119,778	(1,155,659)	
OTHER INCOME (EXPENSE)				
Equity in losses from investments	(14,486)	--	(16,088)	
Other income	455	--	7,006	
Interest income	1,429	--	1,872	
Interest expense	(772,228)	(50,551)	(804,781)	
	(784,830)	(50,551)	(811,991)	
INCOME (LOSS) BEFORE INCOME TAXES	(1,318,605)	69,227	(1,967,650)	
INCOME TAXES (BENEFIT)	(244,278)	--	(459,878)	
NET INCOME (LOSS)	$ (1,074,327)	$ 69,227	$ (1,507,772)	$
UNAUDITED PRO FORMA DATA (Note 1):				
Income before income taxes (benefit)	$ --	$ 69,227	$ --	$
Income taxes (benefit)	--	27,691	--	
Net income	$ --	$ 41,536	$ --	$
Net income (loss) per share	$ (0.00)	$ 0.00	$ (0.00)	$

	============	=============	============	====
Weighted average number of common shares used in the actual and pro forma net income (loss) per share calculations	680,777,170	450,000,000	627,289,684	450

See Notes to Consolidated Financial Statements.

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

	Six months ended June 30,	
	2004	2003
	(Restated)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ (1,507,772)	$ 29,880
Adjustments to reconcile net income (loss)to net cash used in operating activities:		
Depreciation	43,652	34,362
Amortizaton of intangible assets and deferred financing costs	116,233	49,916
Deferred tax asset	(459,879)	--
Non-cash beneficial conversion feature charge	666,667	--
Compensation expense for stock options and stock issued	89,000	--
Allowance for doubtful accounts	65,368	36,000
Write-off deferred loan costs	24,862	--
Loss on disposal of equipment	35,496	--
Loss on equity investments	16,088	--
Changes in operating assets and liabilities:		
Increase in accounts receivable	(1,133,077)	(618,242)
(Increase) decrease in prepaid expenses	(63,339)	2,487
(Increase) in costs in excess of billings	(26,428)	--
(Increase) decrease in due from stockholders	(2,731)	50,000
Decrease in other assets	14,721	--
Increase in accounts payable and accrued expenses	642,566	46,185
Increase in deferred revenue	49,244	--
Net cash used in operating activities	(1,429,329)	(369,412)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of property and equipment	(186,389)	(19,351)
Investment in DeLeeuw Associates, net of cash acquired	(2,010,266)	--
Investment in Evoke Software Corp., net of cash acquired	466,583	--
Equity investment in Leading Edge Communications Corp.	(83,000)	--
Net cash used in investing activities	(1,813,072)	(19,351)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Cash overdraft	(51,900)	--
Net advances under line of credit	2,041,125	949,863

Line of credit repayment	(1,789,110)	--
Issuance of convertible line of credit notes	4,000,000	225,000
Deferred loan costs in connection with line of credit	(30,534)	--
Principal payments on long-term debt	(657,882)	(291,875)
Principal payments on capital lease obligations	(44,171)	--
Distributions to stockholders	--	(439,784)
Restricted cash	(83,375)	--
Net cash provided by financing activities	3,384,153	443,204
NET INCREASE IN CASH	141,752	54,441
CASH, beginning of period	411,586	--
CASH, end of period	$ 553,338	$ 54,441

See Notes to Consolidated Financial Statements.

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CONVERSION SERVICES INTERNATIONAL, INC.
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six months ended June 30,	
	2004	2003
	(Restated)	
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest	$ 60,046	$ 57,989
Cash paid for income taxes	--	--

SUPPLEMENTAL DISCLOSURE OF NON-CASH ACTIVITIES:

During 2004 and 2003, the Company entered into various capital lease arrangements computer and trade show equipment in the amount of $227,139 and $0, respectively.

During March 2004, the Company acquired substantially all of the assets and liabilities of DeLeeuw Associates, Inc.

The components and allocations of the purchase price were based on the fair value of assets and liabilities acquired as of the acquisition date.

COMPONENTS OF PURCHASE PRICE:

Cash payments	$ 1,939	--
Acquisition costs	71	--
Value of Common Stock	15,840	--
	$ 17,850	--

ALLOCATION OF PURCHASE PRICE:

Approved vendor status (40 month life)	(539)	--
Accounts receivable	(975)	--
Tradename (indefinite life)	(722)	--
Goodwill	(15,844)	--
Other assets	(56)	--
Current liabilities assumed	286	--
	$ --	$ --

During June 2004, the Company acquired substantially all of the assets and liabilities of Evoke Software Corporation.

The components and allocations of the purchase price were based on the fair value of assets and liabilities acquired as of the acquisition date.

COMPONENTS OF PURCHASE PRICE:

Value of Common Stock	$ 12,384	$ --
Acquisition costs	31	--
	$ 12,415	--

ALLOCATION OF PURCHASE PRICE:

Customer contracts (Six year estimated life)	(1,962)	--
Computer software (Three year estimated life)	(1,381)	--
Goodwill	(10,269)	--
Trade name (indefinite life)	(651)	--
Accounts receivable	(580)	--
Furniture and equipment	(184)	--
Cash	(497)	--
Prepaid expenses	(78)	--
Other assets	(11)	--
Deferred revenue	1,254	--
Deferred compensation	443	--
Other liabilities	1,302	--
Minority interest	199	--
	$ --	$ --

On May 5, 2004, a $2,000,000 Unsecured Convertible Line of Credit Note was converted into 16,666,666 shares of Company common stock. The conversion price was $0.12 per share, which represented 75% of the market price on the date of conversion. The $666,667 effect of this beneficial conversion feature is reflected in the Company's statement of operations for the current period.

See Notes to Consolidated Financial Statements.

CONVERSION SERVICES INTERNATIONAL, INC.
AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 - Accounting Policies

Organization and Business

Conversion Services International, Inc. ("CSI" or the "Company") was incorporated in the State of Delaware and has been conducting business since 1990. CSI is principally engaged in the information technology services industry in the following areas: data warehousing, business intelligence, management consulting and professional services, on credit, to its customers principally located in the northeastern United States. On November 1, 2002, the Company acquired the operations of Scosys, Inc. ("Scosys"). Scosys is engaged in the information technology services industry. On January 30, 2004, CSI became a public company through our merger with a wholly-owned subsidiary of LCS Group, Inc. On March 4, 2004, the Company acquired DeLeeuw Associates, Inc. ("DeLeeuw"). DeLeeuw is a management consulting firm specializing in integration, reengineering and project management. On May 1, 2004, the Company acquired a 49% interest in Leading Edge Communications Corporation ("LEC"), a provider of enterprise software and services solutions for technology infrastructure management. On June 28, 2004, the Company acquired substantially all the assets of Evoke Software Corporation ("Evoke"), a provider of data discovery, profiling and quality management software. Doorways, Inc. is a wholly-owned subsidiary of CSI that is currently dormant.

Basis of Presentation

In the opinion of management, the accompanying consolidated balance sheet and related interim consolidated statements of operations and cash flows include all adjustments necessary for their fair presentation in conformity with accounting principles generally accepted in the United States of America. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. Actual results and outcomes may differ from management's estimates and assumptions.

Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-QSB should be read in conjunction with Management's Discussion and Analysis and financial statements and notes thereto included in the Conversion Services International, Inc. Current Report on Form 8-K/A filed with the Securities and Exchange Commission on April 1, 2004.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of CSI and its subsidiaries, Doorways, Inc., DeLeeuw, and Evoke Software Corporation (formerly known as Evoke Asset Purchase Corp.). All intercompany transactions and balances have been eliminated in 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

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. Revenues for large services projects are recognized using the percentage of completion method for long-term construction type contracts where costs to complete the contract could reasonably be estimated. 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.

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. 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.

Amortization

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 that approximates the estimated life of the contracts, based upon the estimated annual cash flows obtained from those contracts, generally five to six years. In conjuction with the DeLeeuw acquisition an intangible asset (Approved Vendor Status) was acquired which has been determined to have a 40 month life and is being amortized over this period.

Goodwill and intangible assets

Goodwill represents the amounts paid in connection with a settlement agreement with the Elligent Consulting Group to re-acquire the ownership rights to the Company in 1998 and in connection with the acquisitions of Scosys, DeLeeuw and Evoke. Additionally, as part of the Scosys, DeLeeuw and Evoke acquisitions, the Company acquired intangible assets. FASB Statement 142 was adopted as of January 1, 2002 for all goodwill recognized in the Company's balance sheet as of December 31, 2001. This statement changed the accounting for goodwill from an amortization method to an impairment-only approach, and introduced a new model for determining impairment charges.

Goodwill and intangible assets are reviewed for impairment whenever events or circumstances indicate impairment might exist, or at least annually. The Company assesses the recoverability of its assets, in accordance with SFAS No. 142 "Goodwill and Other Intangible Assets," comparing projected undiscounted cash flows associated with those assets against their respective carrying amounts. Impairment, if any, is based on the excess of the carrying amount over the fair value of those assets. The Company's goodwill and intangible assets were evaluated and deemed not to be impaired at December 31, 2003. There have been no events or circumstances that would indicate that there has been any impairment during the six months ended June 30, 2004.

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 June 30, 2004, five customers comprised approximately 46% of the Company's accounts receivable balance.

Advertising

The Company expenses advertising costs as incurred. Advertising costs amounted to $54,000 and $68,000, and $600 and $2,300, for the three and six month periods ended June 30, 2004 and 2003, respectively.

Income taxes

The Company accounts for income taxes 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.

On January 1, 2001, CSI elected to be an "S" Corporation, whereby the stockholders account for their share of CSI's earnings, losses, deductions and credits on their federal and various state income tax returns. CSI is subject to New York City and various state income taxes. On September 30, 2003, CSI's "S" Corporation status was revoked in connection with the conversion of convertible subordinated debt into shares of common stock.

For informational purposes, the accompanying statements of operations include an unaudited pro-forma adjustment for income taxes which would have been recorded if CSI had not been an "S" Corporation.

Derivatives

In September 1998, the Financial Accounting Standards Board ("FASB") issued SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133), which requires the recognition of all derivatives as either assets or liabilities measured at fair value, with changes in value reflected as current period income (loss) unless specific hedge accounting criteria are met. The effective date of SFAS No. 133, as amended by SFAS No. 138, is for fiscal years beginning after September 15, 2000. The Company adopted SFAS No. 133 as of January 1, 2001, resulting in no material impact upon adoption or on the subsequent reporting periods.

Equity investments

In August 2003, DeLeeuw acquired a non-controlling interest in DeLeeuw International (a company formed under the laws of Turkey). The Company is accounting for its share of the income (losses) of this investment under the equity method.

CSI acquired 49% of all issued and outstanding shares of common stock of LEC as of May 1, 2004. The acquisition was completed through a Stock Purchase Agreement between CSI and Mary Ferrara, the sole stockholder of LEC. In connection with the acquisition, CSI (i) repaid a bank loan on behalf of the seller in the amount of $35,000; (ii) repaid an LEC bank loan in the amount of $38,000; and (iii) satisfied an LEC obligation for $10,000 of prior compensation to an employee. The Company accounts for its share of the income (losses) of this investment under the equity method.

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.

Restatement of Financial Statements (unaudited)

As a result of discussions with the Staff at the Securities and Exchange Commission, the Company made the decision to restate its accounting for the acquisitions of DeLeeuw Associates, Inc. and Evoke Software Corporation. The original purchase accounting for these acquisitions was recorded by the Company in the Quarterly Report on Form 10-QSB for the quarter ended March 31, 2004 for the DeLeeuw acquisition and for the quarter ended June 30, 2004 for the Evoke acquisition. Additionally, during this process, it was determined that a deferred tax liability and the accounting for certain merger costs were initially recorded incorrectly. These changes require restatement of the Company's Quarterly Reports for the periods ending March 31, June 30 and September 30 2004.

The restatement relates to the following accounting transactions:

- The cost of the common stock issued in the acquisition is being recorded based upon the weighted average trading price of the Company's stock on the OTC Bulletin Board for the four days before and after the announcement of the transaction. The Company previously used an alternative method for valuing the stock issued by the Company in these transactions;

- The Company recorded an intangible asset as a result of the DeLeeuw acquisition and initially classified this asset as having an indefinite life. The Company has revised the classification of this intangible asset and assigned a definitive life to the asset. As a result of this change, approximately $15,000 and $40,000 of additional amortization expense was recorded by the Company during the quarters ended March 31, 2004 and June 30, 2004, respectively.

- The Company initially recorded $300,000 deferred tax liability as part of the DeLeeuw Associates purchase accounting with the corresponding offset to goodwill. This accounting was subsequently determined to be incorrect and was reversed.

- The Company recorded certain merger costs associated with its reverse merger in LCS Group as a reduction of additional paid in capital. It was inadequately determined to be incorrect and this item was recorded as additional expense.

A summary of the balance sheet and income statement effects of the restatement for the three and six months ended June 30, 2004 is as follows:

	As of June 30, 2004	
	As reported	Restated
Goodwill	2,506,224	27,197,882
Intangible assets, net	6,275,095	5,503,823
Total assets	16,648,893	40,569,279
Deferred taxes	(336,900)	(36,900)
Accumulated deficit	(1,586,319)	(1,735,878)
Additional paid-in capital	7,788,169	32,158,114

	Three months ended June 30, 2004		Six months ended June 30,	
	As reported	Restated	As reported	Restated
Depreciation and amortization	61,697	102,108	98,471	152,35
General and administration	--	--	3,162,907	3,195,07
Loss from operations	(493,307)	(533,775)	(1,006,100)	(1,155,65
Loss before income taxes	(1,278,137)	(1,318,605)	(1,818,092)	(1,967,65
Net loss	(1,033,916)	(1,074,327)	(1,358,213)	(1,507,77
Loss per share	(0.00)	(0.00)	(0.00)	(0.0

Reclassifications

Certain amounts have been reclassified to conform to the Company's current presentations. The reclassifications have no effect on total revenue or net loss for the period.

Note 2 - Acquisition of Evoke Software Corporation

On June 28, 2004, CSI, through its subsidiary Evoke Asset Purchase Corp., acquired substantially all of the assets and assumed substantially all of the liabilities of Evoke, a privately-held California corporation. The acquisition was completed pursuant to an Asset Purchase Agreement between CSI, Evoke Asset Purchase Corp. and Evoke. In connection with the acquisition, CSI (i) issued 72,543,956 shares of its common stock to Evoke, 7,150,000 of which have been deposited into an escrow account for a period of one-year and may be reduced based upon claims for indemnification that may be made pursuant to the agreement; (ii) issued 5% of the outstanding shares of the Evoke Asset Purchase Corp. to Evoke; (iii) issued 3,919,093 shares of its common stock to certain executives of Evoke as a severance payment and to certain employees as retention shares; and (iv) agreed to pay $448,154 in deferred compensation to certain employees of Evoke. For accounting purposes, this transaction was deemed to have occurred on June 30, 2004. Transaction volumes between June 28 and June 30, 2004 were de-minimis.

Exclusive of future contingent consideration, the components and allocations of the purchase price was allocated to the various assets and liabilities of Evoke as follows:

COMPONENTS OF PURCHASE PRICE:

Value of Common Stock	$12,384	
Acquisition costs	21	
	$12,405	

ALLOCATION OF PURCHASE PRICE:

Customer contracts	(1,962)	.....(Six year estimated life)
Computer software	(1,381)	.....(Three year estimated life)
Goodwill	(10,259)	
Trade name	(651)	.....(indefinite life)
Accounts receivable	(580)	
Furniture and equipment	(184)	
Cash	(497)	
Prepaid expenses	(78)	
Other assets	(11)	
Deferred revenue	1,254	
Deferred compensation	443	
Other liabilities	1,302	
Minority interest	199	
	$ --	

The following unaudited statements of income and financial position reflect the pro forma consolidated results as of June 30, 2004 and 2003 and for the six month periods then ended. These statements present the consolidated results of Conversion Services International, Inc., DeLeeuw Associates, LLC and Evoke Software Corporation for the aforementioned periods as if the entities had been consolidated for the entire six month periods in both years presented.

	Six Months Ended June 30, 2004	Six Months Ended June 30, 2003
Revenues	$ 15,263,889	$ 12,486,228
Net Loss	$ (1,617,433)	$ (1,232,942)
Net Loss per share	$ (0.00)	$ (0.00)

Note 3 - Property and equipment

Property and equipment consisted of the following:

	June 30, 2004
Computer equipment	$ 787,335
Furniture and fixtures	198,026
Automobiles	72,833
Leasehold improvements	216,306
	1,274,500
Accumulated depreciation	(646,541)
	$ 627,959

Note 4 - Intangible assets

Intangibles acquired have been assigned as follows:

	June 30, 2004
Customer contracts	$ 1,962,000
Approved vendor status	538,814
Computer software	1,381,000
Tradename	1,373,000
Customer lists and contracts	414,000
Proprietary rights and rights to the name of Scosys Inc.	20,000
	5,688,814
Accumulated amortization	(184,991)
	$ 5,503,823

Note 5 - Line of credit

On March 30, 2004, the Company executed a $3,000,000 revolving line of credit with North Fork Bank (formerly known as TrustCompany Bank) secured by substantially all of the corporate assets. The terms of this note provide for interest accruing on advances at seven eighths of one percent (7/8%) over the institution's prime rate.

On August 16, 2004, the Company replaced its $3,000,000 available line of credit with North Fork Bank with a revolving line of credit with Laurus Master Fund, Ltd. ("Laurus"), whereby the Company will have access to borrow up to $6,000,000 based upon eligible accounts receivable. A portion of the Laurus line of credit will be used to pay off all outstanding borrowings from North Fork Bank under the line of credit agreement. See note 13 - subsequent events for further discussion of this transaction.

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Note 6 - Long term debt

Long-term debt consisted of the following:	June 30, 2004
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 conversion price of the shares of common stock is equal to 75% of the average bid price for the prior ten trading days. In the event of the Company's non-compliance with certain requirements, the conversion price may permanently adjust 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. This debt financing cost is being amortized	

into income over the life of the note.	$ 2,000,000
Notes payable under capital lease obligations payable to various finance companies for equipment at varying rates of interest and maturity dates through 2007.	167,755
	2,167,755
Less: Current portion of long-term debt, including obligations under capital leases of $68,137.	(68,137)
	$ 2,099,618

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

Years Ending June 30,	
2005	$ 68,137
2006	71,631
2007	27,987
2008	--
2009	2,000,000
	$ 2,167,755

In May 2004, the conversion option in the unsecured convertible line of credit note dated October 29, 2003 was exercised by the holder. As a result of the exercise, 16,666,666 shares of the Company's common stock were issued at an exercise price per share of $0.12, which price represents 75% of the fair market value of the stock on the date of conversion. Since the conversion price was less than the market value of the common stock, the Company recorded a $666,667 beneficial conversion charge that reduced earnings available to common stockholders. The Company has reflected this beneficial conversion charge in the accompanying consolidated statements of operations.

Note 7 - Related Party Transactions

In November 2003, the Company executed an Independent Contractor Agreement with LEC, whereby CSI agreed to be a subcontractor for LEC, and to provide consultants as required to LEC. In return for these services, CSI receives a fee from LEC based on the hourly rates established for consultants subcontracted to LEC.

CSI acquired 49% of all issued and outstanding shares of common stock of LEC as of May 1, 2004. The acquisition was completed through a Stock Purchase Agreement between CSI and Mary Ferrara, the sole stockholder of LEC. In connection with the acquisition, CSI (i) repaid a bank loan on behalf of the seller in the amount of $35,000; (ii) repaid an LEC bank loan in the amount of $38,000; and (iii) satisfied an LEC obligation for $10,000 of prior compensation to an employee.

For the three and six months ended June 30, 2004, CSI invoiced LEC $871,000 and $1,841,000, respectively, for the services of consultants subcontracted to LEC by CSI. As of June 30, 2004, CSI had accounts receivable due from LEC of approximately $786,000.

As of June 30, 2004, Scott Newman, Chief Executive Officer, and Glenn

Peipert, Chief Operating Officer, owed the Company an aggregate of approximately $206,000, including accrued interest. These loans bear interest at 3% per annum and are due and payable by December 31, 2005.

Note 8 - 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 $227,139.

The following schedule lists future minimum lease payments under the capital leases with their present value as of June 30, 2004:

Years Ending June 30,	
2005	$ 97,734
2006	85,186
2007	26,563
	209,483
Less: Amount representing interest	(41,728)
	$ 167,755

Note 9 - Stock options

The 2003 Incentive 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. On March 29, 2004 and April 12, 2004, the Company granted a total of 19,950,000 options to purchase its common stock at an exercise price of $0.165 per share. The options granted are a combination of both incentive and nonqualified options, vest over a three year period from the date of grant, and expire ten years from the date of grant. Between May and June 2004, the Company granted 11,905,000 options to purchase its common stock at an exercise price of $0.20 per share. The options granted are all incentive options, vest over a three year period from the date of grant, and expire ten years from the date of grant.

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 APB25, 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 450,000 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.

The following pro-forma net income and earnings per share (EPS) reflects the difference between stock compensation costs charged to operations under the APB 25 intrinsic value method and pro-forma stock compensation cost that would have been recorded if the SFAS 123 fair value method had been applied. 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. CSI'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.

	Six months ended June 30, 2004
Reported net loss	$ (1,507,772)
Pro-forma stock compensation, net of tax	(139,238)
Pro forma net loss	$ (1,647,010)
Basic EPS:	
As reported	$ (0.00)
Pro-forma	$ (0.00)
Diluted EPS:	
As reported	$ (0.00)
Pro-forma	$ (0.00)
Weighted average fair value per option share granted	$ 0.13
Weighted average assumptions used to value options granted:	
Risk free interest rate	1.33%
Expected volatility	139%
Expected life (years)	3.00

Note 10 - Earnings Per Share

Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings 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.

The components of basic and diluted earnings per share are as follows:

	Three Months Ended June 30,	
	2004	2003
Net income (loss) available for common stockholders (A)	$ (1,074,327)	$ 69,227
Weighted average outstanding shares of common stock (B)	680,777,170	450,000,000
Common stock and common stock equivalents (C)	680,777,170	450,000,000
Earnings (loss) per share:		

Basic (A/B)	$ (0.00)	$ 0.00
Diluted (A/C)	$ (0.00)	$ 0.00

For the three and six months ended June 30, 2004, 32,305,000 shares attributable to outstanding stock options were excluded from the calculation of diluted earnings per share because the effect was antidilutive. There were no stock options outstanding during 2003. Additionally, the effect of 4,166,666 warrants which were issued on June 7, 2004 were excluded from the calculation of diluted earnings per share for both the three and six months ended June 30, 2004 because the effect was antidilutive.

Note 11 - Income Taxes

Our 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.

During the first six months of 2004, our effective tax rate was estimated to be approximately 40%.

Note 12 - Commitments and Contingencies

On June 29, 2004, Viant Capital LLC commenced legal action against us 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 our loan from a private investor in May 2004. Management believes that this loan does not qualify as a private equity transaction and we intend to vigorously defend the company. As of August 20, 2004, there have been no material developments in the suit. 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.

Note 13 - Subsequent Events

On August 16, 2004, the Company replaced its $3,000,000 line of credit with North Fork Bank with a revolving line of credit with Laurus Master Fund, Ltd. ("Laurus"), whereby the Company will have access to borrow up to $6,000,000 based upon eligible accounts receivable. This revolving line, effectuated through a $2,000,000 convertible minimum borrowing note and a $4,000,000 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) plus 1%, and maturing in three years. 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 $2,000,000 convertible minimum borrowing note and the $4,000,000 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 Company stock or derivatives convertible into Company stock for a price less 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 $5,000,000 to be used for acquisitions. 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 stock or derivatives convertible into Company stock for a price less the fixed conversion price, then the fixed conversion price is reset to the lower price. 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. A portion of Laurus's revolving line of credit will be used to pay off all outstanding borrowings from North Fork Bank. The Company issued Laurus a common stock purchase warrant that provides Laurus with the right to purchase 12,000,000 shares of the Company's common stock. The exercise price for the first 6,000,000 shares acquired under the warrant is $0.29 per share, the exercise price for the next 3,000,000 shares acquired under the warrant is $0.31 per share, and the exercise price for the final 3,000,000 shares acquired under the warrant is $0.35 per share. The common stock purchase warrant expires on August 16, 2011. The Company paid $749,000 in brokerage and transaction closing related costs. These costs will be deducted from the $5,000,000 restricted cash balance being provided to the Company by Laurus.

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

Overview

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 "Issues and Uncertainties" and elsewhere in this report. We undertake no duty to update any forward-looking statement to conform the statement to actual results or changes in our expectations.

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We are in the business of supplying professional services relating to information technology management consulting, data warehousing and business intelligence, and, as a result of our 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. Our clients are primarily in the financial services, pharmaceutical and telecommunications industries, although we have clients in other industries as well. Our clients are primarily located in the northeastern United States. We enable organizations to leverage their corporate information assets by providing strategy, process and methodology, best practices data warehousing, business intelligence, enterprise reporting and analytic solutions.

Conversion Services International, Inc. began operations in 1990. Our services were originally focused on e-business solutions and data warehousing. In the late 1990s, we strategically repositioned ourselves to capitalize on our data warehousing expertise in the fast growing business intelligence/data warehousing space. We became a public company through our merger with a wholly owned subsidiary of LCS Group, Inc., effective as of January 30, 2004.

Our core strategy includes capitalizing on the already established in-house business intelligence/data warehousing ("BI/DW") technical expertise and our seasoned sales force. This is expected to result in organic growth through the acquisition of new customers. In addition, this foundation will be leveraged as we pursue targeted strategic acquisitions. The BI/DW industry as a whole is an extremely fragmented marketplace which we believe is ready for consolidation.

One of our objectives is to make acquisitions of companies in the BI/DW industry that will enable us to accelerate our business plan at lower costs than we would generate internally and also improve our competitive positioning and expand our offerings in a larger geographic area. We intend to seek acquisitions of other consulting firms that have expertise and clients in strategic locations or industries.

Revenue from consulting and professional services is recognized at the time the services are performed, evidence of an arrangement exists, the fee is fixed or determinable and our ability to collect is reasonably assured. On certain large service engagements, revenue is recognized using the percentage of completion method for long-term construction type contracts where costs to complete the engagement could reasonably be estimated. Our services range from providing clients with a single consultant to multi-personnel full-scale projects. Our contracts provide that its services are terminable upon relatively short notice, typically not more than 30 days. There can be no assurance that our clients will continue to enter into contracts with us or that existing contracts will not be terminated. We provide our services directly to end-user organizations, in most cases.

During the six month period ended June 30, 2004, five of our clients accounted for approximately 52% of total revenues. During the six month period ended June 30, 2003, four clients accounted collectively for approximately 55% of total revenues.

Our most significant costs are personnel expenses, which consist of consultant fees, benefits and payroll-related expenses, and outside consultants.

Results of Operations

Revenue

Our revenues are primarily comprised of billings to clients for consulting hours worked on client projects. Revenues for the three and six months ended June 30, 2004 were $6.5 million and $11.8 million, respectively, an increase of 78.0% and 65.9% over the three and six months ended June 30, 2003, respectively. This increase was primarily attributable to project design and infrastructure projects obtained in the fourth quarter of 2003 that are still ongoing, the acquisition of several new clients, business attributed to DeLeeuw Associates, LLC during 2004, and a general increase in consulting business as the overall demand for IT services improves.

Cost of services

Cost of services primarily includes payroll and benefits costs for our consultants. Cost of services was $4.4 million, or 67.2% of revenue, and $8.2 million, or 69.8% of revenue for the three and six months ended June 30, 2004, respectively, compared to $2.5 million, or 68.4% of revenue, and $5.1 million, or 71.6% of revenue for the three and six months ended June 30, 2003, respectively. The increase in absolute dollars resulted primarily from costs related to consultants on project design and infrastructure projects, the acquisition of DeLeeuw Associates, Inc. in March 2004, and additional consultants hired to staff projects for the new clients that we obtained. Cost of services declined as a percentage of revenue due to a shift in the mix of business to higher level projects that have increased hourly billing rates, and higher gross margin percentages associated with them.

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 $0.8 million, or 12.1% of revenue, and $1.4 million, or 11.6% of revenue, for the three and six months ended June 30, 2004, respectively, compared to $0.3 million, or 8.5% of revenue, and $0.6 million, or 8.8% of revenue, for the three and six months ended June 30, 2003, respectively. Selling and marketing costs increased in absolute dollars primarily due to increased payroll and related costs associated with the increased headcount in our sales force. We have hired additional salespeople as part of our strategy to gain new clients and increase our revenue.

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 $1.8 million, or 27.3% of revenue, and $3.2 million, or 27.1% of revenue, for the three and six months ended June 30, 2004, respectively, compared to $0.7 million, or 18.5% of revenue, and $1.2 million, or 16.6% of revenue, for the three and six months ended June 30, 2003, respectively. General and administrative costs primarily increased due to increased headcount resulting from the acquisition of DeLeeuw Associates, Inc., increased salaries paid to our officers due to hiring a chief financial officer during the fourth quarter of 2003 and increasing the salaries of our other company officers to compensate them competitively with other public companies our size. We also increased general and administrative headcount in the first quarter to support the increased size of the business which increased overall salary expense, incurred increased legal and accounting fees associated with becoming a public company and higher insurance premiums due to the growth of the Company.

Depreciation and amortization

Depreciation expense is recorded on our property and equipment which is generally depreciated over a period between three to seven years. Amortization is recorded for acquired intangible assets that have a finite useful life and for financing costs. Amortization of acquired intangible assets that have a finite useful life is recorded over the estimated useful life of the asset. Financing costs are amortized over the life of the related loans. Depreciation and amortization expenses were $0.1 million and $0.2 million for the three and six months ended June 30, 2004, respectively, compared to $51,000 and $95,000 for the three and six months ended June 30, 2003, respectively.

Other income (expense)

We incur interest expense on loans from financial institutions, from capital lease obligations related to the acquisition of equipment used in our business, and on the outstanding convertible line of credit notes. Amortization of the deferred financing costs is also recorded as interest expense. Interest expense recorded was $0.1 million and $0.1 million for the three and six months ended June 30, 2004, respectively, compared to $51,000 and $81,000 for the three and six months ended June 30, 2003, respectively. We earn interest income on deposits with our financial institution. Interest income for the three and six month periods ended June 30, 2004 was $1,400 and $1,900, respectively, compared to zero for the three and six month periods in the prior year. We recorded equity income in our investment in DeLeeuw, Turkey of $9,200 and $7,700 for the three and six months ended June 30, 2004, respectively, and an equity loss in our investment in LEC of $23,700 for the three and six months ended June 30, 2004, respectively.

Income Taxes

An income tax benefit of $0.2 million and $0.5 million was recorded for the three and six months ended June 30, 2004, respectively. This benefit was computed by multiplying our net loss by our estimated effective tax rate of 40%. No income tax expense or benefit was recorded in the prior year as the Company was an "S" Corporation through September 30, 2003. Pro forma income taxes for the comparable three and six month periods in the prior year would have been an income tax provision of $28,000 and $12,000, respectively, using the effective tax rate of 40%.

LIQUIDITY AND CAPITAL RESOURCES

Cash totaled $0.6 million as of June 30, 2004 compared to $0.4 million as of December 31, 2003. Our cash balance is primarily derived from customer remittances, bank borrowings and acquired cash and is used for general working capital needs. We had $83,000 on deposit with a financial institution as collateral for a letter of credit and have classified this as restricted cash on the accompanying consolidated balance sheet.

Cash used by operations during the six months ended June 30, 2004 was $1.4 million, an increase of $1.0 million from the six months ended June 30, 2003. This increase in cash used by operations is primarily due to a $0.5 million increase in accounts receivable, a $0.5 million increase in the deferred tax asset during the six month period and the net loss of $0.7 million, which was partially offset by an increase in accounts payable and accrued expenses of $0.6 million. The increase in accounts receivable is due to billings to new clients and increased business with several established clients. Non-cash expenses included depreciation, amortization, and the allowance for doubtful accounts.

Cash used by investing activities was $1.8 million during the six months ended June 30, 2004. This was due to payments of $2.0 million made primarily as acquisition payments for DeLeeuw Associates, Inc. and for the purchases of equipment for the Company.

Cash provided by financing activities was $3.4 million during the six months ended June 30, 2004. During the first six months of 2004, $4.0 million was raised from the issuance of line of credit notes, all outstanding amounts under our previous line of credit and notes payable agreements with Fleet Bank, totaling $2.3 million, were repaid and $2.0 million was borrowed from our new line of credit with North Fork Bank.

On August 16, 2004, the Company replaced its $3.0 million line of credit with North Fork Bank with a revolving line of credit with Laurus Master Fund, Ltd. ("Laurus"), whereby the Company will have 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) plus 1%, and maturing in three years. 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 Company stock or derivatives convertible into Company stock for a price less 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. 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 stock or derivatives convertible into Company stock for a price less the fixed conversion price, then the fixed conversion price is reset to the lower price. 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. A portion of Laurus's revolving line of credit will be used to pay off all outstanding borrowings from North Fork Bank. 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. The Company paid $0.75 million in brokerage and transaction closing related costs. These costs will be deducted from the $5.0 million restricted cash balance being provided to the Company by Laurus.

In May 2004, pursuant to the complete conversion of an unsecured convertible line of credit note issued in October 2003, the participating investor received 16,666,666 shares of our common stock, plus interest. Further in May 2004, we raised an additional $2.0 million pursuant to a new five-year unsecured promissory note with the same investor. In June 2004, we replaced the May 2004 note by issuing a five-year $2.0 million unsecured convertible line of credit note with the same investor. The note accrues at an annual interest rate of 7%, and the conversion price of the shares of common stock issuable under the note is equal to 75% of the average bid price for the prior ten trading days (prior to the date of conversion) of the common stock on the date of conversion. Under certain circumstances, the conversion price may be adjusted to a fixed conversion price of $0.105 per share. In addition, such investor received a warrant to purchase 4,166,666 shares of our common stock at an exercise price of $0.14 per share. This warrant expires in June 2009.

We believe existing cash, borrowing capacity under the line of credit or alternative financing sources, and funds generated from operations should be sufficient to meet operating requirements over the upcoming twelve month period. We may raise additional funds 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

We do not have any transactions, agreements or other contractual arrangements that constitute off-balance sheet arrangements.

RECENTLY ISSUED ACCOUNTING STANDARDS

In December 2003, the FASB issued Interpretation 46R (FIN 46R), a revision to Interpretation 46 (FIN 46), Consolidation of Variable Interest Entities. FIN 46R clarifies some of the provisions of FIN 46 and exempts certain entities from its requirements. FIN 46R is effective at the end of the first interim period ending after March 15, 2004. Entities that have adopted FIN 46 prior to this effective date can continue to apply the provisions of FIN 46 until the effective date of FIN 46R. The Company adopted FIN 46 on January 1, 2004 and it did not have a material impact on our financial statements.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Revenue recognition

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 on the number of hours worked by consultants at an agreed-upon rate per hour. Revenues for large services projects are recognized using the percentage of completion method for long-term construction type contracts where costs to complete the contract could reasonably be estimated. 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.

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.

Amortization

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 five 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 these contracts, generally five to six years. In conjuction with the DeLeeuw acquisition, an intangible asset (Approved Vendor Status) was acquired which has been determined to have a 40 month life and is being amortized over this period.

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Goodwill and intangible assets

Goodwill represents the amounts paid in connection with a settlement agreement with the Elligent Consulting Group to re-acquire the ownership rights to the Company in 1998 and in connection with the acquisitions of Scosys, DeLeeuw and Evoke. Additionally, as part of the Scosys, DeLeeuw and Evoke acquisitions, the Company acquired intangible assets. FASB Statement 142 was adopted as of January 1, 2002 for all goodwill recognized in the Company's balance sheet as of December 31, 2001. This statement changed the accounting for goodwill from an amortization method to an impairment-only approach, and introduced a new model for determining impairment charges.

Goodwill and intangible assets are reviewed for impairment whenever events or circumstances indicate impairment might exist, or at least annually. The Company assesses the recoverability of its assets, in accordance with SFAS No. 142 "Goodwill and Other Intangible Assets," comparing projected undiscounted cash flows associated with those assets against their respective carrying amounts. Impairment, if any, is based on the excess of the carrying amount over the fair value of those assets. The Company's goodwill and intangible assets were evaluated and deemed not to be impaired at December 31, 2003. The Company has determined during its preliminary annual impairment review that the goodwill recorded for both the DeLeeuw and Evoke acquisitions is likely to be impaired.

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 June 30, 2004, five customers comprised approximately 46% of the Company's accounts receivable balance.

Income taxes

The Company accounts for income taxes 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.

On January 1, 2001, CSI elected to be an "S" Corporation, whereby the stockholders account for their share of CSI's earnings, losses, deductions and credits on their federal and various state income tax returns. CSI is subject to New York City and various state income taxes. On September 30, 2003, CSI's "S" Corporation status was revoked in connection with the conversion of convertible subordinated debt into shares of common stock.

For informational purposes, the accompanying statements of operations include an unaudited pro-forma adjustment for income taxes which would have been recorded if CSI had not been an "S" Corporation.

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 our financial outlook.

For further information, refer to the business description and risk factors sections included in our Form SB-2 filed with the SEC on May 6, 2004.

Item 3. Controls and Procedures

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 their evaluation, our management concluded at the time of our original Form 10-QSB filing that our disclosure controls and procedures were effective. 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. in March 2004 and Evoke Software Corporation in June 2004, 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:

- 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;

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

- 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:

- 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

- 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 $125,000, 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:

- 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;

- 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;

- 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;

- 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;

- 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;

- 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

- 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 future financial statements. 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.

In connection with restating our financial statements as provided in this report, our chief executive officer and our chief financial officer, with the participation of other management, re-evaluated the effectiveness of our disclosure controls and procedures for the quarter ended March 31, 2004 and based on the re-evaluation by our chief executive officer and our chief financial officer, they concluded that, as of March 31, 2004, there were certain material weaknesses in our internal control procedures and in our valuation and purchase accounting of our acquisitions in 2004, which has resulted in a conclusion that such disclosure controls were not effective at a reasonable assurance level.

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. During the first quarter of 2004, there were no changes in our internal controls over financial reporting that have materially affected or are reasonably likely to materially affect our internal controls over financial reporting. Subsequent to the first quarter of 2004, 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;

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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 1. Legal Proceedings

On June 29, 2004, Viant Capital LLC commenced legal action against us 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 our loan from a private investor in May 2004. Management believes that this loan does not qualify as a private equity transaction and we intend to vigorously defend the company. As of August 20, 2004, there have been no material developments in the suit. 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.

Item 2. Changes in Securities.

On May 5, 2004, pursuant to the conversion of an unsecured convertible line of credit note, participating investors received 16,666,666 shares of our common stock and 4,166,666 warrants to purchase shares of our common stock at an exercise price of $0.14 per share. These warrants expire in May 2009. See Item 2 to Part I.

On June 28, 2004, CSI, through its subsidiary Evoke Asset Purchase Corp., acquired substantially all of the assets and assumed substantially all of the liabilities of Evoke, a privately-held California corporation. The acquisition was completed pursuant to an Asset Purchase Agreement between CSI, Evoke Asset Purchase Corp. and Evoke. In connection with the acquisition, CSI (i) issued 72,543,956 shares of its common stock to Evoke, 7,150,000 of which have been deposited into an escrow account for a period of one-year and may be reduced based upon claims for indemnification that may be made pursuant to the agreement; (ii) issued 5% of the outstanding shares of the Evoke Asset Purchase Corp. to Evoke; (iii) issued 3,919,093 shares of its common stock to certain executives of Evoke as a severance payment and to certain employees as retention shares; and (iv) agreed to pay $448,154 in deferred compensation to certain employees of Evoke. See Note 2 to Financial Statements.

Item 5. Other Information

On August 16, 2004, the Company replaced its $3,000,000 line of credit with North Fork Bank with a revolving line of credit with Laurus Master Fund, Ltd. ("Laurus"), whereby the Company will have access to borrow up to $6,000,000 based upon eligible accounts receivable. This revolving line, effectuated through a $2,000,000 convertible minimum borrowing note and a $4,000,000 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) plus 1%, and maturing in three years. 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 $2,000,000 convertible minimum borrowing note and the $4,000,000 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 Company stock or derivatives convertible into Company stock for a price less 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 $5,000,000 to be used for acquisitions. 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 stock or derivatives convertible into Company stock for a price less the fixed conversion price, then the fixed conversion price is reset to the lower price. 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. A portion of Laurus's revolving line of credit will be used to pay off all outstanding borrowings from North Fork Bank. The Company issued Laurus a common stock purchase warrant that provides Laurus with the right to purchase 12,000,000 shares of the Company's common stock. The exercise price for the first 6,000,000 shares acquired under the warrant is $0.29 per share, the exercise price for the next 3,000,000 shares acquired under the warrant is $0.31 per share, and the exercise price for the final 3,000,000 shares acquired under the warrant is $0.35 per share. The common stock purchase warrant expires on August 16, 2011. The Company paid $749,000 in brokerage and transaction closing related costs. These costs will be deducted from the $5,000,000 restricted cash balance being provided to the Company by Laurus.

Item 6. Exhibits and Reports on Form 8-K

(a) The following is a list of exhibits to this Form 10-QSB:

4.1* Security Agreement, dated August 16, 2004, among the Registrant, DeLeeuw Associates, LLC, CSI Sub Corp. (DE), Evoke Software Corporation and Laurus Master Fund, Ltd. ("Laurus")

4.2* Securities Purchase Agreement, dated August 16, 2004, among the Registrant and Laurus

4.3* Registration Rights Agreement, dated August 16, 2004, among the Registrant and Laurus

4.4* Secured Convertible Minimum Borrowing Note, dated August 16, 2004

4.5* Secured Revolving Note, dated August 16, 2004

4.6* Secured Convertible Term Note, dated August 16, 2004

4.7* Common Stock Purchase Warrant, dated August 16, 2004

4.8* Stock Pledge Agreement, dated August 16, 2004, among the Registrant and Laurus

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

* Previously filed.

(b) Reports on Form 8-K:

Five reports on Form 8-K were filed during the reporting period, as follows:

Form 8-K/A filed by the Company on April 1, 2004, pertaining to Item Nos. 1 and 7 regarding a change in control and financial statements.

Form 8-K/A filed by the Company on May 18, 2004, pertaining to Item No. 7 regarding financial statements of business acquired.

Form 8-K filed by the Company on May 27, 2004, pertaining to Item Nos. 4 and 7 regarding a change in certifying accountant.

Form 8-K filed by the Company on May 28, 2004, pertaining to Item Nos. 7 and 9 regarding FD disclosure.

Form 8-K filed by the Company on June 29, 2004, pertaining to Item Nos. 4 and 7 regarding a change in certifying accountant.

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)

April 12, 2005