

FORM 10-QSB

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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

For the Quarterly Period Ended September 30, 2005

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the Transition Period from _____ to _____

Commission File #0-11078

THE AMERICAN EDUCATION CORPORATION

(Exact name of small business issuer as specified in its charter)

Nevada

(State or other jurisdiction of
incorporation or organization)

73-1621446

(IRS Employer Identification No.)

7506 North Broadway Extension, Suite 505, Oklahoma City, OK 73116

(Address of principal executive offices)

(405) 840-6031

(Issuer's telephone number)

Securities registered pursuant to Section 12(b) of the Act: NONE

**Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value \$.025 per share**

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

YES NO

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES NO

Number of shares of the issuer's common stock outstanding as of November 11, 2005: **14,133,461**

Transitional Small Business Disclosure Format

YES NO

THE AMERICAN EDUCATION CORPORATION

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PART I – FINANCIAL INFORMATION

ITEM 1 – CONSOLIDATED BALANCE SHEETS

THE AMERICAN EDUCATION CORPORATION CONSOLIDATED BALANCE SHEETS

	<u>September 30</u> <u>2005</u> <u>(unaudited)</u>	<u>December 31</u> <u>2004</u> <u>(audited)</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 866,460	\$ 549,343
Accounts receivable, net of allowance for returns and uncollectible accounts of \$265,000 and \$200,000	3,188,167	2,146,264
Inventory	16,344	14,485
Prepaid expenses and deposits	420,482	305,897
Deferred tax asset	<u>107,266</u>	<u>86,542</u>
Total current assets	4,598,719	3,102,531
Property and equipment, at cost	1,372,480	1,308,735
Less accumulated depreciation and amortization	<u>(1,219,229)</u>	<u>(1,164,389)</u>
Net property and equipment	153,251	144,346
Other assets:		
Capitalized software costs, net of accumulated amortization of \$8,825,140 and \$7,652,777	3,766,930	3,815,680
Goodwill, net of accumulated amortization of \$-0- and \$369,097	--	1,215,015
Deferred tax asset – long-term	<u>51,674</u>	<u>--</u>
Total other assets	<u>3,818,604</u>	<u>5,030,695</u>
Total assets	<u>\$ 8,570,574</u>	<u>\$ 8,277,572</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable trade	\$ 67,134	\$ 285,261
Accrued liabilities	1,054,443	693,122
Deferred revenue	1,031,329	654,337
Notes payable and current portion of long-term debt	<u>745,642</u>	<u>371,862</u>
Total current liabilities	2,898,548	2,004,582
Other long-term accrued liabilities	681,975	470,475
Deferred income tax liability – Long-term	--	103,921
Long-term debt	<u>--</u>	<u>305,880</u>
Total liabilities	<u>3,580,523</u>	<u>2,884,858</u>
Commitments and contingencies	-	-
Stockholders' Equity:		
Preferred Stock, \$.001 par value;		
Authorized - 50,000,000 shares-issued and outstanding-none	-	-
Common Stock, \$.025 par value		
Authorized 30,000,000 shares		
Issued and outstanding - 14,133,461 shares	359,186	359,186
Additional paid in capital	6,698,817	6,698,817
Treasury stock, at cost, 234,000 shares	(319,125)	(319,125)
Retained deficit	(1,346,164)	(1,346,164)
Year-to-date earnings	<u>(402,663)</u>	<u>-</u>
Total stockholders' equity	<u>4,990,051</u>	<u>5,392,714</u>
Total liabilities and stockholders' equity	<u>\$ 8,570,574</u>	<u>\$ 8,277,572</u>

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

THE AMERICAN EDUCATION CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
THREE MONTHS ENDED September 30, 2005 AND 2004
(unaudited)

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	<u>2005</u>	<u>2004</u>
Sales	\$ 2,489,284	\$ 2,601,412
Cost of goods sold	<u>234,091</u>	<u>346,636</u>
Gross profit	2,255,193	2,254,776
Operating expenses:		
Selling and marketing	960,623	809,070
Operations	163,749	124,911
General and administrative	571,610	523,610
Amortization of capitalized software costs	<u>409,064</u>	<u>362,854</u>
Total operating expenses	<u>2,105,046</u>	<u>1,820,445</u>
Operating income from continuing operations	150,147	434,331
Other income (expense):		
Interest expense	<u>(13,543)</u>	<u>(19,615)</u>
Income from continuing operations before income taxes	136,604	414,716
Deferred income tax expense	<u>54,642</u>	<u>165,886</u>
Income from continuing operations	81,962	248,830
Loss from discontinued operations (net of tax benefits 2005 - \$42,448; 2004 - \$0) (Note 14)	<u>(63,671)</u>	<u>(227,438)</u>
Net Income	<u>\$ 18,291</u>	<u>\$ 21,392</u>
Earnings per share:		
Basic:		
Continuing operations	\$.006	\$.018
Discontinued operations	\$ (.005)	\$ (.016)
Net income	\$.001	\$.002
Diluted:		
Continuing operations	\$.005	\$.016
Discontinued operations	\$ (.004)	\$ (.015)
Net income	\$.001	\$.001
Weighted average common shares outstanding:		
Basic	14,133,461	14,133,461
Diluted	17,074,264	15,668,711

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

THE AMERICAN EDUCATION CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
NINE MONTHS ENDED September 30, 2005 AND 2004
(unaudited)

	<u>2005</u>	<u>2004</u>
Sales	\$ 7,987,414	\$ 7,873,473
Cost of goods sold	<u>861,658</u>	<u>1,016,713</u>
Gross profit	7,125,756	6,856,760
Operating expenses:		
Selling and marketing	2,733,628	2,752,851
Operations	449,206	372,638
General and administrative	1,802,744	1,401,795
Impairment of goodwill (Note15)	1,215,015	--
Amortization of capitalized software costs	<u>1,172,364</u>	<u>1,040,721</u>
Total operating expenses	<u>7,372,957</u>	<u>5,568,005</u>
Operating income (loss) from continuing operations	(247,201)	1,288,755
Other income (expense):		
Interest expense	<u>(42,112)</u>	<u>(50,039)</u>
Income (loss) from continuing operations before income taxes	(289,313)	1,238,716
Deferred income tax expense <u>(benefit)</u>	<u>(71,464)</u>	<u>494,645</u>
Income (loss) from continuing operations	(217,849)	744,071
Loss from discontinued operations (net of tax benefits 2005 - \$104,855; 2004 - \$0) (Note 14)	<u>(184,814)</u>	<u>(526,698)</u>
Net Income (loss)	<u>\$ (402,663)</u>	<u>\$ 217,373</u>
Earnings per share:		
Basic:		
Continuing operations	\$ (.015)	\$.052
Discontinued operations	\$ (.013)	\$ (.037)
Net income (loss)	\$ (.028)	\$.015
Diluted:		
Continuing operations	\$ (.013)	\$.048
Discontinued operations	\$ (.011)	\$ (.034)
Net income (loss)	\$ (.024)	\$.014
Weighted average common shares outstanding:		
Basic	14,133,461	14,133,461
Diluted	17,074,264	15,668,711

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

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THE AMERICAN EDUCATION CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
NINE MONTHS ENDED SEPTEMBER 30, 2005 AND 2004
(unaudited)

	<u>2005</u>	<u>2004</u>
Cash flows from operating activities:		
Net income (loss)	\$ (402,663)	\$ 217,373
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,442,218	1,255,875
Reserve for bad debts	65,000	132,014
Deferred compensation	211,500	163,500
Other	--	29,074
Changes in assets and liabilities:		
Accounts receivable	(1,106,903)	(453,050)
Inventories	(1,859)	4,091
Prepaid expenses and other	(114,585)	(260,433)
Accounts payable and accrued liabilities	143,194	(406,832)
Deferred revenue	376,992	266,835
Deferred income taxes	(176,319)	442,560
Net cash provided by operating activities	<u>1,436,575</u>	<u>1,391,007</u>
Cash flow from investing activities:		
Software development costs capitalized	(1,123,613)	(958,213)
Purchase of property and equipment	(63,745)	(29,456)
Net cash used in investing activities	<u>(1,187,358)</u>	<u>(987,669)</u>
Cash flows from financing activities:		
Proceeds received from issuance of debt	400,000	--
Principal payments on notes payable	(332,100)	(263,023)
Net cash provided by financing activities	<u>67,900</u>	<u>(263,023)</u>
Net increase in cash	317,117	140,315
Cash at beginning of the period	<u>549,343</u>	<u>216,676</u>
Cash at end of the period	<u>\$ 866,460</u>	<u>\$ 356,991</u>

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

THE AMERICAN EDUCATION CORPORATION
Part I
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
FOR THE PERIODS ENDED SEPTEMBER 30, 2005 AND 2004

NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1. Description of Business:

The American Education Corporation's ("the Company") business is the development and marketing of educational software to elementary, middle and secondary schools, adult literacy centers and vocational, junior and community colleges. In addition, the Company has two subsidiaries, Learning Pathways, Ltd. ("LPL"), Derby, UK, and Dolphin, Inc. ("Dolphin"), Voorhees, NJ. LPL modifies the Company's U.S. curriculum offering to conform to the UK's educational system and markets these products directly to UK and other international markets. Dolphin is a developer of educational software for many of the nation's leading textbook and electronic publishers. As indicated below, both of these subsidiaries' status has changed in the past twelve months in an effort to reorganize the Company and concentrate on the core profitable business.

In December 2004, the Company determined that the assets of LPL were impaired and its value was written down to zero. Subsequently, it has been classified as an asset held for sale and, therefore, its operations are shown as discontinued. On November 7, 2005, subsequent to the closing of this reporting period, the Company transferred all of the stock of LPL to Learning.com who has assumed the responsibility for the LPL operations. The Company expects to incur approximately \$60,000 in additional expenses related to its disposition of LPL in the fourth quarter of 2005. Under the terms of the agreement with Learning.com, the Company will receive royalties on sales of its product by LPL beginning in January 2006.

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Effective June 2005, the Company determined that the goodwill of the Dolphin subsidiary was impaired and it was written off. The Company is exiting the software development business for outside customers and will be transferring certain Dolphin employees to the Company's payroll to enhance internal development efforts.

2. Basis of Presentation:

The summary of significant accounting policies of the Company is presented to assist in understanding the Company's financial statements. These accounting policies conform to generally accepted accounting principles and have been consistently applied in the preparation of the financial statements.

The Company's consolidated financial statements include the Company and its wholly owned subsidiaries. All material intercompany transactions have been eliminated.

The interim consolidated financial statements at September 30, 2005, and for the three and nine-month periods ended September 30, 2005 and 2004 are unaudited, but include all adjustments that the Company considers necessary for a fair presentation. The December 31, 2004 balance sheet was derived from the Company's audited financial statements.

The accompanying unaudited financial statements are for the interim periods and do not include all disclosures normally provided in annual financial statements. They should be read in conjunction with the Company's audited financial statements included in the Company's Form 10-KSB/A for the year ended December 31, 2004. The accompanying unaudited interim financial

statements for the three and nine month periods ending September 30, 2005 are not necessarily indicative of the results that can be expected for the entire year.

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

3. **Revenue Recognition:**

The Company recognizes revenue in accordance with the American Institute of Certified Public Accountant's Statement of Position 97-2, 98-9 and modifications thereto on software revenue recognition. The Company has also adopted revenue recognition policies regarding sales with multiple deliverables which comply with Emerging Issues Task Force Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables," which became effective July 1, 2003. Revenue for software design services at Dolphin is recognized on the percentage-of-completion method.

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4. **Capitalized Software Costs:**

Capitalized software costs consist of licenses for the rights to produce and market computer software, salaries and other direct costs incurred in the production of computer software. Costs incurred in conjunction with product development are charged to research and development expense until technological feasibility is established. Thereafter, all software development costs are capitalized and amortized on a straight-line basis over the product's estimated economic life of between three and five years.

5. **Goodwill:**

Goodwill represents the excess of the cost of purchased companies over the fair value of their net assets at the date of acquisition. Goodwill is reviewed for possible impairment at least annually or more frequently upon the occurrence of an event or when circumstances indicate that the carrying amount is greater than its fair value. During 2005, the Company determined that the carrying amount of the goodwill related to the acquisition of Dolphin exceeded its fair value and an impairment loss of \$1,215,015 has been recognized. (See Note 15.)

6. **Inventories:**

Inventories are stated at the lower of cost (first-in, first-out), or market, and consist of packaging and educational software materials.

7. **Property and Equipment:**

Property and equipment is stated at cost. Depreciation is provided on the straight-line basis over the estimated useful life of the assets, which is five years.

8. **Debt:**

The Company had the following indebtedness under notes and loan agreements:

	<u>Current</u>	<u>Long-term</u>	<u>Total</u>
Line of credit with bank, matures November 30, 2005; payments of \$24,000 per month plus interest at the bank's prime rate plus 2% (8.75% at September 30, 2005)	\$ 39,762	\$ --	\$ 39,762
Revolving line of credit with bank, matures March 31, 2006; maximum line – \$450,000, interest at the bank's prime rate plus 2% (8.75% at September 30, 2005)	--	--	--
Subordinated debt due to unrelated individual, originated March 30, 2005, matures March 30, 2006 and may be renewed for one year at the option of the holder; interest at 8% payable at maturity; convertible into the Company's common stock at \$.463 per share	400,000	--	400,000
Subordinated debt due to shareholder affiliates, originated April 1, 2003, matures September 30, 2006; interest at 8% payable quarterly, principal due at maturity, convertible into the Company's common stock at \$.40 per share	305,880	--	305,880
	<u>\$745,642</u>	<u>\$ --</u>	<u>\$745,642</u>

9. **Stock Options:**

The Company has historically measured compensation from issuing employee stock options under the accounting prescribed by APB Opinion No. 25, "Accounting for Stock Issued to Employees" which is an intrinsic value method. Accounting pronouncement SFAS No. 123(R), "Share-based Payment," replaces SFAS No. 123 and supersedes APB Opinion No. 25. SFAS 123 (R) establishes financial accounting and reporting standards for transactions in which an entity exchanges its equity instruments for goods or services. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS 123(R) requires a public entity to measure the cost of employee services received in an exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award (the vesting period). As a small business issuer the Company is required to adopt SFAS No. 123(R) effective as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. This Statement applies to all awards granted after the required effective date and to awards modified, repurchased, or cancelled after that date. The cumulative effect of initially applying this Statement, if any, will be recognized as of the required effective date.

The following pro forma disclosures show the effect on net income as if SFAS 123(R) had been applied prior to the required effective date. The Company's pro forma income and earnings per share are as follows for the nine months ended September 30:

	<u>2005</u>	<u>2004</u>
Net income (loss) – as reported	(\$402,663)	\$217,373
Stock – based employee compensation expense – pro forma	<u>48,500</u>	<u>46,485</u>
Net income (loss) – pro forma	(451,163)	170,888
Basic earnings per common share – as reported	(\$.03)	\$.02
Diluted earnings per common share – as reported	(.02)	.01
Basic earnings per common share – pro forma	(\$.03)	\$.01
Diluted earnings per common share – pro forma	(.03)	.01

10. Statements of Cash Flows:

In the Consolidated Statements of Cash Flows, cash and cash equivalents may include currency on hand, demand deposits with banks or other financial institutions, treasury bills, commercial paper, mutual funds or other investments with original maturities of three months or less. The carrying values of the Company's assets and liabilities approximate fair value due to their short-term nature.

11. Income Taxes:

The Company has adopted the provisions of Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS 109"). SFAS 109 requires recognition of deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns, determined by using the enacted tax rates in effect for the year in which the differences are expected to reverse.

12. Computation of Earnings Per Share:

The Company has adopted Statement of Financial Accounting Standards No. 128 "Earnings Per Share" ("SFAS 128"). SFAS 128 requires presentation of basic and diluted earnings per share. Basic earnings per share are calculated based only upon the weighted average number of common shares outstanding during the period. Diluted earnings per share are calculated based upon the weighted average number of common and, where dilutive, potential common shares outstanding during the period, utilizing the treasury stock method. Potential common shares include conversion of convertible debt and options to purchase common stock.

The weighted average number of basic and diluted common shares outstanding is as follows:

	<u>2005</u>	<u>2004</u>
Basic	14,133,461	14,133,461
Diluted	17,074,264	15,668,711

13. Commitments and Contingencies:

The Company amortizes capitalized software costs over the product's estimated useful life. Due to inherent technological changes in the software development industry, the period over which such capitalized software cost is being amortized may have to be accelerated.

14. Discontinued Operations:

Effective December 31, 2004 Learning Pathways, Ltd. was deemed to be an asset held for sale and an impairment loss of \$1,150,000 was recognized. On November 7, 2005 LPL was subsequently sold and, therefore, in 2005 the results of operations for this business unit are presented as discontinued operations. The income statement for the prior year has been restated to reflect the results as if LPL had been discontinued as of the beginning of 2004. Assets and liabilities at September 30, 2005 were not material, and, therefore, no separate balance sheet disclosure is deemed necessary.

15. Impairment of Goodwill:

Effective June 30, 2005 the Company determined that the goodwill recorded on the balance sheet that resulted from the acquisition of Dolphin was impaired and wrote off the entire amount of \$1,215,015. The Company is winding down Dolphin's software development business for outside customers and will transfer certain Dolphin employees to the Company's payroll to expand its internal software development staff.

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ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

Overview

The American Education Corporation is a developer of instructional content, computer adaptive assessment testing software, and software management technology specifically designed to manage the delivery of and record the results of student progress in schools and other institutions. Java-based technology, the **A+nyWhere Learning System® ("A+LS")** Versions 3.0 and 4.0 of educational software products, provides a research-based, integrated curriculum offering of software for grade levels 1-12 for Reading, Mathematics, Language Arts, Science, Writing, History, Government, Economics and Geography. In addition, the Company provides formative assessment testing and formative instructional content for various segments of the primary, secondary and postsecondary educational markets. All Company products are designed to provide for LAN, WAN and Internet delivery options. The Company has developed computer adaptive, formative assessment testing tools to provide educators with the resources to more effectively use the Company's curriculum content, which is aligned to important state and national academic standards. Spanish-language versions are available for Mathematics and Language Arts for grade levels 1-8.

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The A+LS comprehensive family of educational software is now in use in over 11,000 schools, centers of adult literacy, colleges and universities, and correctional institutions in the U.S., UK and other international locations. **A+dvancer™** College Readiness *Online*, the Company's postsecondary offering, identifies and assists students in attaining college entry-level academic skills in Arithmetic, Elementary Algebra, Reading Comprehension, and Sentence Skills. A+dvancer reduces demand on institutional admissions and developmental departments, while providing students with both improved skills assessment and the alignment to developmental and remedial coursework in an online, self-paced learning environment.

The Company is a technology-based publishing enterprise. To remain competitive it must constantly invest in the development of programming technology to keep its product offering up-to-date and ensure that its products maintain compatibility with the frequently changing and revised database and operating system platforms sold to schools by other developers. The Company must also update its content and underwrite content revisions to realign its content with new or updated state and national educational standards to remain competitive. To accomplish this essential, ongoing corporate function requires the retention and recruitment of a highly skilled professional workforce. These investments are essential, recurring costs of doing business that impact the Company's operating cost and margin structures.

The Company's business is subject to risks or uncertainties. Among these uncertainties are a dependency on funding for school technology purchases, lengthy sales cycles, seasonal demand cycles and a dependency on retention of key personnel. Certain matters discussed herein (including the

documents incorporated herein by reference) may contain forward-looking statements intended to qualify for the safe harbors from liabilities established by the Private Securities Litigation Reform Act of 1995. These forward-looking statements can generally be identified as such because the context of the statement will include words such as the Company "believes," "plans," "intends," "anticipates," "expects," or words of similar import. Similarly, statements that describe the Company's future plans, objectives, estimates, or goals are also forward-looking statements. Such statements address future events and conditions concerning capital expenditures, earnings, litigation, liquidity, capital resources and accounting matters. Actual results in each case could differ materially from those currently anticipated in such statements as a result of factors such as future economic conditions, changes in customer demands, future legislative, regulatory and competitive developments in markets in which the Company operates and other circumstances affecting anticipated revenues and costs. Accordingly, investors should be alert to the possibility that factors beyond the control of management may have impact on the short or long-term operations of the business. The Company undertakes no duty to update forward-looking statements to reflect the impact of events or circumstances that arise after the date the forward-looking statement was made.

RESULTS OF OPERATIONS – THREE MONTHS ENDED SEPTEMBER 30, 2005 AS COMPARED TO THE THREE MONTHS ENDED SEPTEMBER 30, 2004

Effective December 31, 2004, the Company's UK subsidiary, Learning Pathways, was deemed to be an asset held for sale and its value was written down to zero as an impairment loss. Therefore, its operations are shown as discontinued. The 2004 amounts have been restated to reclassify the results of Learning Pathways as discontinued. Therefore, the comparisons discussed here for the quarter and for the nine months ended September 30, 2005 below are only for the Company and its Dolphin, Inc. subsidiary. Net consolidated sales for the three months ended September 30, 2005 totaled \$2,489,284 compared to \$2,601,412 for the same period in 2004. This represents a decrease of 4% over the comparable 2004 quarter and is attributable to an increase in revenues at AEC offset by decreases at Dolphin. The Company achieved an increase at AEC of approximately \$25,000, or 1% over the prior year, despite what management believes to be the negative impacts of hurricanes Katrina, Rita and Wilma on third quarter revenue results. The geographic areas affected by these hurricanes include several of the Company's largest revenue producing states. The Company believes that these weather-related impacts to its revenues are temporary and that most orders anticipated for this quarter were delayed or deferred to a future period. Management believes that state and federal governmental programs for educational funding remain positive for the foreseeable future. However, it should be noted that recent spikes in fuel and overall energy costs are of concern and the impact of these significant, unplanned costs are being monitored for their possible impact on the Company's future performance. The sales decrease of approximately \$138,000 at Dolphin is a result of the previously announced exit from the contract software development business. Dolphin employees began to provide additional development resources for AEC during the third quarter of 2005. The Company expects that Dolphin contract development services sales to outside customers will be completed by the end of the 2005 fiscal year.

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Cost of goods sold as a percentage of sales revenue for the three months ending September 30, 2005 decreased to 9% from 13% of net revenues for the same period in 2004. This improvement is attributed to a larger portion of consolidated sales contributed by the core AEC operating unit. The Company's principal product family, **A+nyWhere Learning System**[®], provided gross profit margins of 97% in the third quarter of 2005, consistent with prior quarters. Cost of goods sold represents the actual cost to produce the software products and includes certain allocated overhead costs.

Total operating expenses for the three months ended September 30, 2005, increased to \$2,105,046, compared to \$1,820,445 for the same 2004 quarter, an increase of 16%. As a percentage of sales revenue, operating expenses increased from 70% in 2004 to 85% in 2005. The increase in total operating expenses is a result of increases in marketing and selling expenditures, operations expenses, general and administrative expenses and amortization of product development costs. Selling and marketing costs increased by 19%, from \$809,070 for the three months ended September 30, 2004, to \$960,623 for the current period. The increase in the third quarter 2005 selling expenses is largely attributable to changes in sales mix, which resulted in increased sales commissions of approximately \$135,000 as the Company billed a higher percentage of orders directly to school customers. The Company recognizes

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sales revenue based upon the type of customer. If the sale is made to a distributor who in turn resells a product to the end user, the amount of the sale is recorded and no commission is due the distributor and the transaction is recorded as a net sale. If the sale is billed direct to the school or other end user, a commission is paid to the distributor or a sales representative, which increases amount of the sale, but increases marketing expense as a result of an obligation to pay a commission. These commissions paid may vary depending upon the type of sale and the status of the individual or organization making the sale. The decision to sell and to bill direct to the customer and pay a subsequent commission can result from a number of factors, including credit policy issues with individual distributors as a result of payment history or limitations on authorized limits. Additionally, method of delivery of the product may necessitate direct billing to the customer and the subsequent payment of a commission. An example would be an online product sale that requires delivery from Company servers and the related record keeping on the licensed number of users accessing the product online as well as the number of units delivered. This level of record keeping requires Company monitoring and billing directly to the customer. These factors create a change in sales mix affecting the amount of commission paid and the manner in which revenues may be recorded by the Company. Accordingly, these factors, and the source and nature of recorded revenue, can impact period revenue recognition. Additionally, the related costs of securing revenue may vary from period to period. Operating expenses increased by 31% from \$124,911 for the three months ended September 30, 2004 to \$163,749 for the same period in 2005. This increase results from increased compensation and benefits due to additional technical support staff hired during the year. General and administrative expenses increased by 9% from \$523,610 in 2004 to \$571,610. General and administrative salaries and benefits increased approximately \$37,000 due to the addition of personnel in several areas and audit and legal fees increased approximately \$10,000 as a result of additional legal work during the third quarter.

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Interest expense was \$13,543 for the three months ended September 30, 2005 as compared to \$19,615 for the same 2004 quarter, reflecting the lower amount of bank debt outstanding on an average daily basis somewhat offset by the additional interest cost of the increase in convertible debt issued by the Company. There was net income of \$18,291 for the three months ended September 30, 2005 compared to net income of \$21,392 for the same period in 2004.

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**RESULTS OF OPERATIONS – NINE MONTHS ENDED SEPTEMBER 30, 2005
AS COMPARED TO THE NINE MONTHS ENDED SEPTEMBER 30, 2004**

Net sales for the nine months ended September 30, 2005, totaled \$7,987,414 compared to \$7,873,473 for the same period in 2004. This represents an increase of 1% over the comparable 2004 period and is attributable to an increase in revenues at AEC offset by decreases at Dolphin. The Company achieved an increase at AEC of approximately \$250,000, or 3% over the prior year, despite the negative impacts of hurricanes Katrina, Rita and Wilma on third quarter's revenue. Management believes that the environment for state and federal governmental educational funding remains positive for the foreseeable future. The sales decrease of approximately \$135,000 at Dolphin is a result of the previously announced exit from the contract software development business. As noted above, the Dolphin employees began to provide additional development resources for AEC during the third quarter of 2005. The Company expects that Dolphin sales to customers that it is obligated to complete under the existing contracts and their associated performance obligations will be completed by the end of the 2005 fiscal year.

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Cost of goods sold as a percentage of sales revenue for the nine months ending September 30, 2005 decreased to 11% compared to 13% for the same period in 2004. As noted for the quarterly results, this improvement is attributed to the increase in the sales contributed by the core AEC operating unit, which has lower cost of sales as a percentage of sales than Dolphin. The Company's principal product families, A+dvanced Learning System and the A+nyWhere Learning System, provided gross profit margins of 97% in the first nine months of 2005.

Total operating expenses for the nine months ended September 30, 2005 (excluding the \$1,215,015 impairment of goodwill write-down), increased to \$6,157,942, compared to \$5,568,005 for the same 2004 period, an increase of 11%. As a percentage of sales revenue, operating expenses increased from 71% in 2004 to 77% in 2005. The increase in total operating expenses is a result of a decrease in marketing and selling expenditures, an increase in operations expenses, an increase in general and administrative expenses as well as an increase in amortization of product development charges for the period. Selling

and marketing expenses decreased from \$2,752,851 for the nine months ended September 30, 2004 to \$2,733,628 for the same period in 2005 and is primarily the result of a decrease in commission expense because of changes in sales mix. Sales mix changes can occur, as noted above in the discussion of third quarter results, when a higher or lower amount of the Company's sales are billed directly as a result of credit policies and contributions to total revenues by different sales channels which require the payment of varying commission rates. Operations expense increased from \$372,638 in 2004 to \$449,206 for the same period in 2005, or 21%. This increase is due to the addition of staff in the operations department during the period. General and administrative expenses increased from \$1,401,795 to \$1,802,744, or by 29%, due to several different reasons. General and administrative salaries and benefits increased approximately \$115,000 due to the addition of personnel in accounting and other departments. Deferred compensation payable upon executive officers' and directors' retirement for the period increased \$48,000 as a result of additional employees who were eligible for this program, compared to the prior year. Audit and legal fees increased approximately \$58,000 as a result of required additional legal costs experienced during the first nine months of 2005 and the preparation of the Company's tax returns earlier in fiscal 2005 as compared to 2004. Outside services increased approximately \$64,000 due to consulting fees paid to integrate the Learning Letter Sounds product line content into the Company's product line and advice regarding the future of Dolphin. Bad debt expense increased \$72,000 over the prior year as a result of an increase in the allowance for uncollectible accounts based upon higher accounts receivable balances due to the seasonal nature of the Company's business.

Interest expense for the nine months ended September 30, decreased from \$50,039 in 2004 to \$42,112 in 2005 reflecting the reduction in average daily bank debt levels in 2005 compared to the prior year offset by higher interest rates and higher interest due to the increase in convertible debt issued by the Company in 2005. There was a net loss of \$402,663 for the nine months ended September 30, 2005, as compared to a net income of \$217,373 reported for the same period in 2004. The decrease results from charges recognized by the impairment of goodwill at Dolphin of \$1,215,015 for the period.

Liquidity and Capital Resources

The Company has invested significantly in the development of new products and the acquisition and licensing of new products to improve the ability of the organization and its published products to meet the needs of the marketplace. These changes were required to update, expand and keep current the Company's extensive curriculum product offerings and to position the Company for long-term growth. To finance the business, management has utilized secured bank revolving credit lines, bank financed equipment loans, lease financing sources and convertible debt from private individuals.

As of September 30, 2005 the Company's principal sources of liquidity included cash and cash equivalents of \$866,460, net accounts receivable of \$3,188,167 and inventory of \$16,344. The Company's net cash provided by operating activities during the nine months was \$1,436,575 in 2005 compared to \$1,391,007 in 2004. Net cash used in investing activities for the same period increased by 20% from \$987,669 in 2004 to \$1,187,358 in 2005, and was comprised primarily of investment in capitalized software development costs. During the nine months ended September 30, 2005 debt due to financial institutions was reduced by \$332,100 or 89%, reflecting bank indebtedness of \$39,762 at September 30, 2005.

In April 2003, the Company borrowed \$305,880 from major shareholder affiliates, which is subordinated to the debt owed to the Company's senior lender. This debt matures in September of 2006 and is convertible into the Company's common stock at \$.40 per share. On March 30, 2005, the Company entered into a Convertible Note Purchase Agreement with an unaffiliated individual. Pursuant to the terms of the Convertible Note Purchase Agreement, the Company issued the note purchaser an unsecured 8% Subordinated Convertible Note in the original aggregate principal amount of \$400,000. All principal and interest on the Note is due and payable on March 30, 2006 (the "Initial Maturity Date"), subject to the Note Purchaser's option to extend the Initial Maturity Date twelve months to March 30, 2007 (the "Extended Maturity Date"). The Company may not prepay principal or interest on the Note prior to the Initial Maturity Date. The Note is convertible at any time at the note purchaser's option into shares of the Company's common stock at the initial conversion price of \$0.463 per share, subject to certain anti-dilution adjustments. Any shares of common stock issued upon conversion of the Note will have "piggy-back" registration rights. The proceeds from the subordinated convertible debt were used to reduce accounts payable, bank debt and to support the normal operations of the business.

At September 30, 2005, the Company had working capital of \$1,700,171 compared to \$1,097,949 at December 31, 2004. The Company has a \$450,000 revolving line of credit that bears interest at a rate of 2.00% over the prime rate (8.75% as of September 30, 2005) and matures on March 31, 2006. At September 30, 2005, the Company had no borrowings under this line of credit. Additionally, the Company has a term loan with an aggregate principal balance of \$39,762 as of September 30, 2005. The term loan bears interest at a rate of 2.00% over the prime rate (8.75% as of September 30, 2005) and matures on November 30, 2005. The Company is continuing to discuss future borrowing arrangements with its current lender and several bank financing sources.

With the addition of new products, the Company's expanded market presence, the elimination of unprofitable subsidiary operations and the current favorable trends in government school spending, it is believed that the Company will maintain a pattern of sustainable growth in revenues and earnings in future years, barring unforeseen external circumstances and events. Management believes that the Company can support this expansion from its operating cash flows and credit lines. If successful, the Company should be able to enhance the overall financial performance of the business and continue to improve the Company's balance sheet and financial position.

Deleted: With the expansion of the Company's product lines, the addition of new products and expanding market presences, as well as the favorable trends in government school spending the Company expects to see in 2005 and subsequent years, combined with the elimination of losses from the subsidiary business units, management believes that the Company will return to a pattern of growth similar to the increases demonstrated in prior years which exceeded approximately 20%. [Is this still true considering the effects of the Hurricanes?]

Additional working capital beyond that available to the Company from its internally generated cash flows may be required to expand operations as a result of anticipated continued growth of the business. Management has and will consider options available to access such funding, including expanded debt and additional equity financing as dictated by the needs of the business.

Off-Balance Sheet Arrangements

The Company does not have any off-balance sheet arrangements.

Critical Accounting Policies

Management is responsible for the integrity of the financial information presented herein. The Company's financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. Where necessary, they reflect estimates based on management's judgment. Significant accounting policies that are important to the portrayal of the Company's financial condition and results, which in some cases require management's judgment, are summarized in the Notes to Interim Consolidated Financial Statements, which are included herein.

ITEM 3 - CONTROLS AND PROCEDURES

It is the responsibility of the Chief Executive Officer and the Chief Financial Officer to ensure that the Company maintains disclosure controls and procedures designed to provide reasonable assurance that material information, both financial and non-financial, and other information required under the securities laws to be disclosed is identified and communicated to senior management on a timely basis. The Company's disclosure controls and procedures include controls and other procedures of the Company that are designed to ensure that information required to be disclosed by the Company in its reports that it submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

As of September 30, 2005, management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of disclosure controls and procedures pursuant to Exchange Act Rule 13a-14 as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded the disclosure controls and procedures currently in place are adequate to ensure material information and other information requiring disclosure are identified and communicated in a timely fashion and that such disclosure controls and procedures were effective. During the three months ended September 30, 2005, there have been no changes in internal controls, or in factors that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

THE AMERICAN EDUCATION CORPORATION

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

Management knows of no pending or threatened litigation involving the Company that is considered material to the on-going operations and viability of the Company.

Item 2. Changes in Securities

None.

Item 3. Default Upon Senior Securities

Omitted from this report as inapplicable.

Item 4. Submission of Matters to Vote of Securities Holders

None.

Item 5. Other Information

Omitted from this report as inapplicable.

Item 6. Exhibits

The following exhibits have been filed as a part of this report:

Exhibit No.	Description of Exhibits
3.1	Articles of Incorporation of The American Education Corporation (incorporated by reference Annex B to the Definitive Proxy Statement filed with the Securities and Exchange Commission on October 12, 2001)
3.2	Bylaws of The American Education Corporation (incorporated by reference to Annex C to the Definitive Proxy Statement filed with the Securities and Exchange Commission on October 12, 2001)
4.1	Form of Stock Certificate (incorporated by reference to Form 8-A12G/A filed with the Securities and Exchange Commission on January 20, 2004)
4.2	Directors' Stock Option Plan (incorporated by reference to Exhibit B to the Definitive Proxy Statement filed with the Securities and Exchange Commission on April 24, 1998)
4.3	First Amendment to the Directors' Stock Option Plan (incorporated by reference to the Company's registration statement on Form S-8 filed with the Securities and Exchange Commission on October 22, 1999)

- 4.4 Stock Option Plan for Employees (incorporated by reference to Exhibit C to the Definitive Proxy Statement filed with the Securities and Exchange Commission on April 24, 1998)
- 4.5 First Amendment to the Stock Option Plan for Employees (incorporated by reference to the Company's registration statement on Form S-8 filed with the Securities and Exchange Commission on October 22, 1999)
- 4.6 Second Amendment to the Stock Option Plan for Employees (incorporated by reference to Exhibit 4.7 to the Company's registration statement on Form S-8 filed with the Securities and Exchange Commission on September 29, 2000)
- 10.1 Purchase Agreement for the acquisition by the Company of Learning Pathways, Limited (incorporated by reference to the exhibit in the Current Report on Form 8-K filed with the Securities and Exchange Commission on December 15, 1998)
- 10.2 Stock Purchase Agreement for the acquisition by the Company of Dolphin, Inc. (incorporated by reference to the exhibit in the Current Report on Form 8-K filed with the Securities and Exchange Commission on January 10, 2000)
- 10.3 Convertible Note Purchase Agreement dated March 30, 2005 by and between The American Education Corporation and David J. Smith (incorporated by reference to the exhibit in the Current Report on Form 8-K filed with the Securities and Exchange Commission on April 11, 2005)
- 10.4 The American Education Corporation 8% Subordinated Convertible Promissory Note dated March 30, 2005 in favor of David J. Smith (incorporated by reference to the exhibit in the Current Report on Form 8-K filed with the Securities and Exchange Commission on April 11, 2005)
- 10.5 Promissory Note dated March 31, 2004 from The American Education Corporation in favor of UMB Bank, N.A. (incorporated by reference to the exhibit in the quarterly report 10-Q filed with the Securities and Exchange Commission on August 15, 2005)
- 10.6 Promissory Note dated March 31, 2004 from The American Education Corporation in favor of UMB Bank, N.A. (incorporated by reference to the exhibit in the quarterly report 10-Q filed with the Securities and Exchange Commission on August 15, 2005)
- 10.7 Employment Agreement with Jeffrey E. Butler dated December 5, 1998 (incorporated by reference to the exhibit in the quarterly report 10-Q filed with the Securities and Exchange Commission on August 15, 2005)
- 10.8 Employment Agreement with Thomas A. Shively dated December 5, 1998 (incorporated by reference to the exhibit in the quarterly report 10-Q filed with the Securities and Exchange Commission on August 15, 2005)
- 10.9 Employment Agreement with Neil R. Johnson dated December 5, 1998 (incorporated by reference to the exhibit in the quarterly report 10-Q filed with the Securities and Exchange Commission on August 15, 2005)
- 10.10 Promissory Note dated October 16, 2000 from Jeffrey E. Butler in favor of the Company (incorporated by reference to the exhibit in the annual report 10-KSB/A filed with the Securities and Exchange Commission on September 9, 2005)
- 10.11 Promissory Note dated September 30, 2004 from the Company in favor of John Garber (incorporated by reference to the exhibit in the annual report 10-KSB/A filed with the Securities and Exchange Commission on September 9, 2005)

- 10.12 Promissory Note dated September 30, 2004 from the Company in favor of Janis L. Butler (incorporated by reference to the exhibit in the annual report 10-KSB/A filed with the Securities and Exchange Commission on September 9, 2005)
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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.

The American Education Corporation

/s/ Jeffrey E. Butler
Jeffrey E. Butler,
Chief Executive Officer
Chairman of the Board
Treasurer

/s/ Neil R. Johnson
Neil R. Johnson
Chief Financial Officer
Chief Accounting Officer

Date: November 14, 2005

Exhibit 31.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002

I, Jeffrey E. Butler, certify that:

1. I have reviewed this quarterly report on Form 10-QSB of The American Education Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based upon such evaluation; and
 - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: November 14, 2005

/s/ Jeffrey E. Butler
Signature
Title: Chief Executive Officer

Exhibit 31.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002

I, Neil R. Johnson, certify that:

1. I have reviewed this quarterly report on Form 10-QSB of The American Education Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based upon such evaluation; and
 - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: November 14, 2005

/s/ Neil R. Johnson
Signature
Title: Chief Financial Officer

Exhibit 32.1

CERTIFICATION BY CHIEF EXECUTIVE OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-QSB of The American Education Corporation (the "Company") for the period ended September 30, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Jeffrey E. Butler, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of the operations of the Company.

By: /s/ Jeffrey E. Butler
Jeffrey E. Butler
Chief Executive Officer

November 14, 2005

Exhibit 32.2

CERTIFICATION BY CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-QSB of The American Education Corporation (the "Company") for the period ended September 30, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Neil R. Johnson, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of the operations of the Company.

By: /s/ Neil R. Johnson
Neil R. Johnson
Chief Financial Officer

November 14, 2005