SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended December 31, 1997

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 No. 0-18492

DIGITAL SOLUTIONS, INC.
(Exact name of registrant as specified in its charter)

New Jersey	22-1899798
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
300 Atrium Drive, Somerset, NJ	08873
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (732) 748-1700

Former name, former address and former fiscal year, if changed since last report.

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

19,298,010 shares of Common Stock, par value $.001 per share, were outstanding as of February 11, 1998.

DIGITAL SOLUTIONS, INC. AND SUBSIDIARIES
FORM 10-Q

December 31, 1997

Table of Contents

DIGITAL SOLUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	DECEMBER 31, 1997 (unaudited)	SEPTEMBER 30, 1997
ASSETS		
CURRENT ASSETS		
Cash	$ 685,000	$ 841,000
Restricted Cash	738,000	738,000
Accounts receivable, net of allowance	5,637,000	5,820,000
Other current assets	444,000	402,000
Total current assets	7,504,000	7,801,000
EQUIPMENT AND IMPROVEMENTS		
Equipment	3,253,000	3,170,000
Leasehold improvements	49,000	47,000
	3,302,000	3,217,000
Accumulated depreciation and amortization	2,385,000	2,310,000
	917,000	907,000
DEFERRED TAX ASSET	760,000	760,000
GOODWILL, net of amortization	4,282,000	4,344,000
OTHER ASSETS	309,000	351,000
TOTAL ASSETS	$13,772,000	$14,163,000

The accompanying notes to the consolidated financial statements are an integral part of these consolidated financial statements.

DIGITAL SOLUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	DECEMBER 31, 1997 (unaudited)	SEPTEMBER 30, 1997
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Short-term borrowings	$ 2,567,000	$ 2,697,000
Current portion of long-term debt	93,000	113,000
Accounts payable	1,836,000	2,254,000
Accrued expenses and other current liabilities	3,579,000	4,138,000
Total current liabilities	8,075,000	9,202,000
LONG-TERM DEBT	75,000	89,000
Total Liabilities	8,150,000	9,291,000
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY		
Common Stock, $.001 par value; authorized 40,000,000 shares; issued and outstanding 19,298,010 and 19,141,760 at December 31, 1997 and September 30, 1997, respectively	19,000	19,000
Additional paid-in capital	13,643,000	13,393,000
Accumulated deficit	(8,040,000)	(8,540,000)
Total shareholders' equity	5,622,000	4,872,000
TOTAL LIABILITIES AND EQUITY	$ 13,772,000	$ 14,163,000

The accompanying notes to the consolidated financial statements are an integral part of these consolidated financial statements.

DIGITAL SOLUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	FOR THE THREE MONTHS DECEMBER 31,	
	1997	1996
REVENUES	$33,662,000	$30,885,000
DIRECT EXPENSES	31,060,000	28,370,000
Gross profit	2,602,000	2,515,000
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	1,857,000	2,061,000
DEPRECIATION AND AMORTIZATION	169,000	179,000
Income from operations	576,000	275,000
OTHER INCOME (EXPENSE)		
Interest and other income	12,000	17,000
Interest expense	(88,000)	(91,000)
	(76,000)	(74,000)
NET INCOME	$ 500,000	$ 201,000
BASIC EARNINGS PER COMMON SHARE	$ 0.03	$ 0.01
WEIGHTED AVERAGE SHARES OUTSTANDING	19,194,409	18,964,158
DILUTED EARNINGS PER COMMON SHARE	$ 0.03	$ 0.01
DILUTED SHARES OUTSTANDING	19,458,078	19,914,159

The accompanying notes to the consolidated financial statements are an integral part of these consolidated financial statements.

DIGITAL SOLUTIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	FOR THE THREE MONTHS DECEMBER 31, 1997	1996
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 500,000	$ 201,000
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	169,000	179,000
Provision for doubtful accounts	14,000	13,000
Changes in operating assets and liabilities:		
Accounts receivable	169,000	(1,440,000)
Other current assets	(32,000)	(318,000)
Accounts payable, accrued expenses and other current liabilities	(977,000)	733,000
Net cash used in operating activities	(157,000)	(632,000)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of equipment and improvements	(85,000)	--
Net cash used in investing activities	(85,000)	--
CASH FLOWS FROM FINANCING ACTIVITIES		
(Repayments) proceeds from borrowings on revolving line of credit - net	(130,000)	110,000
Payments under capital lease obligations	(34,000)	(36,000)
Proceeds from reduction of required Letters of Credit	--	344,000
Proceeds from issuance of common stock and exercise of common stock options and warrants - net	250,000	214,000
Net cash provided by financing activities	86,000	632,000
Net decrease in cash	(156,000)	--
CASH AT BEGINNING OF PERIOD	841,000	--
CASH AT END OF PERIOD	$ 685,000	$ --

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

Cash paid during the period for interest	$ 82,000	$ 81,000

The accompanying notes to the consolidated financial statements are an integral part of these consolidated financial statements.

DIGITAL SOLUTIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) ORGANIZATION AND BUSINESS

Digital Solutions, Inc. (the Company) was incorporated under the laws of the State of New Jersey on November 25, 1969. The Company, with its subsidiaries, provides a broad spectrum of human resource services including Professional Employer Organization (PEO) services, payroll processing, human resource administration and placement of temporary and permanent employees.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements included herein have been prepared by the registrant, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although the registrant believes that the disclosures are adequate to make the information presented not misleading. These consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's latest annual report on Form 10-K. This financial information reflects, in the opinion of management, all adjustments necessary to present fairly the results for the interim periods. The results of operations for such interim periods are not necessarily indicative of the results for the full year.

The accompanying consolidated financial statements include those of DSI, a New Jersey Corporation and its wholly-owned subsidiaries; DSI Contract Staffing, DSI Staff ConnXions, Staff ConnXions - Northeast, Inc., DSI Staff ConnXions - Southwest, and DSI Staff Rx, Inc. The results of operations of acquired companies have been included in the consolidated financial statements from the date of acquisition. All significant intercompany balances and transactions have been eliminated in the consolidated financial statements.

Earnings Per Common Share

In March 1997, the Financial Accounting Standards Board issued Statement on Financial Accounting Standards Number 128, "Earnings Per Share" (FAS No. 128). FAS 128 requires the presentation of basic earnings per share and diluted earnings per share. "Basic earnings per share" represents net income divided by the weighted average shares outstanding. "Diluted earnings per share" represents net income divided by weighted average shares outstanding adjusted for the incremental dilution of outstanding employee stock options and awards.

(3) COMMITMENTS AND CONTINGENCIES

In connection with the Company's former workers' compensation insurance policy which expired on April 1, 1997, the insurance company developed reserve factors on each claim that may or may not materialize after the claim is fully investigated. Generally Accepted Accounting Principles require that all incurred, but not paid claims, as well as an estimate for claims incurred, but not reported (IBNR), be accrued on the balance sheet as a current liability, although a portion of the claims may not be paid in the following 12 months. As of December 31, 1997 and December 31, 1996, this accrual amounted to $628,000 and $790,000, respectively. On April 1, 1997, the Company entered into a workers' compensation policy with a new carrier. Under the terms of the new workers' compensation insurance program the Company fully accrues the maximum loss on a monthly basis. During the three months ended December 31, 1997 and 1996, the Company recognized approximately $190,000 and $345,000, respectively, as its share of premiums collected from customers covered by these policies in excess of claims and fees paid. The decrease in reported workers' compensation profit is due to the revised methodology in evaluating the Company's exposure as previously discussed and the new insurance program.

The Company has outstanding letters of credit amounting to $1,193,000 as of December 31, 1997. The letters of credit are required to collateralize unpaid claims in connection with the Company's former workers' compensation insurance policy and can only be drawn upon by the beneficiary if the Company does not perform according to the terms of the related agreement. The Company has collateralized these letters of credit by maintaining compensating restricted cash balances of $738,000 and utilizing $455,000 of amounts available under its line of credit. The Company's current policy does not require a letter of credit because the Company funds the estimated loss reserves on a monthly basis.

(4) SHAREHOLDERS' EQUITY

During the first quarter of fiscal 1998, $250,000 was received from an equity investment by the Company's directors and executive officers, as well as from a former director, to be used for general corporate purposes. The raising of these funds was a requirement of the recently negotiated bank line of credit extension.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

Results of Operations

Certain statements contained herein constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995 (the "1995 Reform Act"). Digital Solutions, Inc. (the "Company") desires to avail itself of certain "safe harbor" provisions of the 1995 Reform Act and is therefore including this special note to enable the Company to do so. Forward-looking statements included in this Memorandum involve known and unknown risks, uncertainties, and other factors which could cause the Company's actual results, performance (financial or operating) or achievements to differ from the future results, performance (financial or operating) achievements expressed or implied by such forward looking statements. Such future results are based upon management's best estimates based upon current conditions and the most recent results of operations. These risks include, but are not limited to, risks associated with the Company's recent losses, the Company's ongoing need for a new credit facility, need for additional capital, risks of recently consummated acquisitions as well as future acquisitions, effects of competition and technological changes and dependence upon key personnel.

The Company's revenues for the three months ended December 31, 1997 and 1996 were $33,662,000 and $30,885,000, respectively, which represents an increase of $2,777,000 or 9.0%. This increase is due to the efforts of the internal sales force to continually bring in new business which accounted for all of the increase.

Direct expenses were $31,060,000 for the three months ended December 31, 1997 and $28,370,000 for the comparable period last year, representing an increase of $2,690,000 or 9.5%. Of this increase, $155,000 is due to reporting less profit on the workers' compensation program in the quarter ended December 31, 1997 due to the revised methodology in evaluating workers' compensation reserves and the new insurance program. As a percentage of revenue, direct expenses for the three months ending December 31, 1997 and 1996 were 92.3% and 91.8%, respectively. These increases represent the corresponding higher costs associated with the increase in revenue and a greater mix of PEO business plus lower workers' compensation profit. These increases were attributed to the increase in the PEO business.

Gross profits were $2,602,000 and $2,515,000 for the quarters ended December 31, 1997 and 1996, respectively, or a increase of $87,000. Gross profits, as a percentage of revenue, were 7.7% and 8.1% for the quarters ended December 31, 1997 and 1996, respectively, reflecting the higher mix of PEO business.

SG&A costs for the quarters ended December 31, 1997 and 1996 were $1,857,000 and $2,061,000, respectively, for an decrease of $204,000 or 9.9%. The decrease was attributable to the reduction in overhead costs implemented in the fourth fiscal quarter of 1997.

Depreciation and amortization for the quarters ended December 31, 1997 and 1996 decreased to $169,000 from $179,000, respectively, or $10,000.

Net income for the quarter ended December 31, 1997 was $500,000 versus net income of $201,000 for the similar period in 1996. This increase of $299,000 is attributed to the increase in the PEO business and the reduction in overhead costs.

Liquidity and Capital Resources

The Company's negative working capital position as of December 31, 1997 improved to ($571,000) versus ($1,401,000) as of September 30, 1997. The increase reflects the continued earnings improvement of the Company. At December 31, 1997, the Company had cash of $685,000, restricted cash of $738,000 and accounts receivable, net of $5,637,000.

In February 1995, the Company entered into a one year revolving credit line facility (the "Line") with a bank which was subsequently extended and amended on seven occasions. Each loan extension has been for limited periods of time. The fifth amendment executed as of December 31, 1996, restricted the Company from borrowing any additional funds available on the Line and required weekly principal payments of $10,000, effective February 24, 1997. Effective October 31, 1997, the Company entered into the seventh amendment to the loan agreement. Under the terms of this agreement, which expires October 31, 1998, the Company was required to grant to the bank 500,000 warrants to purchase the Company's common stock. The warrants will vest in amounts of 200,000 and 300,000 as of April 30, 1998 and October 31, 1998, respectively, if the obligations under the loan agreement are not paid in full by these dates. The warrants have an exercise price of $2.4375 per share, which was the fair market value of the stock at the date of the agreement. The Company is obligated to make monthly payments of interest on the outstanding amounts at the bank's floating base rate plus three percent (11.5% at September 30, 1997). Under the present amendment, the Company can not borrow additional funds and continues to make weekly principal payments of $10,000. The line is collateralized by all of the Company's assets. At September 30, 1997 and December 31, 1997, the total amount outstanding on the Line was $2,697,000 and $2,567,000, respectively. In December 1997, the Company's directors and executive officers, as well as a former director, made an equity investment of $250,000 for general corporate purposes. The raising of these funds was a requirement of the recently negotiated bank line of credit extension.

To address the capital needs of the Company, management is presently in discussions with several financial institutions. There can be no assurance that the Company will be successful in its efforts to raise additional funds. At the present time, the Company does not have funds available to repay the Line. Repayment of the Line is due in full on October 31, 1998.

Inflation and changing prices have not had a material effect on the Company's net revenues and results of operations in the last three fiscal years, as the Company has been able to modify its prices to respond to inflation and changing prices.

PART II

OTHER INFORMATION

Item 1. Legal Proceedings

In October 1995, the Company entered into a note and finance agreement with LNB Investment Corporation (LNB) providing for the loan to the Company of up to $3,000,000. The loan was for a term of 15 months and was to be secured by shares of the Company's common stock having a market value of no less than four times the outstanding balance of the loan. LNB agreed not to sell or otherwise liquidate the shares unless the Company were to default under the loan agreement and failed to cure such default after notice. A total of 7,500,000 shares to be pledged as collateral were registered under a registration statement filed under the Securities Act of 1933, as amended.

The Company issued 1,783,334 shares in the name of LNB and delivered the shares to a depository to secure the first portion of the loan of $1,000,000. In January 1996, the Company determined that the shares pledged as collateral had been transferred and sold in violation of the loan and finance agreement. As a result, the financing agreement was terminated and never funded. Through the efforts of the Company, 1,258,334 of these shares were recovered and the Company received proceeds of $229,000 for a partial payment on the 525,000 shares not recovered.

In March 1996, the Company commenced action against LNB, Donaldson, Lufkin & Jenrette Securities Corporation and other individuals to recover damages on account of the wrongful sale of the Company's common stock. On July 2, 1997, the Company settled the action. Without admitting or denying the allegations in the complaint, the defendants agreed to pay $676,000 of which $426,000 ($202,000, net of expenses) has been paid with the balance of $250,000 to be paid by LNB on or before August 4, 1997. As of February 11, LNB failed to make the $250,000 payment due under the settlement agreement. The Company is currently pursuing enforcement alternatives. The subsequent payment is secured by a confession of judgment and a mortgage in the amount of $625,000. The payments under the settlement agreement are in addition to $229,000 previously received from LNB bringing the total recovered to approximately $905,000, assuming LNB complies with the terms of the settlement and remits the last payment of $250,000. The agreement also provides that upon payment of all sums due under the settlement agreement, LNB shall be deemed to have made full restitution to the Company for the claims alleged in the action.

At December 31, 1997 the Company is involved in various other legal proceedings incurred in the normal course of business. In the opinion of management and its counsel, none of these proceedings would have a material effect, if adversely decided, on the consolidated financial position or results of operations of the Company.

Item 5. Other Events

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits - None

(b) Reports on Form 8-K

none filed during the quarter ended December 31, 1997.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DIGITAL SOLUTIONS, INC.
(Registrant)

/s/ Donald W. Kappauf

Donald W. Kappauf
Chief Executive Officer

/s/ Donald T. Kelly

Donald T. Kelly
Chief Financial Officer

Date: February 11, 1998

5

3-MOS
SEP-30-1998
OCT-01-1997
DEC-31-1997
685,000
0
6,513,000
(876,000)
0
7,504,000
3,302,000
(2,385,000)
13,772,000
8,075,000
0
0
0
(19,000)
(5,603,000)
13,772,000
0
33,662,000
0
31,060,000
0
(14,000)
(88,000)
500,000
0
500,000
0
0
0
500,000
.03
.03