

CONVERSION SERVICES INTERNATIONAL INC  
Form 10-Q  
August 15, 2011

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 June 30, 2011

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<br>August 3, 2011 |
|--|----------------------------------|
| Common Stock, \$0.001 par value per<br>share | 139,048,931 shares               |

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CONVERSION SERVICES INTERNATIONAL, INC.

FORM 10-Q

For the three and six months ended June 30, 2011

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

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

|   | June 30,<br>2011   | December 31,<br>2010 |
|---|--------------------|----------------------|
| <b>ASSETS</b>   |                    |                      |
| <b>CURRENT ASSETS</b>   |                    |                      |
| Cash  | \$9,498            | \$285,762            |
| Accounts receivable, net  | 2,359,749          | 3,108,506            |
| Accounts receivable from related parties, net   | 403,507            | 211,179              |
| Prepaid expenses  | 119,909            | 54,628               |
| Costs in excess of billings   | 141,803            | -                    |
| <b>TOTAL CURRENT ASSETS</b>   | <b>3,034,466</b>   | <b>3,660,075</b>     |
| <b>PROPERTY AND EQUIPMENT, at cost, net</b>   | <b>5,385</b>       | <b>6,798</b>         |
| <b>OTHER ASSETS</b>   | <b>30,419</b>      | <b>86,576</b>        |
| <b>Total Assets</b>   | <b>\$3,070,270</b> | <b>\$3,753,449</b>   |
| <b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>  |                    |                      |
| <b>CURRENT LIABILITIES</b>  |                    |                      |
| Line of credit  | \$2,228,150        | \$2,395,233          |
| Accounts payable and accrued expenses   | 2,029,558          | 1,547,064            |
| Series A redeemable convertible preferred stock   | 1,900,000          | 1,868,331            |
| Deferred revenue  | 64,501             | 514,262              |
| Short term notes payable  | 693,595            | 99,408               |
| <b>TOTAL CURRENT LIABILITIES</b>  | <b>6,915,804</b>   | <b>6,424,298</b>     |
| Long-term debt, net of current portion  | -                  | 500,000              |
| <b>Total liabilities</b>  | <b>6,915,804</b>   | <b>6,924,298</b>     |
| Convertible preferred stock, \$0.001 par value, \$100 stated value, 20,000,000 shares authorized  |                    |                      |
| <b>COMMITMENTS AND CONTINGENCIES</b>  |                    |                      |
| <b>STOCKHOLDERS' DEFICIT</b>  |                    |                      |
| Common stock, \$0.001 par value, 300,000,000 shares authorized;<br>130,519,069 and 128,475,087 issued at June 30, 2011 and December 31, 2010,<br>respectively | 130,519            | 128,475              |

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|   |               |               |
|---|---------------|---------------|
| Series B convertible preferred stock, 20,000 shares issued and outstanding at June 30, 2011 and December 31, 2010, respectively | 1,352,883     | 1,352,883     |
| Additional paid in capital  | 68,196,570    | 68,165,281    |
| Treasury stock, at cost, 1,145,382 shares in treasury as of June 30, 2011 and December 31, 2010, respectively                   | (423,869 )    | (423,869 )    |
| Accumulated deficit   | (73,101,637 ) | (72,393,619 ) |
| Total Stockholders' Deficit   | (3,845,534 )  | (3,170,849 )  |
| Total Liabilities and Stockholders' Deficit   | \$3,070,270   | \$3,753,449   |

See Notes to Condensed Consolidated Financial Statements

CONVERSION SERVICES INTERNATIONAL, INC.  
AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
FOR THE THREE AND SIX MONTHS ENDED JUNE 30,  
(Unaudited)

|   | For the three months ended |                      | For the six months ended |                      |
|---|----------------------------|----------------------|--------------------------|----------------------|
|   | 2011                       | 2010                 | 2011                     | 2010                 |
| <b>REVENUE:</b>   |                            |                      |                          |                      |
| Services  | \$ 3,137,254               | \$ 3,956,413         | \$ 6,078,092             | \$ 8,260,762         |
| Related party services  | 603,336                    | 474,390              | 980,352                  | 936,135              |
| Reimbursable expenses   | 124,716                    | 153,508              | 216,900                  | 345,247              |
| Other   | 42,275                     | 63,500               | 92,860                   | 82,500               |
|   | 3,907,581                  | 4,647,811            | 7,368,204                | 9,624,644            |
| <b>COST OF REVENUE:</b>   |                            |                      |                          |                      |
| Services  | 2,205,712                  | 2,722,360            | 4,533,511                | 5,930,406            |
| Related party services  | 524,673                    | 418,262              | 864,689                  | 849,260              |
| Consultant expenses   | 135,015                    | 154,000              | 239,516                  | 365,560              |
|   | 2,865,400                  | 3,294,622            | 5,637,716                | 7,145,226            |
| <b>GROSS PROFIT</b>   | <b>1,042,181</b>           | <b>1,353,189</b>     | <b>1,730,488</b>         | <b>2,479,418</b>     |
| <b>OPERATING EXPENSES</b>   |                            |                      |                          |                      |
| Selling and marketing   | 405,239                    | 631,835              | 959,440                  | 1,317,491            |
| General and administrative  | 528,827                    | 667,730              | 1,208,424                | 1,401,884            |
| Depreciation and amortization   | 9,009                      | 23,099               | 27,759                   | 47,481               |
|   | 943,075                    | 1,322,664            | 2,195,623                | 2,766,856            |
| <b>INCOME (LOSS) FROM OPERATIONS</b>  | <b>99,106</b>              | <b>30,525</b>        | <b>(465,135 )</b>        | <b>(287,438 )</b>    |
| <b>OTHER EXPENSE</b>  |                            |                      |                          |                      |
| Interest expense, net   | (95,980 )                  | (94,765 )            | (242,883 )               | (193,912 )           |
|   | (95,980 )                  | (94,765 )            | (242,883 )               | (193,912 )           |
| <b>INCOME (LOSS) BEFORE INCOME TAXES</b>                                    | <b>3,126</b>               | <b>(64,240 )</b>     | <b>(708,018 )</b>        | <b>(481,350 )</b>    |
| <b>INCOME TAXES</b>   | <b>-</b>                   | <b>-</b>             | <b>-</b>                 | <b>-</b>             |
| <b>NET INCOME (LOSS)</b>  | <b>3,126</b>               | <b>(64,240 )</b>     | <b>(708,018 )</b>        | <b>(481,350 )</b>    |
| Accretion of issuance costs associated with convertible preferred stock     | -                          | (95,000 )            | -                        | (190,000 )           |
| Dividends on convertible preferred stock                                    | (21,250 )                  | (45,000 )            | (42,500 )                | (90,000 )            |
| <b>NET LOSS ATTRIBUTABLE TO COMMON STOCKHOLDERS</b>                         | <b>\$ (18,124 )</b>        | <b>\$ (204,240 )</b> | <b>\$ (750,518 )</b>     | <b>\$ (761,350 )</b> |
| Basic and diluted loss per common share attributable to common stockholders | \$ (0.00 )                 | \$ (0.00 )           | \$ (0.01 )               | \$ (0.01 )           |

Weighted average shares used to  
compute net income (loss) per  
common share:

|                   |             |             |             |             |
|-------------------|-------------|-------------|-------------|-------------|
| Basic and diluted | 129,368,861 | 123,570,367 | 129,317,189 | 123,470,726 |
|-------------------|-------------|-------------|-------------|-------------|

See Notes to Condensed Consolidated Financial Statements

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

|   | 2011              | 2010             |
|---|-------------------|------------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                   |                  |
| Net loss  | \$(708,018 )      | \$(481,350 )     |
| Adjustments to reconcile net loss to net cash used in operating activities:         |                   |                  |
| Depreciation of property and equipment and amortization of leasehold improvements   | 7,057             | 18,023           |
| Amortization of deferred financing costs  | 20,702            | 29,459           |
| Accretion of convertible preferred stock discount and beneficial conversion feature | 31,669            | -                |
| Stock based compensation  | -                 | 16,134           |
| Increase (decrease) in allowance for doubtful accounts                              | (8,082 )          | 15,247           |
| Changes in operating assets and liabilities:  |                   |                  |
| Decrease in accounts receivable   | 739,535           | 1,160,788        |
| Increase in accounts receivable from related parties                                | (175,024 )        | (26,385 )        |
| (Increase) decrease in prepaid expenses and other assets                            | (171,628 )        | 10,936           |
| Increase (decrease) in accounts payable and accrued expenses                        | 519,836           | (401,166 )       |
| (Decrease) increase in deferred revenue   | (449,761 )        | 53,418           |
| Net cash (used in) provided by operating activities                                 | (193,714 )        | 395,104          |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                   |                  |
| Purchase of property and equipment  | (5,644 )          | -                |
| Net cash used in investing activities   | (5,644 )          | -                |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |                   |                  |
| Net repayments under the line of credit   | (167,083 )        | (484,269 )       |
| Borrowings under short term notes payable   | 100,000           | -                |
| Principal payments on short term notes  | (9,823 )          | -                |
| Net cash used in financing activities   | (76,906 )         | (484,269 )       |
| <b>NET DECREASE IN CASH</b>   | <b>(276,264 )</b> | <b>(89,165 )</b> |
| CASH, beginning of period   | 285,762           | 96,957           |
| CASH, end of period   | \$9,498           | \$7,792          |

See Notes to Condensed Consolidated Financial Statements



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

|  | 2011       | 2010       |
|--|------------|------------|
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW<br>INFORMATION:           |            |            |
| Cash paid for interest   | \$ 159,296 | \$ 190,191 |
| Common stock issued in payment of preferred stock<br>dividends | 75,833     | 90,000     |

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.

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared by the Company, in conformity with US generally accepted accounting principles and in accordance with the rules and regulations of the Securities and Exchange Commission for quarterly reports on Form 10-Q, and are unaudited. The results of operations for the three and six months ended June 30, 2011 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 June 30, 2011, 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, 2010, filed with the Securities and Exchange Commission on March 23, 2011, 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

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

equivalent amount of reimbursable expenses are included in cost of services.

#### 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 these 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 June 30, 2011, receivables related to Bank of America and Leading Edge Communications ("LEC"), a related party, comprised approximately 48.3% and 14.7% of the Company's accounts receivable balance, respectively. At December 31, 2010, receivables related to Bank of America and PNC Bank comprised approximately 25.3% and 33.5% 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 June 30, 2011 and December 31, 2010, the Company has no unrecognized tax benefits. As of June 30, 2011 and December 31, 2010, 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 - Liquidity Issues and Going Concern

The Company has incurred a \$708,018 net loss for the six months ended June 30, 2011 and a loss of \$771,753 for the year ended December 31, 2010. The Company has incurred significant losses during the years ended December 31, 2004 through 2008, negative cash flows from operating activities for the years ended December 31, 2004 through 2008, and had an accumulated deficit of \$73.1 million at June 30, 2011. 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, we cannot predict whether we will become profitable or if our profitability levels will be sufficient to sustain the Company. 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 June 30, 2011, the Company had a cash balance of approximately \$9,498, compared to \$285,762 at December 31, 2010, and a working capital deficiency of \$3.9 million.

On April 6, 2011, Access Capital, Inc. ("Access Capital") and the Company entered into an amendment to the Loan and Security Agreement, dated as of March 31, 2008. The Amended agreement continues to provide the Company with a revolving line of credit of up to a maximum of \$3,500,000, based upon collateral availability, and has a 90% advance rate against eligible accounts receivable. The amendment provides for a three year term and has a base interest rate of prime plus 8.75% and provides for interest rate reductions based upon the Company's achievement of cash flow goals.

See Note 4 of the Notes to Condensed Consolidated Financial Statements for further discussion on the Line of Credit.

In February 2006, the Company issued Series A Preferred Stock, in the amount of \$1,900,000, which was redeemable for cash or common stock at the Company's option on February 6, 2011. The Company did not have sufficient cash or available shares to redeem the Series A Preferred and, as a result, is in default with respect to the redemption of this security as of the date of this filing. The Company expects to, at its next annual meeting of shareholders, propose to the Company's stockholders an amendment to the Company's Certificate of Incorporation to increase the number of authorized shares of Common Stock in an amount as to allow the Company to pay the redemption price in shares of Common Stock. If and when such a proposal is approved by the Company's shareholders, the Company expects to redeem the Series A Preferred with shares of Common Stock. Until the Company pays the redemption price of the Series A Preferred, holders of the Series A Preferred will continue to receive dividends in the amount of 5% per annum as set forth in the Certificate of Designations.

Additional capital or financing 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 –New Accounting Standards

In May 2011, the FASB issued ASU No. 2011-04, “Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs” (ASU 2011-04). This newly issued accounting standard clarifies the application of certain existing fair value measurement guidance and expands the disclosures for fair value measurements that are estimated using significant unobservable (Level 3) inputs. This ASU is effective on a prospective basis for annual and interim reporting periods beginning on or after December 15, 2011, which for the Company will be the fiscal year that begins on January 1, 2012. The Company does not expect that adoption of this standard will have a material impact on its financial position or results of operations.

Note 4 - Line of credit

On April 6, 2011, Access Capital, Inc. (“Access Capital”) and the Company entered into an amendment to the Loan and Security Agreement, dated as of March 31, 2008. Under the original Loan and Security Agreement, Access Capital provided the Company with a revolving line of credit of up to a maximum of \$3,500,000, based upon collateral availability, and has a 90% advance rate against eligible accounts receivable. The line of credit was for a three year term and had a base interest rate of prime plus 2.75% and a default rate of 18%.

Under the Amended Loan and Security Agreement, Access Capital continues to provide the Company with a revolving line of credit of up to a maximum of \$3,500,000, based upon collateral availability, and has a 90% advance rate against eligible accounts receivable and has a three year term. The line of credit has a base interest rate of prime plus 8.75% and provides for interest rate reductions based upon the Company’s achievement of cash flow goals. The interest rate is reduced by between 0.50% and 3.00% based upon the Company’s achievement of positive cumulative cash flow of between \$250,000 and \$1,500,000. The default interest rate is 3% above the applicable rate at the time of the default. Customer payments continue to be made directly to Access Capital.

Also under the amended agreement, the Company is required to maintain positive Cash Flow, as defined, on up to a rolling six month basis. Starting April, 2011, the end of each month (each a “Test Date”), the Company is required to maintain positive Cash Flow for the period ending on the Test Date, commencing from the later of (i) April 1, 2011 or (ii) six months prior to the Test Date. For example, on September 30, 2011, the Company is required to maintain positive Cash Flow for the period from April 1, 2011 to September 30, 2011. On November 30, 2011, the Company would be required to maintain positive Cash Flow for the period ending June 1, 2011 to November 30, 2011. As of June 30, 2011, the Company’s cumulative cash flow under this covenant is approximately \$96,105.

As of June 30, 2011, \$2.2 million was outstanding under this line of credit and approximately \$355,000 was available.

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 of these shares 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.

The following summarizes the stock option transactions during 2011:

| Shares | Weighted<br>average exercise<br>price |
|--------|---------------------------------------|
|--------|---------------------------------------|

|  |            |    |      |
|--|------------|----|------|
| Options outstanding at December 31, 2010 | 3,997,999  | \$ | 0.80 |
| Options granted                          | -          |    | -    |
| Options exercised                        | -          |    | -    |
| Options canceled                         | (826,333 ) |    | 0.55 |
| Options outstanding at June 30, 2011     | 3,171,666  | \$ | 0.86 |

The following table summarizes information concerning outstanding and exercisable Company common stock options at June 30, 2011:

| 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           | 940,000             | \$ 0.250                        | 5.3   | 940,000             | \$ 0.250                        |
| \$ 0.46-\$0.60           | 1,000,000           | 0.461                           | 4.5   | 1,000,000           | 0.460                           |
| \$ 0.83                  | 691,000             | 0.830                           | 4.4   | 691,000             | 0.830                           |
| \$ 2.475-\$3.45          | 540,666             | 2.711                           | 2.8   | 540,666             | 2.711                           |
|                          | 3,171,666           |                                 |   | 3,171,666           |                                 |

The Company recorded zero and \$19,909 and zero and \$16,134 of expense related to stock options which vested during the three and six months ended June 30, 2011 and 2010, respectively.

#### Note 6 – Loss Per Share

Basic loss per share is computed on the basis of the weighted average number of common shares outstanding. Diluted loss per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding stock options using the “treasury stock” method and the effect of convertible debt instruments and warrants as if they had been converted at the beginning of each period presented.

Basic and diluted loss per share was determined as follows:

|   | For the three months ended<br>June 30,<br>2011 |              | For the six months ended June<br>30,<br>2011 |              |
|---|--|--------------|--|--------------|
|   | 2011   | 2010         | 2011   | 2010         |
| Net loss attributable to common stockholders                  | \$(18,124 )                                    | \$(204,240 ) | \$(750,518 )                                 | \$(761,350 ) |
| Weighted average outstanding shares of common stock           | 129,368,861                                    | 123,570,367  | 129,317,189                                  | 123,470,726  |
| Basic and diluted income (loss) per common share:             |  |              |  |              |
| Net loss per common share attributable to common stockholders | \$(0.00 )                                      | \$(0.00 )    | \$(0.01 )                                    | \$(0.01 )    |

For the three and six month periods ended June 30, 2011 and 2010, 3,171,666 shares and 4,447,999 shares, respectively, attributable to outstanding stock options were excluded from the calculation of diluted loss per share because the effect was antidilutive. Additionally, the effect of 66,172,151 warrants and 36,596 options which were issued prior to June 30, 2011 and 2010, respectively, and outstanding as of June 30, 2011, were excluded from the calculation of diluted loss per share for the three month periods ended June 30, 2011 and 2010, as appropriate, because the effect was antidilutive. Also excluded from the calculation of loss per share because their effect was antidilutive were 16,666,667 shares of common stock underlying the \$500,000 convertible line of credit note to TAG Virgin Islands, Inc. as of June 30, 2011 and 2010, 145,170,038 shares underlying the Series A redeemable convertible preferred stock and 4,000,000 shares underlying the Series B convertible preferred stock.



Note 7 – Preferred Stock

In February 2006, we entered into a Securities Purchase Agreement with investors represented by TAG Virgin Islands, Inc. (“TAG”), pursuant to which we issued 19,000 shares of our newly created Series A Convertible Preferred Stock, \$.001 par value (the “Series A Preferred”). Each share of Series A Preferred has a stated value of \$100.00. We received proceeds of \$1,900,000. The Series A Preferred has a cumulative annual dividend equal to five percent (5%), which is payable semi-annually in cash or common stock, at our election, and is convertible into shares of the Company’s common stock at any time at a price equal to \$0.50 per share (subject to adjustment). In addition, the Series A Preferred has no voting rights, but has liquidation preferences and certain other privileges. Pursuant to the Securities Purchase Agreement, the TAG investors were also granted a warrant to purchase 1,900,000 shares of our common stock exercisable at a price of \$0.60 per share (subject to adjustment), exercisable for a period of five years.

The Company did not have sufficient cash or available shares to redeem the Series A Preferred on the February 1, 2011 redemption date and, as a result, is in default with respect to the redemption of this security as of the date of this filing. The Company expects to, at its next annual meeting of shareholders, propose to the Company’s stockholders an amendment to the Company’s Certificate of Incorporation to increase the number of authorized shares of Common Stock in an amount as to allow the Company to pay the redemption price in shares of Common Stock. If and when such a proposal is approved by the Company’s shareholders, the Company expects to redeem the Series A Preferred with shares of Common Stock. Until the Company pays the redemption price of the Series A Preferred, holders of the Series A Preferred will continue to receive dividends in the amount of 5% per annum as set forth in the Certificate of Designations.

Note 8 - Major Customers

During the three months ended June 30, 2011, the Company had sales relating to three major customers, Bank of America, LEC, a related party, and Boston Scientific comprising 35.6%, 15.6% and 10.6% of revenues, respectively, and totaling approximately \$1,391,934, \$608,506 and \$412,466, respectively. Amounts due from services provided to these customers included in accounts receivable was approximately \$1,958,385 at June 30, 2011. As of June 30, 2011, receivables related to services performed for Bank of America, LEC and Boston Scientific accounted for approximately 48.3%, 14.7% and 7.9% of the Company’s accounts receivable balance, respectively.

During the six months ended June 30, 2011, the Company had sales relating to two major customers, Bank of America and LEC, a related party, comprising 34.7% and 13.4% of revenues, respectively, and totaling approximately \$2,553,948 and \$985,522, respectively. Amounts due from services provided to these customers included in accounts receivable was approximately \$1,740,577 at June 30, 2011. As of June 30, 2011, receivables related to Bank of America and LEC accounted for approximately 48.3% and 14.7% of the Company's accounts receivable balance, respectively.

During the three months ended June 30, 2010, the Company had sales relating to three major customers, PNC Bank, Bank of America and LEC, a related party, comprising 37.2%, 12.9% and 10.2% of revenues, respectively, and totaling approximately \$1,730,560, \$599,266 and \$474,390, respectively. Amounts due from services provided to these customers included in accounts receivable was approximately \$1,724,675 at June 30, 2010. As of June 30, 2010, receivables related to services performed for PNC Bank, Bank of America and LEC accounted for approximately 25.2%, 23.1% and 9.3% of the Company's accounts receivable balance, respectively.

During the six months ended June 30, 2010, the Company had sales relating to two major customers, PNC Bank and Bank of America, comprising 33.2% and 11.7% of revenues, respectively, and totaling approximately \$3,197,722 and \$1,127,416, respectively. Amounts due from services provided to these customers included in accounts receivable was approximately \$1,446,385 at June 30, 2010. As of June 30, 2010, receivables related to PNC Bank and Bank of America accounted for approximately 25.2% and 23.1% of the Company's accounts receivable balance, respectively.

#### Note 9 - Commitments and Contingencies

##### Legal Proceedings

As of June 30, 2011, the Company has a claim pending in the Superior Court of New Jersey Law Division-Civil Part, Morris County, in which the Company sued National Digital Medical Archive, Inc. (hereinafter "Defendant" or "NDMA"), for services rendered to NDMA by the Company in 2009. This case arises out of NDMA's failure to pay the Company approximately \$0.4 million pursuant to a Professional Services Agreement, dated August 13, 2008, between CSI and NDMA (hereinafter the "Agreement"), and the Agreement's two accompanying Statements of Work, dated June 12, 2008 and August 29, 2008, that were time and materials based projects (hereinafter collectively with the Agreement referred to as the "SOWs"). NDMA interposed an answer and asserted multiple affirmative defenses and counterclaimed against the Company for approximately \$4.5 million based on the Company's alleged non-performance under the SOWs and for approximately \$3.8 million for unjust enrichment which is pled in the alternative. A mediation was held in May 2011 and the case was not settled during the mediation. Discovery has just started and a trial in this action is not expected to occur until the fall of 2011. The Company believes it has meritorious claims for non-payment pending against NDMA and the Company will also vigorously defend against NDMA's counterclaims. Although the ultimate outcome cannot presently be determined, in management's opinion, after consultation with its legal counsel, the likelihood of a material adverse outcome is not considered probable.

##### Lease Commitments

Future minimum lease payments due under all operating lease agreements as of June 30, 2011 are as follows:

| Years Ending June 30 | Office     |
|----------------------|------------|
| 2012                 | \$ 147,373 |
| 2013                 | 141,873    |
| 2014                 | 141,873    |
| 2015                 | 70,937     |

|            |            |
|------------|------------|
| Thereafter | -          |
|            | \$ 502,056 |

The Company's corporate headquarters are located at 100 Eagle Rock Avenue, East Hanover, New Jersey 07936, where it operates under an amended lease agreement expiring December 31, 2015. The Company leases approximately 9,137 square feet of office space in this facility. Monthly rent with respect to our East Hanover, New Jersey facility for the period beginning January 1, 2011 and ending December 31, 2015 is \$11,822.75. In addition to minimum rentals, the Company is liable for its proportionate share of real estate taxes and operating expenses, as defined. The Company has also rented office space from HQ Global Workplaces, LLC at 401 North Tryon Street, Charlotte, North Carolina 28202, where it operates under a one year lease agreement expiring December 31, 2011. The monthly rent for this space is approximately \$625. The Company notified the landlord of its intent to vacate the office space in April 2011.

## Note 10 - Related Party Transactions

Refer to footnote 8 for the related party transaction disclosure as a major customer.

As of June 30, 2011, the balance outstanding with respect to the loan from Glenn Peipert, our former 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.

In April 2011, the Company executed Unsecured Notes Payable agreements (the "Notes") with Sam Sodano, Vice President of Professional Services, William Hendry, Vice President and CFO and Radel Associates, LLC whereby an aggregate of \$100,000 was loaned to the Company. The Notes are due March 1, 2012, bear interest at 5% per annum and provide for repayment of principal and interest on a monthly basis beginning in June 2011. These Notes are subordinated to Access Capital.

## 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," "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<br>Operations Data for the<br>three<br>months ended June 30, |             | Selected Statement of<br>Operations Data for the<br>six<br>months ended June 30, |             |
|---|--|-------------|--|-------------|
|   | 2011   | 2010        | 2011   | 2010        |
| Net revenue   | \$3,907,581  | \$4,647,811 | \$7,368,204  | \$9,624,644 |
| Gross profit  | 1,042,181  | 1,353,189   | 1,730,488  | 2,479,418   |
| Net income (loss)   | 3,126  | (64,240 )   | (708,018 )   | (481,350 )  |
| Net loss attributable to common stockholders                  | (18,124 )  | (204,240 )  | (750,518 )   | (761,350 )  |
| Basic and diluted income (loss) per common share:             |  |             |  |             |
| Net loss per common share attributable to common stockholders | \$(0.00 )  | \$(0.00 )   | \$(0.01 )  | \$(0.01 )   |

|                             | Selected Statement of<br>Financial Position Data as<br>of |                      |
|-----------------------------|---|----------------------|
|                             | June 30,<br>2011  | December<br>31, 2010 |
| Working capital deficiency  | \$(3,881,338)   | \$(2,764,223)        |
| Total assets                | 3,070,270   | 3,753,449            |
| Total stockholders' deficit | (3,845,534)   | (3,170,849)          |

### Three and Six Months Ended June 30, 2011 and 2010

#### Revenue

The Company's revenue is primarily comprised of billings to clients for consulting hours worked on client projects. Revenue of \$3.9 million and \$7.4 million for the three and six months ended June 30, 2011, respectively, decreased by \$0.7 million, or 15.9%, and \$2.2 million, or 23.4%, as compared to revenue of \$4.6 million and \$9.6 million for the three and six months ended June 30, 2010, 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 six months ended June 30, 2011 and 2010:

|   | For the three months ended June 30, |                        |               |                        |   |  |
|---|-------------------------------------|------------------------|---------------|------------------------|---|--|
|   | 2011                                | % of total<br>revenues | 2010          | % of total<br>revenues |   |  |
|   | \$                                  |                        | \$            |                        |   |  |
| Strategic Consulting                        | \$1,518,056                         | 38.8                   | % \$1,340,299 | 28.8                   | % |  |
| Business Intelligence / Data<br>Warehousing | 1,619,198                           | 41.4                   | % 2,616,114   | 56.3                   | % |  |
| Data Management                             | 603,336                             | 15.4                   | % 474,390     | 10.2                   | % |  |
| Reimbursable expenses                       | 124,716                             | 3.2                    | % 153,508     | 3.3                    | % |  |
| Other                                       | 42,275                              | 1.1                    | % 63,500      | 1.4                    | % |  |

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|                              | \$3,907,581                       | 100.0      | % | \$4,647,811 | 100.0      | % |
|------------------------------|-----------------------------------|------------|---|-------------|------------|---|
|                              | For the six months ended June 30, |            |   | 2010        |            |   |
|                              | 2011                              |            |   |             |            |   |
|                              | \$                                | % of total |   | \$          | % of total |   |
|                              |                                   | revenues   |   |             | revenues   |   |
| Strategic Consulting         | \$2,800,912                       | 38.0       | % | \$2,818,406 | 29.3       | % |
| Business Intelligence / Data |                                   |            |   |             |            |   |
| Warehousing                  | 3,277,180                         | 44.5       | % | 5,442,356   | 56.5       | % |
| Data Management              | 980,352                           | 13.3       | % | 936,135     | 9.7        | % |
| Reimbursable expenses        | 216,900                           | 2.9        | % | 345,247     | 3.6        | % |
| Other                        | 92,860                            | 1.3        | % | 82,500      | 0.9        | % |
|                              | \$7,368,204                       | 100.0      | % | \$9,624,644 | 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 Business Transformation Solutions division.

Strategic consulting revenue of \$1.5 million, or 38.8% of total revenue, for the three months ended June 30, 2011 increased by \$0.2 million, or 13.3%, as compared to revenue of \$1.3 million, or 28.8% of total revenue, for the three months ended June 30, 2010. This increase is primarily due to a \$0.8 million increase in revenue related to Bank of America during the current period as compared to the prior year. This increase was partially offset by a \$0.6 million reduction in revenue related to a project at PNC Bank that began in April 2009 and concluded in third quarter of 2010. For the three month period ended June 30, 2011, in the strategic consulting line of business, there was a 23.8% increase in average consultant headcount, a 38.2% increase in billable hours and a 5.0% increase in utilization. The average bill rate decreased 20.2% as compared to the prior year.

Strategic consulting revenue of \$2.8 million, or 38.0% of total revenue, for the six months ended June 30, 2011 remained unchanged as compared to revenue of \$2.8 million, or 29.3% of total revenue, for the six months ended June 30, 2010. During the six month period ended June 30, 2011, revenue from Bank of America increased \$1.4 million as compared to the prior year period. However, this increase was offset by a \$1.2 million reduction in revenue related to a project at PNC Bank that began in April 2009 and concluded in third quarter of 2010. Additionally, revenue declined by \$0.2 million related to prior year projects with several other clients that completed prior to the current period. For the six months ended June 30, 2011, in the strategic consulting line of business, there was a 14.6% increase in average consultant headcount, a 31.8% increase in billable hours and a 14.9% increase in utilization. The average bill rate decreased 27.3% as compared to the prior year.

#### 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 \$1.6 million, or 41.4% of total revenue, for the three months ended June 30, 2011 decreased by \$1.0 million, or 38.1%, as compared to revenue of \$2.6 million, or 56.3% of total revenue, for the three months ended June 30, 2010. This decrease is primarily due to a \$0.8 million reduction in revenue related to prior year projects that completed in the prior period and a \$1.0 million decrease in revenue related to projects that continued from the prior year. These revenue reductions were partially offset by \$0.8 million of new project revenue obtained during the quarter. Overall, the BI/DW line of business had a 44.6% decrease in average consultant headcount and a 39.3% decrease in billable hours. The average bill rate increased during the current period by 7.1% and the utilization rate increased by 9.3% during the current period as compared to the prior year.

Business intelligence/data warehousing (“BI/DW”) revenue of \$3.3 million, or 44.5% of total revenue, for the six months ended June 30, 2011 decreased by \$2.1 million, or 39.8%, as compared to revenue of \$5.4 million, or 56.5% of total revenue, for the six months ended June 30, 2010. This decrease is primarily due to a \$2.0 million reduction in revenue related to prior year projects that completed in the prior period and a \$1.4 million decrease in revenue related to projects that continued from the prior year. These revenue reductions were partially offset by \$1.2 million of new project revenue obtained during the quarter. Overall, the BI/DW line of business had a 44.4% decrease in average consultant headcount, a 37.8% decrease in billable hours and the average bill rate decreased by 0.1%. The utilization rate increased by 4.3% during the current period as compared to the prior year.

#### 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 \$0.6 million, or 15.4% of total revenue, for the three months ended June 30, 2011 increased by \$0.1 million, or 27.2%, as compared to revenue of \$0.5 million, or 10.2% of total revenue, for the three months ended June 30, 2010. The revenue for the quarter increased as compared to the prior year due to work obtained



for a new client during the current period. The data management line of business experienced a 2.0% decrease in billable hours, a 16.6% decrease in the utilization rate, a 32.1% increase in the average bill rate and a 43.8% increase in average headcount during the current period.

Data management revenue of \$1.0 million, or 13.3% of total revenue, for the six months ended June 30, 2011 increased by \$0.1 million, or 4.7%, as compared to revenue of \$0.9 million, or 9.7% of total revenue, for the six months ended June 30, 2010. The revenue for the six month period ended June 30, 2011 increased as compared to the prior year due to work obtained for a new client during the current period. The data management line of business experienced a 12.1% decrease in billable hours, a 15.9% decrease in the utilization rate, an 18.5% increase in the average bill rate and a 20.0% increase in average headcount during the current period.

#### Cost of revenue

Cost of revenue includes payroll and benefit and other direct costs for the Company's consultants. Cost of revenue was \$2.9 million, or 73.3% of revenue, and \$5.6 million, or 76.5% of revenue, for the three and six months ended June 30, 2011, respectively, representing a decrease of \$0.4 million, or 13.0%, and \$1.5 million, or 21.1%, as compared to \$3.3 million, or 70.9% of revenue, and \$7.1 million, or 74.2% of revenue, for the three and six months ended June 30, 2010, respectively.

Cost of services was \$2.2 million, or 70.3% of services revenue for the three months ended June 30, 2011, representing a decrease of \$0.5 million, or 19.0%, as compared to \$2.7 million, or 68.8% of services revenue for the three months ended June 30, 2010. Cost of services decreased during the three months ended June 30, 2011, as compared to the prior year, primarily due to a decrease in services revenue during the period, accounting for a \$0.5 million decrease in cost of services. The Company had an average of 58 consultants in the current period and 77 in the prior year period, resulting in a 24.7% decrease in consultant headcount.

Cost of services was \$4.5 million, or 74.6% of services revenue for the six months ended June 30, 2011, representing a decrease of \$1.4 million, or 23.6%, as compared to \$5.9 million, or 71.8% of services revenue for the six months ended June 30, 2010. Cost of services decreased during the six months ended June 30, 2011, as compared to the prior year, primarily due to a decrease in services revenue during the period, however, higher margin prior year projects that were a significant component of the prior year revenues were completed and were replaced with business generating a lower profit margin in the current period. As a result, the cost of services as a percentage of services revenue increased by 2.8% points, from 71.8% in the prior year to 74.6% in the current period. The Company had an average of 60 consultants in the current period and 83 in the prior year period, resulting in a 27.7% decrease in consultant headcount.

Cost of related party services was \$0.5 million, or 87.0% of related party services revenue, for the three months ended June 30, 2011, representing an increase of \$0.1 million, or 25.4%, as compared to \$0.4 million, or 88.2% of related party services revenue, for the three months ended June 30, 2010. The increase in the cost of related party services for the current period results from the increase in related party revenue during the period. The Company had an average of 19 consultants performing services for the related party in the current period and 16 in the prior year period, resulting in an 18.8% increase in average consultant headcount.

Cost of related party services was \$0.9 million, or 88.2% of related party services revenue, for the six months ended June 30, 2011, representing an increase of \$0.1 million, or 1.8%, as compared to \$0.8 million, or 90.7% of related party services revenue, for the six months ended June 30, 2010. The increase in the cost of related party services for the current period results from the increase in related party revenue during the period. The Company had an average of 16 consultants performing services for the related party in the current period and 15 in the prior year period, resulting in a 6.7% increase in consultant headcount.

#### Gross profit

Gross profit was \$1.0 million, or 26.7% of revenue, and \$1.7 million, or 23.5% of revenue, for the three and six months ended June 30, 2011, respectively, representing a decrease of \$0.4 million, or 23.0%, and \$0.8 million, or 30.2%, as compared to \$1.4 million, or 29.1% of revenue, and \$2.5 million, or 25.8% of revenue, for the three and six months ended June 30, 2010, respectively.

Gross profit from services was \$0.9 million, or 29.7% of services revenue, for the three months ended June 30, 2011, representing a decrease of \$0.3 million from the prior year's gross profit from services of \$1.2 million, or 31.2% of services revenue. The decrease 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 \$1.5 million, or 25.4% of services revenue, for the six months ended June 30, 2011, representing a decrease of \$0.8 million from the prior year's gross profit from services of \$2.3 million, or 28.2% of services revenue. The decrease 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 \$78,663, or 13.0% of related party services revenue for the three months ended June 30, 2011, representing an increase of \$22,535 from the prior year's gross profit of \$56,128, or 11.8% of related party services revenue for the three months ended June 30, 2010. 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 \$115,663, or 11.8% of related party services revenue for the six months ended June 30, 2011, representing an increase of \$28,788 from the prior year's gross profit of \$86,875, or 9.3% of related party services revenue for the six months ended June 30, 2010. 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 \$0.4 million, or 10.4% of revenue, and \$1.0 million, or 13.0% of revenue, for the three and six months ended June 30, 2011, respectively, decreasing by \$0.2 million, or 35.9%, and \$0.3 million, or 27.2%, as compared to \$0.6 million, or 13.6% of revenue, and \$1.3 million, or 13.7% of revenue, for the three and six months ended June 30, 2010, respectively.

Selling and marketing expense decreased by \$0.2 million for the three month period ended June 30, 2011, as compared to the prior year, primarily due to a \$0.2 million reduction in payroll and payroll related expenses primarily due to a reduction in headcount, and reduced travel and costs of subscribing to recruiting databases.

Selling and marketing expense decreased by \$0.3 million for the six month period ended June 30, 2011, as compared to the prior year, primarily due to a \$0.3 million reduction in payroll and payroll related expenses primarily due to a reduction in headcount, and reduced travel, rent expense, costs of subscribing to recruiting databases and trade show expense.

#### 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 \$0.5 million, or 13.5% of revenue, and \$1.2 million, or 16.4% of revenue, for the three and six months ended June 30, 2011, declining \$0.2 million, or 20.8%, and \$0.2 million, or 13.8%, as compared to \$0.7 million, or 14.4% of revenue, and \$1.4 million, or 14.6% of revenue, for the three and six months ended June 30, 2010.

General and administrative expense decreased by \$0.2 million for the three month period ended June 30, 2011, as compared to the prior year, primarily due to a \$0.2 million reduction in payroll and payroll related expense, liability insurance costs, travel and rent expense.

General and administrative expense decreased by \$0.2 million for the six month period ended June 30, 2011, as compared to the prior year, primarily due to a \$0.1 million reduction in payroll and payroll related expense and a \$0.1 million in various expense categories including professional fees, training and seminars, utilities, and bad debt expense.

#### 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 \$9,009 and \$27,759 for the three and six months ended June 30, 2011 and \$23,099 and \$47,481 for the three and six months ended June 30, 2010, respectively.

#### Other income (expense)

Interest expense was \$95,980 and \$242,883 during the three and six months ended June 30, 2011, respectively, and was \$94,765 and \$193,912 for the three and six months ended June 30, 2010, respectively. Interest expense increased by \$48,971 during the six month period ended June 30, 2011 as compared to the prior year period primarily due to a \$79,169 reclassification of the accretion of issuance costs and the dividends related to the Series A convertible preferred stock to interest expense. This increase was partially offset by a \$31,280 reduction in interest expense on the Access Capital line of credit which was due to lower loan balances in the current period as compared to the prior year.

#### Liquidity and Capital Resources

The Company has incurred a \$708,018 net loss for the six months ended June 30, 2011 and a loss of \$771,753 for the year ended December 31, 2010. The Company has incurred significant losses during the years ended December 31, 2004 through 2008, negative cash flows from operating activities for the years ended December 31, 2004 through 2008, and had an accumulated deficit of \$73.1 million at June 30, 2011. 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, we cannot predict whether we will become profitable or if our profitability levels will be sufficient to sustain the Company. 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 June 30, 2011, the Company had a cash balance of approximately \$9,498, compared to \$285,762 at December 31, 2010, and a working capital deficiency of \$3.9 million.

On April 6, 2011, Access Capital, Inc. ("Access Capital") and Conversion Services International, Inc. (the "Company") entered into an amendment to that certain Loan and Security Agreement, which was dated as of March 31, 2008. Under the original Loan and Security Agreement, Access Capital provided the Company with a revolving line of credit of up to a maximum of \$3,500,000, based upon collateral availability, and has a 90% advance rate against eligible accounts receivable. The line of credit was for a three year term and had a base interest rate of prime plus 2.75% and a default rate of 18%.

Under the Amended Loan and Security Agreement, Access Capital provided the Company with a revolving line of credit of up to a maximum of \$3,500,000, based upon collateral availability, and has a 90% advance rate against eligible accounts receivable. The line of credit is for a three year term. The line of credit has a base interest rate of prime plus 8.75% and provides for interest rate reductions based upon the Company's achievement of cash flow goals. The interest rate is reduced by between 0.50% and 3.00% based upon the Company's achievement of positive cumulative cash flow of between \$250,000 and \$1,500,000. The default interest rate is 3% above the applicable rate at the time of the default. "Cash Flow" as defined in the Amended Loan and Security Agreement means, the net income (as defined by GAAP) of the Company, plus any non-cash charges, less payments (i) to the Company's officers or related persons, (ii) under capital leases and (iii) for capital expenditures.

Also under the Amended Loan and Security Agreement, the Company would not be required to meet certain working capital amounts, but rather, the Company is required to maintain positive Cash Flow on up to a rolling six month basis. Starting April, 2011, the end of each month (each a "Test Date"), the Company is required to maintain positive Cash Flow for the period ending on the Test Date, and commencing from the later of (i) April 1, 2011 or (ii) six months prior to the Test Date. For example, on September 30, 2011, the Company is required to maintain positive Cash Flow for the period from April 1, 2011 to September 30, 2011. On November 30, 2011, the Company would be required to maintain positive Cash Flow for the period ending June 1, 2011 to November 30, 2011. As of June 30, 2011, the Company's cumulative cash flow under this covenant is approximately \$96,105.

In February 2006, the Company issued Series A Preferred Stock, in the amount of \$1,900,000, which was redeemable for cash or common stock at the Company's option on February 6, 2011. The Company did not have sufficient cash or available shares to redeem the Series A Preferred and, as a result, is in default with respect to the redemption of this security as of the date of this filing. The Company expects to, at its next annual meeting of shareholders, propose to the Company's stockholders an amendment to the Company's Certificate of Incorporation to increase the number of authorized shares of Common Stock in an amount as to allow the Company to pay the redemption price in shares of Common Stock. If and when such a proposal is approved by the Company's shareholders, the Company expects to redeem the Series A Preferred with shares of Common Stock. Until the Company pays the redemption price of the Series A Preferred, holders of the Series A Preferred will continue to receive dividends in the amount of 5% per annum as set forth in the Certificate of Designations.

The Company's working capital deficit was \$3.9 million as of June 30, 2011 which represented a \$1.1 million increase in the working capital deficit when compared to the working capital deficit of \$2.8 million as of December 31, 2010. The \$1.1 million increase in the working capital deficit is due to a \$0.4 million reduction in accounts receivable and prepaid expenses, a \$0.6 million increase in short term notes payable, a \$0.5 million increase in accounts payable and accrued expenses and a \$0.3 million reduction in cash, which was partially offset by a \$0.2 million reduction in the Access Capital line of credit balance, a \$0.4 million reduction in deferred revenue and a \$0.1 million increase in costs in excess of billings. The reductions in accounts receivable and the Access Capital line of credit balance are due to \$0.7 million of reduced revenues during the six months ended June 30, 2011 as compared to the six months ended December 31, 2010. The \$0.6 million increase in short term notes payable is due to a reclassification of \$0.5 million of long term debt to short term during the current period and \$0.1 million of short term borrowings by the Company during the current period.

Cash used in operating activities during the six months ended June 30, 2011 was approximately \$0.2 million compared to cash provided by operating activities of \$0.4 million for the six months ended June 30, 2010. The \$0.6 million increase in cash used in operating activities as compared to the prior year was primarily the result of a \$0.5 million increase in cash used by accounts receivable, a \$0.5 million reduction in deferred revenue, a \$0.2 million increase in prepaid expenses and other assets and a \$0.3 million increase in cash used by 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, partially offset by a \$0.9 million increase in cash used by accounts payable.

Cash used in investing activities of \$5,644 during the current period was for the purchase of computer equipment. There was no cash used in investing activities during the prior period.

Cash used in financing activities was \$0.1 million during the six month period ended June 30, 2011 and cash used in financing activities was \$0.5 million during the six month period ended June 30, 2010. During the current period, the cash used in financing activities was due to \$0.2 million of net repayments of the Company's revolving line of credit as a result of the reduced collateral base, partially offset by \$0.1 million of short term borrowings. The cash used in financing activities during the six month period ended June 30, 2010 was due to \$0.5 million of net repayments under the Company's revolving line of credit agreement with Access Capital.

As of June 30, 2011, \$2.2 million was outstanding under this line of credit and approximately \$355,000 was available.

There are currently no material commitments for capital expenditures.

As of June 30, 2011 and December 31, 2010, the Company had accounts receivable due from LEC of approximately \$0.4 million and \$0.2 million, respectively. There are no known collection problems with respect to LEC.

For the three and six months ended June 30, 2011 and 2010, we invoiced LEC \$0.6 million and \$0.5 million and \$1.0 million and \$0.9 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 June 30, 2011:

| Lender  | Type of facility             | Outstanding as of June 30, 2011 (not including interest) (all numbers approximate) | Remaining Availability (if applicable) |
|---|------------------------------|--|--|
| Access Capital, Inc.                                    | Line of Credit               | \$ 2,228,150   | \$ 355,064                             |
| TAG Virgin Islands, Inc. Investors – due April 30, 2012 | Convertible Promissory Notes | \$ 500,000   | \$ -                                   |
| Glenn Peipert   | Promissory Note              | \$ 103,418   | \$ -                                   |
| Hendry, Sodano, Radel Associates                        | Promissory Notes             | \$ 90,177  |  |
| <b>TOTAL</b>  |                              | <b>\$ 2,921,745</b>  | <b>\$ 355,064</b>                      |

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

| Holder                             | Type of Instrument                   | Principal amount outstanding as of June 30, 2011 |
|------------------------------------|--------------------------------------|--|
| TAG Virgin Islands, Inc. 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>                              |

Additional capital or financing 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.

#### New Accounting Standards

In May 2011, the FASB issued ASU No. 2011-04, “Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs” (ASU 2011-04). This newly issued accounting standard clarifies the application of certain existing fair value measurement guidance and expands the disclosures for fair value measurements that are estimated using significant unobservable (Level 3) inputs. This ASU is effective on a prospective basis for annual and interim reporting periods beginning on or after December 15, 2011, which for the Company will be the fiscal year that begins on January 1, 2012. The Company does not expect that adoption of this standard will have a material impact on its financial position or results of operations.

#### 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.

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

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 4. 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, 2010 continues to be ineffective as of June 30, 2011. In connection with our Annual Report on Form 10-K for the fiscal year ended December 31, 2010, 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 second quarter of 2011 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

As of June 30, 2011, the Company has a claim pending in the Superior Court of New Jersey Law Division-Civil Part, Morris County, in which the Company sued National Digital Medical Archive, Inc. (hereinafter "Defendant" or "NDMA"), for services rendered to NDMA by the Company in 2009. This case arises out of NDMA's failure to pay the Company approximately \$0.4 million pursuant to a Professional Services Agreement, dated August 13, 2008, between CSI and NDMA (hereinafter the "Agreement"), and the Agreement's two accompanying Statements of Work, dated June 12, 2008 and August 29, 2008, that were time and materials based projects (hereinafter collectively with the Agreement referred to as the "SOWs"). NDMA interposed an answer and asserted multiple affirmative defenses and counterclaimed against the Company for approximately \$4.5 million based on the Company's alleged non-performance under the SOWs and for approximately \$3.8 million for unjust enrichment which is pled in the alternative. Discovery

has just started in this case. A mediation was held in May 2011. The case was not settled during the mediation. A trial in this action will not occur until the fall of 2011. The Company believes it has meritorious claims for non-payment pending against NDMA and the Company will also vigorously defend against NDMA's counterclaims.

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

|         |    |  |
|---------|----|--|
| 101.INS | ** | XBRL Instance Document                                 |
| 101.SCH | ** | XBRL Taxonomy Extension Schema Document                |
| 101.CAL | ** | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF | ** | XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB | ** | XBRL Taxonomy Extension Label Linkbase Document        |
| 101.PRE | ** | XBRL Taxonomy Extension Presentation Linkbase Document |

\*\* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

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: August 15, 2011

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