

CONVERSION SERVICES INTERNATIONAL INC  
Form 10-Q  
November 12, 2009

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

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2009

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: 001-32623

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

Delaware  
(State or other jurisdiction of  
incorporation or organization)

20-0101495  
(I.R.S. Employer  
Identification No.)

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

07936  
(Zip Code)

(973) 560-9400  
(Registrant's telephone number, including area code)

None  
(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller Reporting Company

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

Class	Outstanding at November 10, 2009
Common Stock, \$0.001 par value per share	121,136,289 shares

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CONVERSION SERVICES INTERNATIONAL, INC.

FORM 10-Q

For the three and nine months ended September 30, 2009

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

CONVERSION SERVICES INTERNATIONAL, INC.  
AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(Unaudited)

	September 30, 2009	December 31, 2008
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash	\$ 31,473	\$ 338,240
Accounts receivable, net	4,661,597	3,440,810
Accounts receivable from related parties, net	398,542	284,028
Prepaid expenses	87,042	140,493
<b>TOTAL CURRENT ASSETS</b>	<b>5,178,654</b>	<b>4,203,571</b>
<b>PROPERTY AND EQUIPMENT, at cost, net</b>	<b>41,880</b>	<b>68,536</b>
<b>OTHER ASSETS</b>	<b>116,473</b>	<b>306,778</b>
<b>Total Assets</b>	<b>\$ 5,337,007</b>	<b>\$ 4,578,885</b>
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>		
<b>CURRENT LIABILITIES</b>		
Line of credit	\$ 3,075,964	\$ 2,349,920
Short term notes payable	600,000	1,384,811
Accounts payable and accrued expenses	2,049,946	1,503,145
Deferred revenue	272,236	159,177
Related party note payable	109,113	102,796
<b>TOTAL CURRENT LIABILITIES</b>	<b>6,107,259</b>	<b>5,499,849</b>
Long-term debt, net of current portion	500,000	-
<b>Total liabilities</b>	<b>6,607,259</b>	<b>5,499,849</b>
Convertible preferred stock, \$0.001 par value, \$100 stated value, 20,000,000 shares authorized		
Series A convertible preferred stock, 19,000 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively	1,393,332	1,108,332
<b>COMMITMENTS AND CONTINGENCIES</b>	<b>-</b>	<b>-</b>
<b>STOCKHOLDERS' DEFICIT</b>		
Common stock, \$0.001 par value, 300,000,000 shares authorized; 121,072,124 and 119,594,463 issued and outstanding at September 30, 2009 and December 31, 2008, respectively	121,072	119,594

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Series B convertible preferred stock, 20,000 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively	1,352,883	1,352,883
Additional paid in capital	68,381,656	68,575,918
Treasury stock, at cost, 1,145,382 shares in treasury as of September 30, 2009 and December 31, 2008, respectively	(423,869)	(423,869)
Accumulated deficit	(72,095,326)	(71,653,822)
Total Stockholders' Deficit	(2,663,584)	(2,029,296)
Total Liabilities and Stockholders' Deficit	\$ 5,337,007	\$ 4,578,885

See Notes to Condensed Consolidated Financial Statements



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Earnings per share:

Basic	\$	0.01	\$	(0.04)	\$	(0.01)	\$	(0.08)
Diluted	\$	0.01	\$	(0.04)	\$	(0.01)	\$	(0.08)

Shares used in calculation of earnings per share:

Basic	119,895,174	117,909,029	119,813,903	114,348,981
Diluted	133,651,512	117,909,029	119,813,903	114,348,981

See Notes to Condensed Consolidated Financial Statements

CONVERSION SERVICES INTERNATIONAL, INC.  
AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE NINE MONTHS ENDED SEPTEMBER 30,  
(Unaudited)

	2009	2008
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss	\$ (441,504)	\$ (8,397,614)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation of property and equipment and amortization of leasehold improvements	37,325	120,333
Amortization of intangible assets	-	56,470
Amortization of debt discounts	69,070	236,844
Amortization of relative fair value of warrants issued	115,189	164,259
Amortization of deferred financing costs	44,188	47,271
Stock based compensation	115,965	449,179
Goodwill impairment	-	4,636,266
Loss on extinguishment of debt	-	553,846
(Decrease) increase in allowance for doubtful accounts	(97,909)	166,789
Losses (income) from equity investments	103,298	(12,876)
Changes in operating assets and liabilities:		
Increase in accounts receivable	(1,118,865)	(127,422)
(Increase) decrease in accounts receivable from related parties	(118,527)	5,921
Decrease in prepaid expenses and other assets	27,202	17,109
Increase in accounts payable and accrued expenses	529,369	163,491
Increase in deferred revenue	113,058	28,167
Net cash used in operating activities	(622,141)	(1,891,967)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of property and equipment	(10,670)	(24,016)
Net cash used in investing activities	(10,670)	(24,016)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net borrowings (repayments) under line of credit	726,044	(1,021)
Proceeds from issuance of short-term note payable	-	400,000
Principal payments on short-term notes payable	(400,000)	-
Deferred financing costs	-	(61,786)
Issuance of Company common stock	-	200,000
Principal payments on capital lease obligations	-	(10,164)
Principal payments on related party notes	-	(13,230)
Net cash provided by financing activities	326,044	513,799
<b>NET DECREASE IN CASH</b>	<b>(306,767)</b>	<b>(1,402,184)</b>
CASH, beginning of period	338,240	1,506,866
CASH, end of period	\$ 31,473	\$ 104,682

See Notes to Condensed Consolidated Financial Statements





CONVERSION SERVICES INTERNATIONAL, INC.  
AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE NINE MONTHS ENDED SEPTEMBER 30,  
(Unaudited)

	2009	2008
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>		
Cash paid for interest	\$ 469,362	\$ 223,987
<b>SUPPLEMENTAL DISCLOSURE OF NON-CASH ACTIVITIES:</b>		
Common stock issued in conversion of long-term debt to equity	-	600,000
Common stock issued in payment of dividends on preferred stock	111,250	144,029

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” or the “Company”) was incorporated in the State of Delaware and has been conducting business since 1990. CSI and its wholly owned 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 to its customers principally located in the northeastern United States.

CSI was formerly known as LCS Group, Inc. (“LCS”). In January 2004, CSI merged with and into a wholly owned subsidiary of LCS. In connection with this transaction, among other things, LCS changed its name to “Conversion Services International, Inc.”

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared by the Company and are unaudited. The results of operations for the three and nine months ended September 30, 2009 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 September 30, 2009, and for all periods presented, have been made. Footnote disclosure has been condensed or omitted as permitted by Securities and Exchange Commission rules over interim financial statements.

These condensed consolidated financial statements should be read in conjunction with the annual audited consolidated financial statements and the notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2008 and other reports filed with the Securities and Exchange Commission.

Principles of Consolidation

The accompanying condensed consolidated financial statements include the accounts of the Company and its subsidiaries. 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

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 revenue as activities are performed by the Company over the estimated performance period. Revenue recognized in excess of billings is recorded as cost in excess of billings. Billings in excess of revenue recognized are recorded as deferred revenue until revenue recognition criteria are met. Reimbursements, including those relating to travel and other

out-of-pocket expenses, are included in revenue, and an equivalent amount of reimbursable expenses are included in cost of services.

The Company recognizes revenue in accordance with generally accepted accounting principles. As a result, in the event that collectability from a client is not reasonably assured, revenue is recognized on the cash basis. During the nine month period ended September 30, 2009, approximately \$180,769 of billings to National Digital Medical Archives (“NDMA”) has been deferred and will be recognized as revenue upon collection of the receivable.

#### Extinguishment of debt

In March 2008, the Company and TAG Virgin Islands, Inc. executed a Note Conversion Agreement whereby certain investors represented by TAG Virgin Islands, Inc. converted debt due to them under an Unsecured Convertible Line of Credit Note dated June 7, 2004 into Company Common Stock. A loss of \$553,846 on this transaction was recorded as an early extinguishment of debt.

In July 2008, the Company and TAG Virgin Islands, Inc. executed six promissory notes whereby certain investors represented by TAG Virgin Islands, Inc. provided \$200,000 to the Company under short-term promissory notes. The Company repaid these notes in September 2009.

In September 2008, the Company and TAG Virgin Islands, Inc. executed a promissory note whereby certain investors represented by TAG Virgin Islands, Inc. provided \$200,000 to the Company under a short-term promissory note. The Company repaid this note in September 2009.

#### Fair value of financial instruments

The Company utilizes the fair value standards defined by generally accepted accounting principles which provide guidance for measuring fair value and requires certain disclosures. A fair value hierarchy is used which is categorized into three levels based on the inputs to the valuation techniques used to measure fair value. Certain valuation techniques are used, such as the market approach (comparable market prices), the income approach (present value of future income or cash flows) and the cost approach (cost to replace the service capacity of an asset or replacement cost).

The Company estimates that the carrying value of its financial instruments which includes cash, line of credit and notes payable approximates fair value, as all financial instruments are short term in nature or bear interest at variable rates.

#### 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 September 30, 2009, receivables related to PNC Bank and National Digital Medical Archives ("NDMA") comprised approximately 32.9% and 15.9% of the Company's accounts receivable balance, respectively.

Cash balances in banks are secured by the Federal Deposit Insurance Corporation subject to certain limitations.

#### 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.

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 net operating losses.

Prior to recording its income tax liability, the Company makes a determination as to whether it is more likely than not that a tax position will be sustained upon examination based upon the technical merits of the position. If the more-likely-than-not threshold is met, the tax position is measured to determine the amount to recognize in the financial statements. At September 30, 2009, the Company has no unrecognized tax benefits. As of September 30, 2009, the Company had no accrued interest or penalties related to uncertain tax positions.

#### 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 - Going Concern

The Company has incurred net losses for the nine months ended September 30, 2009 and the years ended December 31, 2004 through 2008, negative cash flows from operating activities for the nine months ended September 30, 2009 and the years ended December 31, 2004 through 2008, and had an accumulated deficit of \$72.1 million at September 30, 2009. The Company has relied upon cash from its financing activities to fund its ongoing operations as it has not been able to generate sufficient cash from its operating activities in the past, and there is no assurance that it will be able to do so in the future. Due to this history of losses and operating cash consumption, the Company cannot predict how long it will continue to incur further losses or whether it will become profitable again, or if the Company's business will improve. These factors raise substantial doubt as to its ability to continue as a going concern. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

As of September 30, 2009, the Company had a cash balance of approximately \$31,473, compared to \$0.3 million at December 31, 2008, and a working capital deficiency of \$0.9 million.

The liquidity issues that have resulted from the Company's history of losses have been addressed in the past through the sale of Company common stock, preferred stock and by entering into various debt instruments. During 2008, the Company issued 10% Convertible Unsecured Notes and warrants to purchase Company common stock in exchange for \$450,000 cash. During September and October 2009, these notes have been repaid by the Company. Additionally, in 2008 the Company and TAG Virgin Islands, Inc. executed a Stock Purchase Agreement whereby an investor represented by TAG Virgin Islands, Inc. purchased 2,500,000 shares of Company common stock for a total investment of \$200,000.

The Company executed a revolving line of credit agreement in March 2008 with Access Capital, Inc. (“Access Capital” or “Access”). As of June 30, 2008, the Company was in default of the Loan and Security Agreement and remains in default as of September 30, 2009. As a result of the default, Access has increased the interest rate payable on borrowings under the line of credit to 18% per annum, has notified the Company’s clients of their security interest in the amounts due to the Company, and has provided instruction that payments are to be made directly to Access Capital. Refer to footnote 4 of the Notes to Condensed Consolidated Financial Statements for further discussion on the Line of Credit.

On June 7, 2004, the Company issued a five-year \$2,000,000 Unsecured Convertible Line of Credit Note. \$950,000 of the original principal balance has previously been converted to Company common stock and \$550,000 has been repaid in cash prior to the October 31, 2009 maturity. The remaining \$500,000 balance has been extended to April 30, 2012.

The Company needs additional capital in order to survive. Additional capital will be needed to fund current working capital requirements, ongoing debt service and to repay the obligations that are maturing over the upcoming 12 month period. Our primary sources of liquidity are cash flows from operations, borrowings under our revolving credit facility, and various short and long term financings. We plan to continue to strive to increase revenues and to control operating expenses in order to reduce, or eliminate, the operating losses. Additionally, we will continue to seek equity and/or debt financing in order to enable us to continue to meet our financial obligations until we achieve profitability. There can be no assurance that any such funding will be available to us on favorable terms, or at all. Failure to obtain sufficient financing would have substantial negative ramifications to the Company.

#### Note 3 - Recently Issued Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) established the FASB Accounting Standards Codification (Codification) as the source of authoritative U.S. generally accepted accounting principles (GAAP) recognized by the FASB to be applied to nongovernmental entities and rules and interpretive releases of the SEC as authoritative GAAP for SEC registrants. The Codification supersedes all the existing non-SEC accounting and reporting standards upon its effective date and subsequently, the FASB will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. This guidance is effective for interim periods ending after September 15, 2009. We adopted this guidance for the period ended September 30, 2009, with no effect on our consolidated results of operations and financial condition for the three and nine months ended September 30, 2009.

In October 2009, the FASB issued Update No. 2009-13, which amends the Revenue Recognition topic of the Codification. This update provides amendments to the criteria in Subtopic 605-25 of the Codification for separating consideration in multiple-deliverable arrangements. As a result of those amendments, multiple-deliverable arrangements will be separated in more circumstances than under existing U.S. GAAP. The amendments establish a selling price hierarchy for determining the selling price of a deliverable and will replace the term fair value in the revenue allocation guidance with selling price to clarify that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant. The amendments will also eliminate the residual method of allocation and require that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method and will require that a vendor determine its best estimate of selling price in a manner that is consistent with that used to determine the price to sell the deliverable on a standalone basis. These amendments will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted. We are currently evaluating the impact the adoption of this update might have on our consolidated results of operations and financial condition.

In October 2009, the FASB issued Update No. 2009-14, which amends the Software topic of the Codification. The amendments in this update change the accounting model for revenue arrangements that include both tangible products

and software elements. Tangible products containing software components and nonsoftware components that function together to deliver the tangible product's essential functionality are no longer within the scope of the software revenue guidance in Subtopic 985-605 of the Codification. In addition, the amendments in this update require that hardware components of a tangible product containing software components always be excluded from the software revenue guidance. In that regard, the amendments provide additional guidance on how to determine which software, if any, relating to the tangible product also would be excluded from the scope of the software revenue guidance. The amendments also provide guidance on how a vendor should allocate arrangement consideration to deliverables in an arrangement that includes both tangible products and software. The amendments also provide further guidance on how to allocate arrangement consideration when an arrangement includes deliverables both included and excluded from the scope of the software revenue guidance. These amendments will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted. We are currently evaluating the impact the adoption of this update might have on our consolidated results of operations and financial condition.

During the first and second quarters of 2009, we adopted the following accounting guidance, none of which had a material effect on our consolidated results of operations or financial condition:

In June 2008, the FASB revised the authoritative guidance for earnings per share, which establishes that unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. In contrast, the right to receive dividends or dividend equivalents that the holder will forfeit if the award does not vest does not constitute a participation right and such an award does not meet the definition of a participating security in its current form (that is, prior to the requisite service having been rendered for the award). We adopted this guidance as of January 1, 2009. The adoption of this guidance had no effect on our consolidated results of operations and financial condition for the three and nine months ended September 30, 2009.



In April 2009, the FASB revised the authoritative guidance for financial instruments. The guidance requires disclosures about fair value of financial instruments in interim financial statements as well as in annual financial statements. This guidance is effective for interim periods ending after June 15, 2009. The adoption of this guidance had no material effect on our consolidated results of operations and financial condition for the three and nine months ended September 30, 2009.

In April 2009, the FASB revised the authoritative guidance for fair value measurements and disclosures to provide additional guidance in determining whether a market for a financial asset is not active and a transaction is not distressed for fair value measurement purposes. This guidance is effective for interim periods ending after June 15, 2009. We adopted this guidance for the period ending June 30, 2009. The adoption of this guidance had no effect on our consolidated results of operations and financial condition for the three and nine months ended September 30, 2009.

In April 2009, the FASB revised the authoritative guidance for investments in debt and equity securities to provide guidance in determining whether impairments in debt securities are other-than-temporary, and modifies the presentation and disclosures surrounding such instruments. This guidance is effective for interim periods ending after June 15, 2009. We adopted the provisions of this guidance for the period ending June 30, 2009. The adoption of this guidance had no effect on our consolidated results of operations and financial condition for the three and nine months ended September 30, 2009.

In May 2009, the FASB revised the authoritative guidance for subsequent events, which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. This guidance is effective for financial statements issued for interim and annual reporting periods ending after June 15, 2009. We adopted this guidance for the period ended June 30, 2009, and have provided the disclosures required for the period ending September 30, 2009.

#### Note 4 - Line of credit

The Company executed a revolving line of credit agreement in March 2008 with Access Capital. This line of credit provides for borrowing up to a maximum of \$3,500,000, based upon collateral availability, a 90% advance rate against eligible accounts receivable, has a three year term, and an interest rate of prime (which was 3.25% as of September 30, 2009) plus 2.75% prior to a default, but 18% upon default. The Company has pledged substantially all of its assets as collateral for this debt. The Company must comply with a minimum working capital covenant which requires the Company to maintain minimum monthly working capital of \$400,000. The Company was not in compliance with this covenant as of June 30, 2008 and remains in default as of September 30, 2009. Additionally, during the second year of the three year term the Company must maintain a minimum average monthly loan balance of \$2,250,000 and \$2,500,000 in the third year. The Company must also pay an annual facility fee equal to 1% of the maximum available under the facility and a \$1,750 per month collateral management fee. Further debt incurred by the Company may need to be subordinated to Access Capital, Inc.

The Company was in default of the Loan and Security Agreement as of September 30, 2009 since its working capital was below the minimum required working capital of \$400,000. In the event of a default under the Loan and Security Agreement, Access Capital's remedies include, but are not limited to, the following:

- Access may perform or observe such covenant on behalf and in the name, place and stead of the Company and may take actions which they deem necessary to cure or correct such failure, including, but not limited to, payment of taxes, satisfaction of liens, performance of obligations owed to debtors, procurement of insurance, execution of assignments, security agreements and financing statements and the endorsement of instruments;
-

upon the occurrence of, and for so long as any event of default exists, the interest rate is increased to one and one-half percent (1.5%) per month;

- Access may notify the Company's account debtors of their security interest in the accounts, collect them directly and charge the collection costs and expenses to the Company's account;
- at Access Capital's election, following the occurrence of an event of default, they may terminate the Loan and Security Agreement. In the event of early termination after the occurrence of default, the Company would be liable for various early payment fees, penalties and interest;
- Access shall have the right to demand repayment in full of all obligations, whether or not otherwise due, including required prepayment fees, interest, and penalties.

As a result of this default, to date, Access has increased the interest rate payable on borrowings under the line of credit to 18% per annum, has notified the Company's clients of their security interest in the amounts due to the Company, and has provided instruction that payments are to be made directly to Access Capital.

As of September 30, 2009, \$3.1 million was outstanding under the line of credit and the annual interest rate remained at 18%.

## Note 5 - Stock Based Compensation

The 2003 Incentive Plan (“2003 Plan”) authorizes the issuance of up to 10,000,000 shares of common stock for issuance upon exercise of options. It also authorizes the issuance of stock appreciation rights and restricted stock, however, none have been issued. 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 the nine months ended September 30, 2009 or during the years ended December 31, 2008 or 2007.

The following summarizes the stock option transactions under the 2003 Plan during 2009:

	Shares	Weighted average exercise price
Options outstanding at December 31, 2008	5,204,997	\$ 0.76
Options granted	-	-
Options exercised	-	-
Options canceled	(365,666)	0.77
Options outstanding at September 30, 2009	4,839,331	\$ 0.76

The following table summarizes information concerning outstanding and exercisable Company common stock options at September 30, 2009:

Range of exercise prices	Options outstanding	Weighted average exercise price	Weighted average remaining contractual life	Options exercisable	Weighted average exercise price
\$0.25-\$0.30	2,009,999	\$ 0.260	7.0	1,349,983	\$ 0.260
\$0.46-\$0.60	1,005,000	0.461	6.3	1,005,000	0.461
\$0.83	1,204,000	0.830	4.9	1,204,000	0.830
\$2.475-\$3.45	620,332	2.750	4.5	620,332	2.750
	4,839,331			4,179,315	

In accordance with generally accepted accounting principles, the Company recorded approximately \$3,544 and \$115,965 and \$169,753 and \$449,178 of expense related to stock options which vested during the three and nine months ended September 30, 2009 and 2008, respectively.

## Note 6 – Earnings (loss) Per Share

Basic earnings (loss) per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings (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 and the effect of convertible debt instruments as if they had been converted at the beginning of each period presented.

The following is a reconciliation of net income available to common stockholders for purposes of basic earnings per share to net income available to common stockholders for purposes of diluted earnings per share for each of the

periods noted:

	For the three months ended September 30,		the nine months ended September 30,	
	2009	2008	2009	2008
Net income (loss) attributable to common stockholders for purposes of computing basic earnings per share	\$ 1,152,618	\$ (4,360,850)	\$ (861,504)	\$ (8,850,393)
Effect of dividends on conversion of convertible preferred stock	45,000	-	-	-
Effect of interest on conversion of \$50,000, 10% convertible short term note dated October 2, 2008	1,250	-	-	-
Effect of interest on \$200,000, 10% convertible short term notes dated July 28, 2008	4,946	-	-	-
Effect of interest on \$200,000, 10% convertible short term note dated September 2, 2008	3,533	-	-	-
Effect of interest on conversion of line of credit note dated June 7, 2004	18,375	-	-	-
Net income attributable to common stockholders for purposes of computing diluted earnings per share	\$ 1,225,722	\$ (4,360,850)	\$ (861,504)	\$ (8,850,393)

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The following is a reconciliation of basic to diluted shares outstanding:

	For the three months ended September 30,		For the nine months ended September 30,	
	2009	2008	2009	2008
Basic shares outstanding	119,895,174	117,909,029	119,813,903	114,348,981
Additional weighted average shares attributable to convertible securities and warrants:				
\$50,000, 10% convertible short term note dated October 2, 2008	1,000,000	-	-	-
\$200,000, 10% convertible short term notes dated July 28, 2008	2,472,826	-	-	-
\$200,000, 10% convertible short term note dated September 2, 2008	1,766,304	-	-	-
Warrant exercises using treasury stock method	50,541	-	-	-
Convertible preferred stock Series A	3,800,000	-	-	-
Convertible preferred stock Series B	4,000,000	-	-	-
Shares underlying convertible line of credit note dated June 7, 2004	666,667	-	-	-
Diluted shares outstanding	133,651,512	117,909,029	119,813,903	114,348,981

Potentially dilutive shares excluded from the calculation as their effect would be anti-dilutive:

	For the three months ended September 30,		For the nine months ended September 30,	
	2009	2008	2009	2008
Outstanding stock options which are anti-dilutive	4,839,331	5,438,330	4,839,331	5,438,330
Warrants which are anti-dilutive	68,137,052	68,191,505	69,191,505	68,191,505
Shares underlying convertible line of credit note dated June 7, 2004	-	666,667	666,667	666,667
\$50,000, 10% convertible short term note dated October 2, 2008	-	-	1,000,000	-
\$200,000, 10% convertible short term notes dated July 28, 2008	-	2,500,000	2,500,000	2,500,000
\$200,000, 10% convertible short term note dated September 2, 2008	-	2,500,000	2,500,000	2,500,000
Convertible preferred stock Series A which are anti-dilutive	-	3,800,000	3,800,000	3,800,000
Convertible preferred stock Series B which are anti-dilutive	-	4,000,000	4,000,000	4,000,000

Total	72,976,383	87,096,502	88,497,503	87,096,502
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#### Note 7 - Major Customers

During the three months ended September 30, 2009, the Company had sales relating to two major customers, PNC Bank and NDMA which comprised 38.7% and 15.7% of revenues, respectively, and totaled approximately \$4,385,557. Amounts due from services provided to these customers included in accounts receivable was approximately \$2,470,226 at September 30, 2009. As of September 30, 2009, receivables related to PNC Bank and NDMA accounted for approximately 32.9% and 16.0% of the Company's accounts receivable balance, respectively.

During the nine months ended September 30, 2009, the Company had sales relating to three major customers, PNC Bank, Bank of America and NDMA, which comprised 26.5%, 10.7% and 11.7% of revenues, respectively, and totaling approximately \$4,700,230, \$1,903,355 and \$2,067,245, respectively. Amounts due from services provided to these customers included in accounts receivable was approximately \$2,844,581 at September 30, 2009. As of September 30, 2009, receivables related to PNC Bank, Bank of America and NDMA accounted for approximately 32.9%, 7.4% and 15.9% of the Company's accounts receivable balance, respectively.

During the three and nine months ended September 30, 2008, the Company had revenue relating to two major customers, Bank of America and LEC, a related party, comprising 21.1% and 21.4% and 10.6% and 12.2% of revenues, and totaling approximately \$1,051,000 and \$3,060,000 and \$527,000 and \$1,742,000, respectively. During the three months ended September 30, 2008, the Company also had revenues from one additional major customer, NDMA, comprising 12.7% of revenues, and totaling approximately \$634,000. Amounts due from services provided to these customers included in accounts receivable was approximately \$1,706,320 at September 30, 2008. As of September 30, 2008, receivables related to services performed for Bank of America, LEC and NDMA accounted for approximately 23.4%, 8.6% and 16.5% of the Company's accounts receivable balance, respectively.

#### Note 8 - Commitments and Contingencies

##### Legal Proceedings

From time to time, the Company is either a defendant or the plaintiff in various claims and lawsuits. Although there can be no assurances, management believes that the disposition of such matters will not have a material adverse impact on the results or operations or financial position of the Company.

## Lease Commitments

Years Ending September 30	Office	Sublease	Net
2010	\$ 369,349	\$ 134,137	\$ 235,212
2011	93,455	35,770	57,685
Thereafter	-	-	-
	\$ 462,804	\$ 169,907	\$ 292,897

Effective February 2007, the Company subleased a portion of its East Hanover, New Jersey corporate office space for the remainder of the lease term. 7,154 square feet of the Company's 16,604 square feet of rented office space were subleased from February 15, 2007 to December 31, 2010. The sublease provides for three months of free rent to the sublessee, monthly rent equal to \$5,962 per month from May 15, 2007 to December 31, 2007, \$8,942 per month from January 1, 2008 to December 31, 2009, and \$11,923 per month from January 1, 2010 to December 31, 2010. Additionally, the Company will receive a fixed rental for electric of \$10,731 per annum payable in equal monthly installments throughout the term of the lease.

## Note 9 - Related Party Transactions

Refer to footnote 7 for the related party transaction disclosure as a major customer.

As of September 30, 2009, the balance outstanding with respect to the loan from Glenn Peipert, our Executive Vice President and Chief Operating Officer, to the Company was approximately \$0.1 million, which accrues interest at a simple rate of 8% per annum.

## Note 10 - Subsequent Events

In October 2008, the Company and TAG Virgin Islands, Inc. executed a promissory note whereby certain investors represented by TAG Virgin Islands, Inc. provided \$50,000 to the Company under a short-term promissory note. The Company repaid this note in October 2009.

On June 7, 2004, the Company issued a five-year \$2,000,000 Unsecured Convertible Line of Credit Note. \$950,000 of the original principal balance has previously been converted to Company common stock and \$550,000 has been repaid in cash during October 2009. The remaining \$500,000 balance has been extended to April 30, 2012.

These financial statements were approved by management and the board of directors and were issued on November 12, 2009. Management has evaluated subsequent events through this date.

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

## Special Note About Forward-Looking Statements

Certain statements in Management's Discussion and Analysis ("MD&A"), other than purely historical information, including estimates, projections, statements relating to our business plans, objectives, and expected operating results, and the assumptions upon which those statements are based, are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements generally are identified by the words "believes," "project," "expects," "anticipates," "estimates," "intends," "strategy," "plan," "may," "will," "would," "will be," "will continue," "may result," and similar expressions. Forward-looking statements are based on current expectations and assumptions that

are subject to risks and uncertainties which may cause actual results to differ materially from the forward-looking statements. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

#### Overview of our Business

Conversion Services International, Inc. provides professional services to the Global 2000, as well as mid-market clientele relating to strategic consulting, business intelligence/data warehousing and data management and, through strategic partners, the sale of software. 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 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 business intelligence/data warehousing ("BI/DW") technical expertise and its strategic consulting division. This is expected to result in organic growth through the addition of new customers.



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 our ability to accomplish these goals. When economic conditions decline, companies generally decrease their technology budgets and reduce the amount of spending on the type of information technology (IT) consulting provided by the Company. 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. If the Company is unable to maintain its billing rates or sustain appropriate utilization rates for its professionals, its overall profitability may decline. Several large clients have changed their business practices with respect to consulting services. Such clients now require that we contract with their vendor management organizations in order to continue to perform services. These organizations charge fees generally based upon the hourly rates being charged to the end client. Our revenues and gross margins are being negatively affected by this practice.

The Company will continue to focus on a variety of growth initiatives in order to improve its market share and increase revenue. Moreover, as the Company endeavors to achieve top line growth, through entry on new approved vendor lists, penetrating new vertical markets, and expanding its time and material business, the Company will concentrate its efforts on improving margins and driving earnings to the bottom line.

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

#### 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 September 30,		Selected Statement of Operations Data for the nine months ended September 30,	
	2009	2008	2009	2008
Net revenue	\$ 8,061,242	\$ 4,986,773	\$ 17,734,250	\$ 14,327,368
Gross profit	2,946,980	1,281,688	4,671,895	3,318,702
Net income (loss)	1,292,618	(4,211,772)	(441,504)	(8,397,614)
Net income (loss) attributable to common stockholders	1,152,618	(4,360,850)	(861,504)	(8,850,393)
Basic and diluted income (loss) per common share:				
Basic income (loss) per common share attributable to common stockholders	\$ 0.01	\$ (0.04)	\$ (0.01)	\$ (0.08)
Diluted income (loss) per common share attributable to common stockholders	\$ 0.01	\$ (0.04)	\$ (0.01)	\$ (0.08)

Selected Statement of Financial  
Position Data as of

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	September 30, 2009	December 31, 2008
Working capital deficiency	\$ (928,605)	\$ (1,296,278)
Total assets	5,337,007	4,578,885
Total stockholders' deficit	(2,663,584)	(2,029,296)

Three and Nine Months Ended September 30, 2009 and 2008

Revenue

The Company's revenue is primarily comprised of billings to clients for consulting hours worked on client projects. Revenue of \$8.1 million and \$17.7 million for the three and nine months ended September 30, 2009, respectively, increased by \$3.1 million, or 61.7%, and \$3.4 million, or 23.8%, as compared to revenue of \$5.0 million and \$14.3 million for the three and nine months ended September 30, 2008, respectively.

Revenue for the Company is categorized by strategic consulting, business intelligence, data warehousing and data management. The chart below reflects revenue by line of business for the three and nine months ended September 30, 2009 and 2008:

	For the three months ended September 30,			
	2009		2008	
	\$	% of total revenues	\$	% of total revenues
Strategic Consulting	\$ 3,461,912	43.0%	\$ 1,389,418	27.9%
Business Intelligence / Data Warehousing	3,549,373	44.0%	2,846,385	57.1%
Data Management	531,142	6.6%	527,272	10.6%
Reimbursable expenses	410,470	5.1%	186,158	3.7%
Other	108,345	1.3%	37,540	0.7%
	\$ 8,061,242	100.0%	\$ 4,986,773	100.0%

	For the nine months ended September 30,			
	2009		2008	
	\$	% of total revenues	\$	% of total revenues
Strategic Consulting	\$ 6,556,062	37.0%	\$ 3,952,765	27.6%
Business Intelligence / Data Warehousing	8,628,645	48.7%	7,982,360	55.7%
Data Management	1,567,211	8.8%	1,741,597	12.2%
Reimbursable expenses	855,427	4.8%	498,408	3.5%
Other	126,905	0.7%	152,238	1.0%
	\$ 17,734,250	100.0%	\$ 14,327,368	100.0%

### Strategic consulting

The strategic consulting line of business includes work related to planning and assessing people, process and technology for clients, performing gap analysis, making recommendations regarding technology and business process improvements to assist clients to realize their business goals and maximize their investments in both people and technology. The Company performs strategic consulting work through its CSI DeLeeuw division.

Strategic consulting revenue of \$3.5 million, or 43.0% of total revenue, for the three months ended September 30, 2009 increased by \$2.1 million as compared to revenue of \$1.4 million, or 27.9% of total revenue, for the three months ended September 30, 2008. This increase is primarily due to \$3.1 million increase in revenue related to a project at PNC Bank that began in April 2009. This was partially offset by a \$0.6 million decrease in revenues from Bank of America as compared to the prior year and an additional \$0.4 million of decreases related to various clients. In the strategic consulting line of business, there was a 50.0% increase in consultant headcount and a 76.4% increase in the average bill rate during the quarter, as compared to the prior year period. The Company anticipates that revenue related to the PNC Bank project will continue into the first half of 2010.

Strategic consulting revenue of \$6.6 million, or 37.0% of total revenue, for the nine months ended September 30, 2009 increased by \$2.6 million, or 65.9%, as compared to revenue of \$4.0 million, or 27.6% of total revenue, for the nine months ended September 30, 2008. This increase is primarily due to a \$4.7 million increase in revenue related to a project at PNC Bank that began in April 2009. This increase was partially offset by a \$1.2 million decrease in revenue from Bank of America, a \$0.4 million decrease in revenue from New York Independent System Operator, and \$0.5 million of decreases from various other clients. In the strategic consulting line of business, there was a 16.7% increase in consultant headcount and a 42.7% increase in the average bill rate year to date, as compared to the prior year period.

Business intelligence / Data warehousing

The business intelligence line of business includes work performed with various applications and technologies for gathering, storing, analyzing and providing clients with access to data in order to allow enterprise users to make better and quicker business decisions. The data warehousing line of business includes work performed for client companies to provide a consolidated view of high quality enterprise information. CSI provides services in the data warehouse and data mart design, development and implementation, prepares proof of concepts, implements data warehouse solutions and integrates enterprise information. Since the business intelligence and data warehousing work overlap and the Company has performed engagements which include both business intelligence and data warehousing components, the Company tracks this work as a single line of business and reports the results as a single line of business.

Business intelligence/data warehousing (“BI/DW”) revenue of \$3.5 million, or 44.0% of total revenue, for the three months ended September 30, 2009 increased by \$0.7 million, or 24.7%, as compared to revenue of \$2.8 million, or 57.1% of total revenue, for the three months ended September 30, 2008. This increase is primarily due to a \$1.0 million revenue increase due to projects for Church & Dwight, Johnson and Johnson, Moody’s and Flight Safety, partially offset by \$0.9 million of revenue reductions due to both completed projects and reduced revenue on assignments with continuing clients and the recognition during the quarter ended September 30, 2009 of \$0.6 million of revenue related to NDMA which is being recognized on the cash basis and had previously been deferred. Overall, the BI/DW line of business had a 14.5% increase in consultant headcount and a decrease of 8.4% in the utilization rate as compared to the prior period.

Business intelligence/data warehousing (“BI/DW”) revenue of \$8.6 million, or 48.7% of total revenue, for the nine months ended September 30, 2009 increased by \$0.6 million, or 8.1%, as compared to revenue of \$8.0 million, or 55.7% of total revenue, for the nine months ended September 30, 2008. New 2009 projects in this line of business contributed \$2.2 million to revenue during the nine month period ended September 30, 2009, which is offset by \$1.6 million of non-recurring revenue related to completed projects. Average BI/DW headcount increased 5.4%, average bill rate and consultant utilization remained constant overall for the nine month period ended September 30, 2009 as compared to the prior year. Additionally, \$0.2 million of billings related to NDMA for work performed during the first nine months of 2009 was deferred and will be recognized as revenue upon collection of the outstanding receivable.

#### Data management

The data management line of business includes such activities as Enterprise Information Architecture, Metadata Management, Data Quality/Cleansing/ Profiling. The Company performs these activities through its exclusive subcontractor agreement with its related party, LEC.

Data management revenue of \$0.5 million, or 6.6% of total revenue, for the three months ended September 30, 2009 remained unchanged as compared to revenue of \$0.5 million, or 10.6% of total revenue, for the three months ended September 30, 2008. While the revenue for the quarter remained unchanged, the data management line of business experienced a 32.1% decrease in billable hours and a 21.0% decrease in the utilization rate, which was offset by a 47.9% increase in the average bill rate during the current period as compared to the prior year.

Data management revenue of \$1.6 million, or 8.8% of total revenue, for the nine months ended September 30, 2009 decreased by \$0.1 million, or 10.0%, as compared to revenue of \$1.7 million, or 12.2% of total revenue, for the nine months ended September 30, 2008. This decrease is due to a 31.7% decrease in billable hours and a 24.3% decrease in the utilization rate, partially offset by a 33.0% increase in the average bill rate during the current year to date period as compared to the prior year.

#### Cost of revenue

Cost of revenue includes payroll and benefit and other direct costs for the Company’s consultants. Cost of revenue was \$5.1 million, or 63.4% of revenue, and \$13.1 million, or 73.7% of revenue, for the three and nine months ended September 30, 2009, respectively, representing an increase of \$1.4 million, or 38.0%, and \$2.1 million, or 18.7%, as compared to \$3.7 million, or 74.3% of revenue, and \$11.0 million, or 76.8% of revenue, for the three and nine months ended September 30, 2008, respectively.

Cost of services was \$4.2 million, or 60.1% of services revenue for the three months ended September 30, 2009, representing an increase of \$1.2 million, or 41.4%, as compared to \$3.0 million, or 70.4% of services revenue for the three months ended September 30, 2008. Cost of services increased during the three months ended September 30, 2009 as compared to the prior year due to a \$2.8 million increase in services revenue during the period, accounting for a \$1.3 million increase in cost of services. The increase in the cost of services, as compared to the revenue increase reflects the higher profit margin business that the Company has been obtaining in the current period. Partially offsetting this increase in cost of services is a \$0.1 million decrease in cost of services relating to a reduction in stock compensation expense. The Company had an average of 108 consultants in the current period and 85 in the prior year period, resulting in a 27.1% increase in consultant headcount.

Cost of services was \$10.7 million, or 70.4% of services revenue for the nine months ended September 30, 2009, representing an increase of \$1.9 million, or 22.1%, as compared to \$8.8 million, or 73.4% of services revenue for the nine months ended September 30, 2008. Cost of services increased during the nine months ended September 30, 2009

as compared to the prior year period primarily due to increased revenue during the period, accounting for a \$1.9 million increase in cost of services. Cost of services decreased 3.0% of services revenue as compared to the prior period due to a \$0.2 million deferral of revenue related to billings to NDMA during the current period. Although the cost of services has already been recognized, this revenue will be recognized when payment is received from the client.

Cost of related party services was \$0.5 million, or 87.7% of related party services revenue, for the three months ended September 30, 2009, remaining unchanged as compared to \$0.5 million, or 95.9% of related party services revenue, for the three months ended September 30, 2008.

Cost of related party services was \$1.4 million, or 89.9% of related party services revenue, for the nine months ended September 30, 2009, representing a decrease of \$0.2 million, or 13.6%, as compared to \$1.6 million, or 93.7% of related party services revenue, for the nine months ended September 30, 2008. Cost of related party services decreased for the nine month period primarily due to a decrease in related party consulting revenue during the three months ended September 30, 2009 as compared to the prior year.

#### Gross profit

Gross profit was \$2.9 million, or 36.6% of revenue, and \$4.7 million, or 26.3% of revenue, for the three and nine months ended September 30, 2009, respectively, representing an increase of \$1.6 million, or 129.9% for the three months and an increase of \$1.4 million, or 40.8% for the nine months, as compared to \$1.3 million, or 25.7% of revenue, and \$3.3 million, or 23.2% of revenue, for the three and nine months ended September 30, 2008, respectively.

Gross profit from services was \$2.8 million, or 39.9% of services revenue for the three months ended September 30, 2009, representing an increase of \$1.5 million, or 122.8%, from the prior year's gross profit from services of \$1.3 million, or 29.6% of services revenue. The increase in the gross profit from services as a percentage of services revenue has been outlined previously in the revenue and cost of revenue discussions.

Gross profit from services was \$4.5 million, or 29.6% of services revenue for the nine months ended September 30, 2009, representing an increase of \$1.3 million, or 41.4%, from the prior year's gross profit from services of \$3.2 million, or 26.6% of services revenue. The increase in the gross profit from services as a percentage of services revenue has been outlined previously in the revenue and cost of revenue discussions.

Gross profit from related party services was \$65,587, or 12.3% of related party services revenue for the three months ended September 30, 2009, representing an increase of \$44,120 from the prior year's gross profit of \$21,467, or 4.1% of related party services revenue for the three months ended September 30, 2008. The increase in the gross profit from related party services as a percentage of related party services revenue has been outlined previously in the revenue and cost of revenue discussions.

Gross profit from related party services was \$158,604, or 10.1% of related party services revenue for the nine months ended September 30, 2009, representing an increase of \$48,107, or 43.5% from the prior year's gross profit of \$110,497, or 6.3% of related party services revenue for the nine months ended September 30, 2008. The increase in the gross profit from related party services as a percentage of related party services revenue has been outlined previously in the revenue and cost of revenue discussions.

#### 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, tradeshow, seminars and other programs. Selling and marketing expenses were \$0.7 million, or 9.0% of revenue, and \$2.3 million, or 12.9% of revenue, for the three and nine months ended September 30, 2009, respectively, decreasing by \$0.2 million, or 18.9%, and \$0.3 million, or 11.6%, as compared to \$0.9 million, or 18.0% of revenue, and \$2.6 million, or 18.1% of revenue, for the three and nine months ended September 30, 2008, respectively.

Selling and marketing expense for the three months ended September 30, 2009 decreased by \$0.2 million as compared to the prior year due primarily to a \$0.1 million reduction in payroll and stock compensation expense and a \$0.1 million reduction in professional fees and trade show expense.

Selling and marketing expense for the nine months ended September 30, 2009 decreased by \$0.3 million as compared to the prior year due primarily to a \$0.2 million reduction in payroll and stock compensation expense and a \$0.1 million reduction in professional fees.

#### 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 \$0.7 million, or 9.0% of revenue, and \$1.9 million, or 11.2% of revenue, for the three and nine months ended September 30, 2009, decreasing by \$0.2 million, or 22.7%, and \$1.1 million, or 35.1%, as compared to \$0.9 million, or 18.8% of revenue, and \$3.0 million, or 21.3% of revenue, for the three and nine months ended September 30, 2008, respectively.

The \$0.2 million decrease in general and administrative expense for the three months ended September 30, 2009 as compared to the prior year is primarily due to a \$0.1 million reduction in payroll and stock compensation expense due primarily to a reduction in headcount and a \$0.1 million reduction in bad debt expense during the current period.

The \$1.1 million decrease in general and administrative expense for the nine months ended September 30, 2009 as compared to the prior year is primarily due to a \$0.4 million reduction in payroll and stock option expense due to a reduction in headcount, a \$0.3 million reduction in bad debt expense, and \$0.4 million for expense reductions in the following categories: travel, utilities, bank fees, investor relations, stock exchange listing fees, legal fees, investor relations, rent, business licenses, business taxes and professional fees.

#### Goodwill impairment

Generally accepted accounting principles requires the Company to test intangible assets for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. During the nine month period ended September 30, 2008, it was determined that William McKnight's employment contract would not be extended past its July 21, 2008 expiration date. As a result of this trigger event, the Company performed an interim impairment analysis with respect to the recorded goodwill relating to the McKnight Associates acquisition in the approximate amount of \$1.4 million and determined it to be fully impaired. A \$1.4 million goodwill impairment charge was recorded during the period ended June 30, 2008. Additionally, during the period ended September 30, 2008, as a result of a continued decline in strategic consulting revenues and gross margins during 2008, the goodwill relating to the DeLeeuw Associates business was evaluated and determined to be impaired. As a result of this evaluation, a \$3.2 million goodwill impairment charge was recorded in the quarter ended September 30, 2008, resulting in total goodwill impairment charges during the nine months ended September 30, 2008 of \$4,636,266. There was no goodwill impairment charge during the three or nine month periods ending September 30, 2009.



#### 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. Depreciation and amortization expenses were \$25,108 and \$81,512, for the three and nine months ended September 30, 2009, respectively, representing a \$37,297 and \$142,562 decline from \$62,405 and \$224,074 for the three and nine months ended September 30, 2008, respectively.

#### Other income (expense)

During the nine months ended September 30, 2009, the Company recorded an impairment with respect to its investment in its related party, LEC, and recorded a charge of approximately \$103,000. During the nine months ended September 30, 2008, the Company restructured its debt with TAG Virgin Islands, Inc. and issued Company common stock in repayment of \$0.6 million of the Unsecured Convertible Note dated June 7, 2004. A \$0.6 million loss on the extinguishment of this debt was recorded in March 2008.

Interest expense, which includes amortization of the discount on debt of zero and \$0.1 million during the three and nine months ended September 30, 2009, respectively and \$0.1 million and \$0.2 million during the three and nine months ended September 30, 2008, respectively, was \$0.2 million and \$0.7 million for the three and nine months ended September 30, 2009, respectively, and \$0.3 million and \$0.7 million for the three and nine months ended September 30, 2008, respectively. Interest expense of \$0.2 million for the three months ended September 30, 2009 declined by \$0.1 million as compared to the prior year period. This reduction was due to \$0.1 million of prior year charges related to warrants issued that did not reoccur in the current period. Interest expense of \$0.7 million for the nine months ended September 30, 2009 remained unchanged as compared to the prior year period.

#### Liquidity and Capital Resources

The Company has incurred net losses for the nine months ended September 30, 2009 and the years ended December 31, 2004 through 2008, negative cash flows from operating activities for the nine months ended September 30, 2009 and the years ended December 31, 2004 through 2008, and had an accumulated deficit of \$72.1 million at September 30, 2009. The Company has relied upon cash from its financing activities to fund its ongoing operations as it has not been able to generate sufficient cash from its operating activities in the past, and there is no assurance that it will be able to do so in the future. Due to this history of losses and operating cash consumption, the Company cannot predict how long it will continue to incur further losses or whether it will become profitable again, or if the Company's business will improve. These factors raise substantial doubt as to its ability to continue as a going concern. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

As of September 30, 2009, the Company had a cash balance of approximately \$31,473, compared to \$0.3 million at December 31, 2008, and a working capital deficiency of \$0.9 million.

The liquidity issues that have resulted from the Company's history of losses have been addressed in the past through the sale of Company common stock, preferred stock and by entering into various debt instruments. During 2008, the Company issued 10% Convertible Unsecured Notes and warrants to purchase Company common stock in exchange for \$450,000 cash. During September and October 2009, these notes have been repaid by the Company. Additionally, in 2008 the Company and TAG Virgin Islands, Inc. executed a Stock Purchase Agreement whereby an investor

represented by TAG Virgin Islands, Inc. purchased 2,500,000 shares of Company common stock for a total investment of \$200,000.

The Company executed a revolving line of credit agreement in March 2008 with Access Capital, Inc. (“Access Capital” or “Access”). As of June 30, 2008, the Company was in default of the Loan and Security Agreement and remains in default as of September 30, 2009. As a result of the default, Access has increased the interest rate payable on borrowings under the line of credit to 18% per annum, has notified the Company’s clients of their security interest in the amounts due to the Company, and has provided instruction that payments are to be made directly to Access Capital. Refer to footnote 4 of the Notes to Condensed Consolidated Financial Statements for further discussion on the Line of Credit.

On June 7, 2004, the Company issued a five-year \$2,000,000 Unsecured Convertible Line of Credit Note. \$950,000 of the original principal balance has previously been converted to Company common stock and \$550,000 has been repaid in cash prior to the October 31, 2009 maturity. The remaining \$500,000 balance has been extended to April 30, 2012.

The Company needs additional capital in order to survive. Additional capital will be needed to fund current working capital requirements, ongoing debt service and to repay the obligations that are maturing over the upcoming 12 month period. Our primary sources of liquidity are cash flows from operations, borrowings under our revolving credit facility, and various short and long term financings. We plan to continue to strive to increase revenues and to control operating expenses in order to reduce, or eliminate, the operating losses. Additionally, we will continue to seek equity and/or debt financing in order to enable us to continue to meet our financial obligations until we achieve profitability. There can be no assurance that any such funding will be available to us on favorable terms, or at all. Failure to obtain sufficient financing would have substantial negative ramifications to the Company.

The Company's working capital deficit was \$0.9 million as of September 30, 2009 which represented a \$0.4 million decrease in the working capital deficit when compared to the working capital deficit of \$1.3 million as of December 31, 2008. The primary reason for the decrease in the working capital deficit is a \$0.3 million reduction in cash, a \$0.7 million increase in the outstanding line of credit balance, a \$0.1 million increase in deferred revenue, a \$0.5 million increase in accounts payable and accrued expenses and a \$0.1 million decrease in prepaid expenses, partially offset by a \$1.3 million increase in the accounts receivable balance and a \$0.8 million decrease in short term notes payable as compared to the prior period. The short term notes payable decreased by \$0.8 million due to both the repayment of short term notes and the reclassification of \$0.5 million of short term notes payable to long term debt resulting from the extension of the note payable to April 2012.

Cash used in operating activities during the nine months ended September 30, 2009 was approximately \$0.6 million compared to cash used in operating activities of \$1.9 million for the nine months ended September 30, 2008. The decrease in cash used in operations was primarily the result of a \$1.3 million reduction in the Company's net loss adjusted for non-cash charges/credits recorded in income, such as depreciation, amortization, stock based compensation and bad debt expense, as compared to the prior year period.

Cash used in investing activities was \$10,670 in the current period compared to \$24,016 during the nine months ended September 30, 2008. The Company purchased computer equipment during both the current period and the comparable prior year period.

Cash provided by financing activities was \$0.3 million during the nine months ended September 30, 2009 and cash provided by financing activities was \$0.5 million during the nine months ended September 30, 2008. The cash provided by financing activities during the current period was due to additional borrowings under the Company's revolving line of credit agreement with Access Capital. The cash provided by financing activities during the prior period was primarily the result of the Company's borrowing \$0.4 million under short-term notes payable and obtaining \$0.2 million in exchange for issuing 2.5 million shares of Company common stock.

The Company executed a replacement revolving line of credit agreement in March 2008 with Access Capital, Inc. The Access Capital line of credit provides for borrowing up to a maximum of \$3,500,000, based upon collateral availability, a 90% advance rate against eligible accounts receivable, has a three year term, and an interest rate of prime (which was 3.25% as of September 30, 2009) plus 2.75% prior to a default, but 18% upon default. The Company must comply with a minimum working capital covenant which requires the Company to maintain minimum monthly working capital of \$400,000. The Company was not in compliance with this requirement as of June 30, 2008 and remains in default as of September 30, 2009. Additionally, during the first year of the three year term the Company must maintain an average minimum monthly borrowing of \$2,000,000 which increases the \$2,250,000 in the second year and to \$2,500,000 in the third year. The Company must also pay an annual facility fee equal to 1% of the maximum available under the facility and a \$1,750 per month collateral management fee. Further debt incurred by the Company may need to be subordinated to Access Capital, Inc.

On July 28, 2008, the Company issued 10% Convertible Unsecured Notes (the "Notes") to certain investors represented by TAG Virgin Islands, Inc. for \$200,000. These notes were originally due on December 27, 2008 and are convertible into 2,500,000 shares of common stock at the option of the holders. The maturity dates of the Notes were extended to October 31, 2009 and have been repaid in full during September 2009.

On September 2, 2008, the Company issued a 10% Convertible Unsecured Note (the "Note") to certain investors represented by TAG Virgin Islands, Inc. for \$200,000. This note was originally due on March 1, 2009 and is convertible into 2,500,000 shares of common stock at the option of the holders. The maturity date of the Note had been extended to September 1, 2009 and has been repaid in full during September 2009.

On October 2, 2008, the Company issued a 10% Convertible Unsecured Note (the "Note") to certain investors represented by TAG Virgin Islands, Inc. for \$50,000. This note was originally due on April 1, 2009 and is convertible into 1,000,000 shares of common stock at the option of the holders. The maturity date of the Note was extended to October 31, 2009 and was repaid in full during October 2009.

There are currently no material commitments for capital expenditures.

As of September 30, 2009 and December 31, 2008, the Company had accounts receivable due from LEC of approximately \$0.4 million and \$0.3 million, respectively. There are no known collection problems with respect to LEC.

For the three and nine months ended September 30, 2009 and 2008, we invoiced LEC \$0.5 million and \$1.6 million and \$0.5 million and \$1.7 million, respectively, for the services of consultants subcontracted to LEC by us. The majority of its billing is derived from Fortune 100 clients.

The following is a summary of the debt instruments outstanding as of September 30, 2009:

Lender	Type of facility	Outstanding as of September	
		30, 2009 (not including interest) (all numbers approximate)	Remaining Availability (if applicable)
Access Capital, Inc.	Line of Credit	\$ 3,076,000	\$ 0
Taurus Advisory Group, LLC / TAG			
Virgin Islands, Inc. Investors	Convertible Promissory Notes	\$ 1,100,000	\$ -
Glenn Peipert	Promissory Note	\$ 109,000	\$ -
<b>TOTAL</b>		<b>\$ 4,285,000</b>	<b>\$ 0</b>

Additionally, the Company has two series of preferred stock outstanding as follows:

Holder	Type of Instrument	Principal amount outstanding as of September 30, 2009
Taurus Advisory Group, LLC Investors	Series A Convertible Preferred Stock	\$ 1,900,000
Matthew J. Szulik	Series B Convertible Preferred Stock	\$ 2,000,000
<b>TOTAL</b>		<b>\$ 3,900,000</b>

#### Recently Issued Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) established the FASB Accounting Standards Codification (Codification) as the source of authoritative U.S. generally accepted accounting principles (GAAP) recognized by the FASB to be applied to nongovernmental entities and rules and interpretive releases of the SEC as authoritative GAAP for SEC registrants. The Codification supersedes all the existing non-SEC accounting and reporting standards upon its effective date and subsequently, the FASB will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. This guidance is effective for interim periods ending after September 15, 2009. We adopted this guidance for the period ended September 30, 2009, with no effect on our consolidated results of operations and financial condition for the three and nine months ended September 30, 2009.

In October 2009, the FASB issued Update No. 2009-13, which amends the Revenue Recognition topic of the Codification. This update provides amendments to the criteria in Subtopic 605-25 of the Codification for separating consideration in multiple-deliverable arrangements. As a result of those amendments, multiple-deliverable arrangements will be separated in more circumstances than under existing U.S. GAAP. The amendments establish a selling price hierarchy for determining the selling price of a deliverable and will replace the term fair value in the revenue allocation guidance with selling price to clarify that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant. The amendments will also eliminate the residual method of allocation and require that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method and will require that a vendor determine its best estimate of selling price in a manner that is consistent with that used to determine the price to sell the deliverable on a standalone basis. These amendments will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted. We are currently evaluating the impact the adoption of this update might have on our consolidated results of operations and financial condition.

In October 2009, the FASB issued Update No. 2009-14, which amends the Software topic of the Codification. The amendments in this update change the accounting model for revenue arrangements that include both tangible products

and software elements. Tangible products containing software components and nonsoftware components that function together to deliver the tangible product's essential functionality are no longer within the scope of the software revenue guidance in Subtopic 985-605 of the Codification. In addition, the amendments in this update require that hardware components of a tangible product containing software components always be excluded from the software revenue guidance. In that regard, the amendments provide additional guidance on how to determine which software, if any, relating to the tangible product also would be excluded from the scope of the software revenue guidance. The amendments also provide guidance on how a vendor should allocate arrangement consideration to deliverables in an arrangement that includes both tangible products and software. The amendments also provide further guidance on how to allocate arrangement consideration when an arrangement includes deliverables both included and excluded from the scope of the software revenue guidance. These amendments will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted. We are currently evaluating the impact the adoption of this update might have on our consolidated results of operations and financial condition.

During the first and second quarters of 2009, we adopted the following accounting guidance, none of which had a material effect on our consolidated results of operations or financial condition:

In June 2008, the FASB revised the authoritative guidance for earnings per share, which establishes that unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. In contrast, the right to receive dividends or dividend equivalents that the holder will forfeit if the award does not vest does not constitute a participation right and such an award does not meet the definition of a participating security in its current form (that is, prior to the requisite service having been rendered for the award). We adopted this guidance as of January 1, 2009. The adoption of this guidance had no effect on our consolidated results of operations and financial condition for the three and nine months ended September 30, 2009.

In April 2009, the FASB revised the authoritative guidance for financial instruments. The guidance requires disclosures about fair value of financial instruments in interim financial statements as well as in annual financial statements. This guidance is effective for interim periods ending after June 15, 2009. The adoption of this guidance had no material effect on our consolidated results of operations and financial condition for the three and nine months ended September 30, 2009.

In April 2009, the FASB revised the authoritative guidance for fair value measurements and disclosures to provide additional guidance in determining whether a market for a financial asset is not active and a transaction is not distressed for fair value measurement purposes. This guidance is effective for interim periods ending after June 15, 2009. We adopted this guidance for the period ending June 30, 2009. The adoption of this guidance had no effect on our consolidated results of operations and financial condition for the three and nine months ended September 30, 2009.

In April 2009, the FASB revised the authoritative guidance for investments in debt and equity securities to provide guidance in determining whether impairments in debt securities are other-than-temporary, and modifies the presentation and disclosures surrounding such instruments. This guidance is effective for interim periods ending after June 15, 2009. We adopted the provisions of this guidance for the period ending June 30, 2009. The adoption of this guidance had no effect on our consolidated results of operations and financial condition for the three and nine months ended September 30, 2009.

In May 2009, the FASB revised the authoritative guidance for subsequent events, which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. This guidance is effective for financial statements issued for interim and annual reporting periods ending after June 15, 2009. We adopted this guidance for the period ended June 30, 2009, and have provided the disclosures required for the period ending September 30, 2009.

#### 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 revenue or delay in recognizing revenue could cause operating results to vary significantly from quarter to quarter and could result in future operating losses or reduced net income.

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 revenue on the percentage of completion method of accounting based on the evaluation of actual costs incurred to date compared to total estimated costs. Revenue recognized in excess of billings is recorded as cost in excess of billings. Billings in excess of revenue recognized are recorded as deferred revenue until revenue recognition criteria are met. Reimbursements, including those relating to travel and other out-of-pocket expenses, are included in revenue, and an equivalent amount of reimbursable expenses are included in cost of services.

The Company recognizes revenue in accordance with generally accepted accounting principles. As a result, in the event that collectability from a client is not reasonably assured, revenue is recognized on the cash basis.

#### 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, the previously provided valuation allowance would be reversed. Our current valuation allowance relates predominately to benefits derived from the utilization of our NOL's.



#### Item 4T. Controls and Procedures

Evaluation of disclosure controls and procedures.

As of the end of the period covered by this Quarterly Report, the Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer ("the Certifying Officers"), conducted evaluations of the Company's disclosure controls and procedures. As defined under Sections 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), the term "disclosure controls and procedures" means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's management, including the Certifying Officers, to allow timely decisions regarding required disclosures. Based on this evaluation, the Certifying Officers have concluded that the Company's disclosure controls and procedures were not effective to ensure that material information is recorded, processed, summarized and reported by management of the Company on a timely basis in order to comply with the Company's disclosure obligations under the Exchange Act and the rules and regulations promulgated thereunder.

The Chief Executive Officer's and Chief Financial Officer's conclusion regarding the Company's disclosure controls and procedures is based solely on management's conclusion that the Company's internal control over financial reporting as identified in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008 continues to be ineffective as of September 30, 2009. In connection with our Annual Report on Form 10-K for the fiscal year ended December 31, 2008, our management assessed the effectiveness of the Company's internal control over financial reporting was not effective based on management's identification of a lack of segregation of duties due to the small number of employees dealing with general administrative and financial matters and general controls over information security and user access. Also, the Company's Chief Financial Officer is the only person with an appropriate level of accounting knowledge, experience and training in the selection, application and implementation of generally accepted accounting principles as it relates to complex transactions and financial reporting requirements.

Changes in internal control over financial reporting.

No significant changes were made in our internal control over financial reporting during the Company's third quarter of 2009 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

#### Item 1. Legal Proceedings

From time to time, the Company is either a defendant or the plaintiff in various claims and lawsuits. Although there can be no assurances, management believes that the disposition of such matters will not have a material adverse impact on the results or operations or financial position of the Company.

#### Item 6. 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

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.

Date: November 12, 2009

By: /s/ Lori Cohen  
Lori Cohen  
President and Chief Executive Officer