

INFORMATION ANALYSIS INC

Form 10-Q

November 14, 2011

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

Form 10-Q

(Mark  
One)

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

For the quarterly period ended September 30, 2011

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-22405

Information Analysis Incorporated  
(Exact Name of Registrant as Specified in Its Charter)

Virginia  
(State or other jurisdiction of  
incorporation or organization)

54-1167364  
(I.R.S. Employer  
Identification No.)

11240 Waples Mill Road

Suite 201  
Fairfax, Virginia 22030  
(703) 383-3000

(Address including zip code, and telephone number,  
including area code, of principal executive offices)

Not applicable  
(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 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

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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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated  
filer  Accelerated filer  Non-accelerated filer  Smaller reporting  
company

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

Yes  No

As of November 8, 2011, 11,196,760 shares of common stock, par value \$0.01 per share, of the registrant were outstanding.

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Information Analysis Incorporated

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INFORMATION ANALYSIS INCORPORATED  
FORM 10-Q

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## PART I

## ITEM 1. FINANCIAL STATEMENTS.

INFORMATION ANALYSIS INCORPORATED  
BALANCE SHEETS  
(Unaudited)

	September 30, 2011	December 31, 2010
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 1,946,953	\$ 1,968,077
Accounts receivable, net	1,745,445	771,814
Prepaid expenses	755,790	570,948
Note receivable - employee	6,610	6,438
Total current assets	4,454,798	3,317,277
Fixed assets, net		
Note receivable - employee	29,536	35,705
Other assets	5,976	10,955
Total assets	\$ 4,496,591	\$ 3,370,218
<b>LIABILITIES &amp; STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 781,498	\$ 76,509
Deferred revenue	826,969	652,591
Commissions payable	582,710	446,759
Accrued payroll and related liabilities	242,530	245,518
Other accrued liabilities	75,708	68,759
Total current liabilities	2,509,415	1,490,136
Stockholders' equity:		
Common stock, par value \$0.01, 30,000,000 shares authorized;		
12,839,376 shares issued, 11,196,760 outstanding	128,393	128,393
Additional paid-in capital	14,573,196	14,567,422
Accumulated deficit	(11,784,202)	(11,885,522)
Treasury stock, 1,642,616 shares at cost	(930,211 )	(930,211 )
Total stockholders' equity	1,987,176	1,880,082
Total liabilities and stockholders' equity	\$ 4,496,591	\$ 3,370,218

The accompanying notes are an integral part of the financial statements

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INFORMATION ANALYSIS INCORPORATED  
STATEMENTS OF OPERATIONS  
(Unaudited)

	For the three months ended September 30,	
	2011	2010
<b>Sales</b>		
Professional fees	\$1,329,592	\$1,293,060
Software sales	333,108	658,451
<b>Total sales</b>	<b>1,662,700</b>	<b>1,951,511</b>
<b>Cost of sales</b>		
Cost of professional fees	702,017	722,483
Cost of software sales	278,239	593,119
<b>Total cost of sales</b>	<b>980,256</b>	<b>1,315,602</b>
<b>Gross profit</b>	<b>682,444</b>	<b>635,909</b>
Selling, general and administrative expenses	434,295	374,752
Commission expense	186,909	221,370
<b>Income from operations</b>	<b>61,240</b>	<b>39,787</b>
<b>Other income, net</b>	<b>1,893</b>	<b>2,596</b>
<b>Income before provision for income taxes</b>	<b>63,133</b>	<b>42,383</b>
<b>Provision for income taxes</b>	<b>--</b>	<b>--</b>
<b>Net income</b>	<b>\$63,133</b>	<b>\$42,383</b>
<b>Comprehensive income</b>	<b>\$63,133</b>	<b>\$42,383</b>
<b>Earnings per common share:</b>		
Basic:	\$0.01	\$0.00
Diluted:	\$0.01	\$0.00
<b>Weighted average common shares outstanding:</b>		
Basic	11,196,760	11,196,760
Diluted	11,233,313	11,224,521

The accompanying notes are an integral part of the financial statements

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INFORMATION ANALYSIS INCORPORATED  
STATEMENTS OF OPERATIONS  
(Unaudited)

	For the nine months ended September 30,	
	2011	2010
<b>Sales</b>		
Professional fees	\$ 3,580,792	\$ 3,921,041
Software sales	1,126,126	1,733,906
<b>Total sales</b>	<b>4,706,918</b>	<b>5,654,947</b>
<b>Cost of sales</b>		
Cost of professional fees	1,986,998	2,178,008
Cost of software sales	920,413	1,475,267
<b>Total cost of sales</b>	<b>2,907,411</b>	<b>3,653,275</b>
<b>Gross profit</b>	<b>1,799,507</b>	<b>2,001,672</b>
Selling, general and administrative expenses	1,199,281	1,156,857
Commission expense	504,906	627,540
<b>Income from operations</b>	<b>95,320</b>	<b>217,275</b>
<b>Other income, net</b>	<b>6,000</b>	<b>7,320</b>
<b>Income before provision for income taxes</b>	<b>101,320</b>	<b>224,595</b>
<b>Provision for income taxes</b>	<b>--</b>	<b>--</b>
<b>Net income</b>	<b>\$ 101,320</b>	<b>\$ 224,595</b>
<b>Comprehensive income</b>	<b>\$ 101,320</b>	<b>\$ 224,595</b>
<b>Earnings per common share:</b>		
Basic:	\$ 0.01	\$ 0.02
Diluted:	\$ 0.01	\$ 0.02
<b>Weighted average common shares outstanding:</b>		
Basic	11,196,760	11,196,760
Diluted	11,220,295	11,216,833

The accompanying notes are an integral part of the financial statements

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INFORMATION ANALYSIS INCORPORATED  
STATEMENTS OF CASH FLOWS  
(Unaudited)

For the nine months ended  
September 30,  
2011                      2010

## Cash flows from operating activities:

Net income	\$ 101,320	\$ 224,595
Adjustments to reconcile net income to net cash (used) provided by operating activities:		
Bad debt expense	52,376	13,257
Depreciation and amortization	13,786	17,898
Stock option compensation	5,774	10,591
Changes in operating assets and liabilities		
Accounts receivable	(1,026,007)	(740,022 )
Other receivables and prepaid expenses	(184,842 )	(71,964 )
Accounts payable and accrued expenses	708,950	665,938
Deferred revenue	174,378	26,137
Commissions payable	135,951	287,134
Net cash (used) provided by operating activities	(18,314 )	433,564
Cash flows from investing activities:		
Acquisition of furniture and equipment	(7,617 )	(16,003 )
Net cash used in investing activities	(7,617 )	(16,003 )
Cash flows from financing activities:		
Employee loan repayment (loan)	4,807	(18,968 )
Net cash provided (used) by financing activities	4,807	(18,968 )
Net (decrease) increase in cash and cash equivalents	(21,124 )	398,593
Cash and cash equivalents, beginning of the period	1,968,077	1,478,504
Cash and cash equivalents, end of the period	\$ 1,946,953	\$ 1,877,097
Supplemental cash flow information		
Interest paid	\$--	\$--

The accompanying notes are an integral part of the financial statements

Information Analysis Incorporated

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INFORMATION ANALYSIS INCORPORATED  
NOTES TO FINANCIAL STATEMENTS

1. Basis of Presentation

The accompanying unaudited financial statements have been prepared in conformity with generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions for Form 10-Q and Article 8-03 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the Securities Exchange Commission. In the opinion of management, the unaudited financial statements include all adjustments necessary (which are of a normal and recurring nature) for the fair and not misleading presentation of the results of the interim periods presented. These unaudited financial statements should be read in conjunction with our audited financial statements for the year ended December 31, 2010 included in the Annual Report on Form 10-K filed by the Company with the Securities and Exchange Commission on March 31, 2011. The results of operations for any interim period are not necessarily indicative of the results of operations for any other interim period or for a full fiscal year.

2. Summary of Significant Accounting Policies

Operations

Information Analysis Incorporated (the “Company”) was incorporated under the laws of the Commonwealth of Virginia in 1979 to develop and market computer applications software systems, programming services, and related software products and automation systems. The Company provides services to customers throughout the United States, with a concentration in the Washington, D.C. metropolitan area.

Revenue Recognition

Generally the Company recognizes revenue when a contract has been executed, the contract price is fixed and determinable, delivery of services or products has occurred, and collectability of the contract price is considered probable and can be reasonably estimated. Revenue is earned under time and materials and fixed-price contracts. For sales of third-party software products, revenue is recognized upon delivery.

Revenue on time and materials contracts is recognized based on direct labor hours expended at contract billing rates and adding other billable direct costs.

For fixed-price contracts that are based on unit pricing, the Company recognizes revenue for the number of units delivered in proportion to total expected units to be delivered in any given reporting period.

For fixed-price contracts in which the Company is paid a specific amount to be available to provide a particular service for a stated period of time, revenue is recognized ratably over the service period. The Company applies this method of revenue recognition to sales of maintenance contracts on third-party software sales, as on Adobe and Micro Focus software, for which the Company is responsible for “first line support” to the customer and for serving as a liaison between the customer and the third-party maintenance provider for issues the Company is unable to resolve.

The Company engages in fixed-price contracts with the U.S. Government involving the complex delivery of technology products and services. Accordingly, these contracts are within the scope of the American Institute of Certified Public Accountants Audit and Accounting Guide for Audits of Federal Government Contractors. To the



extent contracts are incomplete at the end of an accounting period, revenue is recognized on the percentage-of-completion method, on a proportional performance basis, using costs incurred in relation to total estimated costs.

Sales of third-party software products such as Adobe and Micro Focus products are reported on a gross basis with the Company as a principal under authoritative guidance issued by the Financial Accounting Standards Board (the “FASB”). This determination was based on the following: 1) the Company has inventory risk as suppliers are not obligated to accept returns, 2) the Company has reasonable latitude, within economic constraints, in establishing price, 3) the Company, in its marketing efforts, frequently aids the customer in determining product specifications, 4) the Company has physical loss inventory risk as title transfers at the shipping point, 5) the Company bears full credit risk, and 6) the amount the Company earns in the transaction is neither a fixed dollar amount nor a fixed percentage.

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2. Summary of Significant Accounting Policies (continued)

The Company's contracts with agencies of the U.S. government are subject to periodic funding by the respective contracting agency. Funding for a contract may be provided in full at inception of the contract or ratably throughout the contract as the services are provided. In evaluating the probability of funding for purposes of assessing collectability of the contract price, the Company considers its previous experiences with its customers, communications with its customers regarding funding status, and the Company's knowledge of available funding for the contract or program. If funding is not assessed as probable, revenue recognition is deferred until realization is deemed probable.

Payments received in advance of services performed are recorded and reported as deferred revenue. Services performed prior to invoicing customers are recorded as unbilled accounts receivable and are presented on the Company's balance sheets in the aggregate with accounts receivable.

Revenue derived as commission for facilitating a sales transaction in which a customer introduced by the Company makes a purchase directly from the Company's supplier or another designated reseller is recognized when the commission payment is received. Since the Company is not a direct party in the sales transaction, payment by the supplier is the Company's confirmation that the sale occurred.

Government Contracts

Company sales to departments or agencies of the U.S. government are subject to audit by the Defense Contract Audit Agency (DCAA), which could result in the renegotiation of amounts previously billed. Because the Company has not entered into any cost plus fixed fee contracts since 1997, management believes there is minimal risk of an audit by DCAA resulting in a material misstatement of previously reported financial statements.

Segment Reporting

In accordance with authoritative guidance issued by the FASB, the Company has concluded that it operates in one business segment, providing products and services to modernize client information systems.

Cash and Cash Equivalents

For the purposes of the statement of cash flows, the Company considers all highly liquid investments with maturities of ninety days or less at the time of purchase to be cash equivalents. Balances at times exceed federally insured limits, but management does not consider this to be a significant concentration of credit risk.

Accounts Receivable

Accounts receivable consist of trade accounts receivable and do not bear interest. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company reviews its allowance for doubtful accounts monthly. Accounts with receivable balances past due over 90 days are reviewed individually for collectability. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance sheet credit exposure related to its customers. The Company has recorded an allowance for doubtful accounts of \$99,863 at September 30, 2011 and \$22,152 at December 31, 2010.

Note Receivable - employee

Note receivable - employee consists of a note to a non-officer employee of the Company. The note bears interest compounded at 3.5%, requires equal semi-monthly payments, and will mature on August 10, 2013.

#### Fixed Assets

Fixed assets are stated at cost and are depreciated using the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized over the term of the lease or the estimated life of the improvement, whichever is shorter. Maintenance and minor repairs are charged to operations as incurred. Gains and losses on dispositions are recorded in current operations.

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2. Summary of Significant Accounting Policies (continued)

Stock-Based Compensation

At September 30, 2011, the Company had the stock-based compensation plans described in Note 3 below. Total compensation expense related to these plans was \$928 and \$1,786 for the quarters ended September 30, 2011 and 2010, respectively, of which \$0 related to options awarded to non-employees. For the nine months ended September 30, 2011 and 2010, total compensation expense related to these plans was \$5,774 and \$10,591, respectively, of which \$0 and \$5,250, respectively, related to options awarded to non-employees. The Company estimates the fair value of options granted to establish the expense using a Black-Scholes valuation model. When stock-based compensation is awarded to employees, the expense is recognized ratably over the vesting period. When stock-based compensation is awarded to non-employees, the expense is recognized immediately.

Earnings Per Share

The Company's earnings per share calculations are based upon the weighted average of shares of common stock outstanding. The dilutive effect of stock options, warrants and convertible notes are included for purposes of calculating diluted earnings per share, except for periods when the Company reports a net loss, in which case the inclusion of such equity instruments would be antidilutive.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2011-04 Fair Value Measurement (Topic 820): "Amendments to Achieve Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs". This Update addresses how to measure fair value and requires new disclosures about fair value measurements. The amendments in this update are effective for interim and annual periods beginning after December 15, 2011. The Company believes that the adoption of this guidance will not have a material impact on its financial position, results of operations or cash flows.

In June 2011, the FASB issued Accounting Standards Update No. 2011-05 for Comprehensive Income (Topic 220): "Presentation of Comprehensive Income". This Update improves the comparability, consistency and transparency of financial reporting and increases the prominence of items reported in other comprehensive income. This update is effective for interim and annual periods beginning after December 15, 2011. The Company believes that the adoption of this guidance will not have a material impact on its financial position, results of operations or cash flows.

Reclassifications

Certain prior period balances have been reclassified to conform to the presentation of the current period.

Income Taxes

Deferred tax assets and liabilities are computed based on the difference between the financial statement and tax basis of assets and liabilities and are measured by applying enacted tax rates and laws for the taxable years in which those differences are expected to reverse. In addition, a valuation allowance is required to be recognized if it is believed more likely than not that a deferred tax asset will not be fully realized. Authoritative guidance prescribes a recognition threshold of more likely than not, and a measurement attribute for all tax positions taken or expected to be taken on a tax return, in order for those positions to be recognized in the financial statements. The Company continually reviews tax laws, regulations and related guidance in order to properly record any uncertain tax liabilities.

#### Fair Value of Financial Instruments

The Company's financial instruments include trade receivables, note receivable-employee, and accounts payable. Management believes the carrying value of financial instruments approximates their fair value, unless disclosed otherwise in the accompanying notes.

#### Subsequent Events

The Company has evaluated the period from September 30, 2011, the date of the financial statements, through the date of the issuance and filing of the financial statements, and has determined that no material subsequent events have occurred that would affect the information presented in these financial statements or require additional disclosure.

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## 3. Stock Options and Warrants

The Company granted stock options to certain of our employees under two plans. The 1996 Stock Option Plan was adopted in 1996 (“1996 Plan”) and had options granted under it through May 29, 2006. In 2006, the Board of Directors approved and the shareholders ratified the 2006 Stock Incentive Plan (“2006 Plan”).

As determined by the members of the Compensation Committee, the Company generally grants options under the 2006 Plan at the estimated fair value at the date of grant, based upon all information available to it at the time.

The Company recognizes compensation costs only for those shares expected to vest on a straight-line basis over the requisite service period of the awards, generally, the option vesting term of six months to two years. There were no option awards in the three months ended September 30, 2011 and 2010. The fair values of option awards granted in the nine months ended September 30, 2011 and 2010, were estimated using a Black-Scholes option pricing model under the following assumptions:

	Nine Months ended September 30,	
	2011	2010
Risk free interest rate	1.65 – 2.30%	2.42% - 3.66%
Dividend yield	0%	0%
Expected term	5 years	5-10 years
Expected volatility	61.7 - 61.9%	63.0% - 97.6%

## 2006 Stock Incentive Plan

The Company has a stock incentive plan, which became effective May 18, 2006, and expires May 17, 2016 (the “2006 Plan”). The 2006 Plan provides for the granting of equity awards to key employees, including officers and directors. The maximum number of shares for which equity awards may be granted under the 2006 Plan is 950,000. Options under the 2006 Plan expire no later than ten years from the date of grant or when employment ceases, whichever comes first, and vest over periods determined by the Board of Directors. The average vesting periods for options granted to employees under the 2006 Plan in the nine months ended September 30, 2011 and 2010, were nineteen months and fourteen months, respectively. The exercise price of each option equals at least the quoted market price of the Company’s stock on the date of grant.

## 1996 Stock Option Plan

The 1996 Plan provided for the granting of options to purchase shares of our common stock to key employees, including officers and directors. The maximum number of shares for which options could be granted under the 1996 Plan was 3,075,000. Options expire no later than ten years from the date of grant or when employment ceases, whichever comes first, and vest over periods determined by the Board of Directors. There were 411,000 and 565,500 unexpired exercisable options remaining from the 1996 Plan at September 30, 2011 and December 31, 2010, respectively.

The status of the options issued under the foregoing option plans as of September 30, 2011, and changes during the nine months ended September 30, 2011 and 2010, were as follows:

	Options outstanding	
	Number of	Weighted
	shares	average
		price per
		share
Balance at December 31, 2010	1,119,000	\$0.30
Options granted	10,000	0.16
Options exercised, expired or forfeited	4,500	0.27
Balance at March 31, 2011	1,124,500	\$0.33
Options granted	35,500	0.17
Balance at June 30, 2011	1,160,000	\$0.29
Options exercised, expired or forfeited	157,000	0.20
Balance at September 30, 2011	1,003,000	\$0.31

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## 3. Stock Options and Warrants (continued)

	Options outstanding Number of shares	Weighted average price per share
Balance at December 31, 2009	1,019,000	\$0.33
Options granted	98,000	0.18
Options exercised, expired or forfeited	4,250	0.53
Balance at March 31, 2010	1,112,750	\$0.35
Options granted	10,000	0.19
Options exercised, expired or forfeited	750	0.07
Balance at June 30, 2010	1,122,000	\$0.31
Options exercised, expired or forfeited	50,000	0.44
Balance at September 30, 2010	1,072,000	\$0.30

The following table summarizes information about options at September 30, 2011:

	Options outstanding			Total shares	Options exercisable		
	Weighted average exercise price	Weighted average remaining contractual life in years	Aggregate intrinsic value		Weighted average exercise price	Weighted average remaining contractual life in years	Aggregate intrinsic value
Total shares	\$ 0.31	4.89	\$ 5,485	942,000	\$ 0.32	4.61	\$ 4,780

Nonvested stock awards as of September 30, 2011 and changes during the nine months ended September 30, 2011, were as follows:

	Nonvested Number of shares	Weighted average grant date fair value
Balance at December 31, 2010	140,250	\$0.09
Granted	10,000	0.09
Vested	59,000	0.10
Balance at March 31, 2011	91,250	\$0.09
Granted	35,500	0.09
Vested	65,000	0.09
Balance at June 30, 2011	61,750	\$0.09
Vested	750	0.08
Balance at September 30, 2011	61,000	\$0.09

As of September 30, 2011 and 2010, unrecognized compensation cost associated with non-vested share-based employee and non-employee compensation totaled \$3,157 and \$3,360, respectively, which are expected to be



recognized over weighted average periods of 8 months and 5 months, respectively.

#### Warrants

The Board of Directors may also grant warrants to directors, employees and others. There were no warrants issued or exercised in the nine months ended September 30, 2011, nor in fiscal year 2010. As of September 30, 2011 and 2010, there were no outstanding warrants.

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## 4. Earnings Per Share

Basic earnings per share excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock, except for periods when the Company reports a net loss because the inclusion of such items would be antidilutive.

The following is a reconciliation of the amounts used in calculating basic and diluted net income (loss) per common share.

	Net Income	Shares	Per Share Amount
Basic net income per common share for the three months ended September 30, 2011:			
Income available to common stockholders	\$63,133	11,196,760	\$0.01
Effect of dilutive stock options	--	36,553	--
Diluted net income per common share for the three months ended September 30, 2011:	\$63,133	11,233,313	\$0.01
Basic net income per common share for the three months ended September 30, 2010:			
Income available to common stockholders	\$42,383	11,196,760	\$0.00
Effect of dilutive stock options	--	27,761	--
Diluted net income per common share for the three months ended September 30, 2010:	\$42,383	11,224,521	\$0.00
Basic net income per common share for the nine months ended September 30, 2011:			
Income available to common stockholders	\$101,320	11,196,760	\$0.01
Effect of dilutive stock options	--	23,535	--
Diluted net income per common share for the nine months ended September 30, 2011:	\$101,320	11,220,295	\$0.01
Basic net income per common share for the nine months ended September 30, 2010:			
Income available to common stockholders	\$224,595	11,196,760	\$0.02
Effect of dilutive stock options	--	20,073	--
Diluted net income per common share for the nine months ended September 30, 2010:	\$224,595	11,216,833	\$0.02

Information Analysis Incorporated

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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Cautionary Statement Regarding Forward-Looking Statements

This Form 10-Q contains forward-looking statements regarding our business, customer prospects, or other factors that may affect future earnings or financial results that are subject to the safe harbor created by the Private Securities Litigation Reform Act of 1995. Such statements involve risks and uncertainties which could cause actual results to vary materially from those expressed in the forward-looking statements. Investors should read and understand the risk factors detailed in our Form 10-K for the fiscal year ended December 31, 2010 and in other filings with the Securities and Exchange Commission. These risks include, among others, the following:

- changes in the funding priorities of the US government;
- changes in the way the US government contracts with businesses;
  - terms specific to US government contracts;
- our failure to keep pace with a changing technological environment;
  - intense competition from other companies;
- inaccuracy in our estimates of the cost of services and the timeline for completion of contracts;
  - non-performance by our subcontractors and suppliers;
    - our dependence on key personnel;
  - our dependence on third-party software and software maintenance suppliers;
    - our failure to adequately integrate businesses we may acquire;
- fluctuations in our results of operations and the resulting impact on our stock price;
  - the exercise of outstanding options and warrants;
  - our failure to adequately protect our intellectual property;
  - the limited public market for our common stock; and
- our forward-looking statements and projections may prove to be inaccurate.

### Our Business

Founded in 1979, Information Analysis Incorporated, to which we sometimes refer as IAI, is in the business of modernizing client information systems, developing and maintaining information technology systems, and performing consulting services to government and commercial organizations. We have performed software conversion projects for over 100 commercial and government customers, including Computer Sciences Corporation, IBM, Computer Associates, Sprint, Citibank, U.S. Department of Homeland Security, U.S. Treasury Department, U.S. Department of Agriculture, U.S. Department of Energy, U.S. Army, U.S. Air Force, U.S. Department of Veterans Affairs, and the Federal Deposit Insurance Corporation. Today, we primarily apply our technology, services and experience to legacy software migration and modernization for commercial companies and government agencies, and to developing web-based solutions for agencies of the federal government.

Three of our customers, one of which is a government agency with which we contract directly, one of which is a company with which we contract for services to government agencies, and one commercial customer, represent material portions of our revenue. These customers accounted for 35.1%, 18.3%, and 11.4%, respectively, of revenue in the first nine months of 2011.

Three Months Ended September 30, 2011 versus Three Months Ended September 30, 2010

### Revenue

Our revenues in the third quarter of 2011 were \$1,662,700, compared to \$1,951,511 in 2010, a decrease of 14.8%. Professional services revenue was \$1,329,592 versus \$1,293,060, an increase of 2.8%, and software product and maintenance revenue was \$333,108 versus \$658,451, a decrease of 49.4%. The increase in professional services revenue was due to new contracts and to increases in activity in some of our existing contracts. The decrease in our software product and maintenance revenue was due to a lack of new product sales and limited maintenance renewals in one of our product lines.

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### Gross Margins

Gross margin was \$682,444, or 41.0% of sales, in the third quarter of 2011 versus \$635,909, or 32.6% of sales, in the third quarter of 2010. For the quarter ended September 30, 2011, \$627,575 of the gross margin was attributable to professional services at a gross margin percentage of 47.2%, and \$54,869 of the gross margin was attributable to software sales at a gross margin percentage of 16.5%. In the same quarter in 2010, we reported gross margins of \$570,577, or 44.1% of sales for professional services and \$65,332, or 9.9% of sales for software sales. Gross margin on professional services increased in terms of both dollars and as a percentage of sales due to new contracts. Gross margin on software sales decreased \$10,463, or 16.0%, on a revenue decrease of \$325,343, or 49.4%. The increase in gross margin as a percentage of software sales is due to changes in the ratio in the mix of product lines sold and a decrease in renewals on low-margin maintenance contracts on one of our product lines. Software product sales and associated margins are subject to considerable fluctuation from period to period, based on the product mix sold.

### Selling, General and Administrative

Selling, general and administrative expenses, exclusive of sales commissions, were \$434,295, or 26.1% of revenues, in the third quarter of 2011 versus \$374,752, or 19.2% of revenues, in the third quarter of 2010. These expenses increased due to increases in bad debt write-offs, overhead labor, business promotion costs, and reporting costs (XBRL).

Commission expense was \$186,909, or 11.2% of revenues, in the third quarter of 2011 versus \$221,370, or 11.3% of revenues, in the third quarter of 2010. This decrease of \$34,461, or 15.6%, is due to the decrease in incentives earned by our sales and marketing personnel, which fluctuate with sales and gross margins at varying rates for each salesperson. The commission earned as a percentage of revenue for the periods presented remained constant.

### Net income

Net income for the three months ended September 30, 2011, was \$63,133, or 3.8% of revenue, versus net income of \$42,383, or 2.2% of revenue, for the same period in 2010. The increase in profitability is due to new business and retained business having better aggregate margins than the contracts that expired, as well as decreases in commission expense. Incentives earned by our sales and marketing personnel fluctuate with sales and gross margins at varying rates for each salesperson.

### Nine Months Ended September 30, 2011 versus Nine Months Ended September 30, 2010

#### Revenue

Our revenues in the first nine months of 2011 were \$4,706,918, compared to \$5,654,947 in 2010, a decrease of 16.8%. Professional services revenue was \$3,580,792 versus \$3,921,041, a decrease of 8.7%, and software product and maintenance revenue was \$1,126,126 versus \$1,733,906, a decrease of 35.1%. Professional services revenue decreased due primarily to the expiration or near completion of a few higher-revenue contracts. There were several new contracts and several contracts with increase in activity, but the revenue increases were insufficient to offset these expirations and decreases in activity on other contracts. The decrease in software product and maintenance revenue was due to a lack of new product sales and limited low-margin maintenance renewals in one of our product lines. Software product sales are subject to considerable fluctuation from period to period, based on customer demand, funding, and lead time.

### Gross Margins

Gross margin was \$1,799,507, or 38.2% of sales, in the first nine months of 2011 versus \$2,001,672, or 35.4% of sales, in the first nine months of 2010. For the nine months ended September 30, 2011, \$1,593,794 of the gross margin was attributable to professional services at a gross margin percentage of 44.5%, and \$205,713 of the gross

margin was attributable to software sales at a gross margin percentage of 18.3%. In the same period in 2010, we reported gross margins of \$1,743,033, or 44.5% of sales for professional services and \$258,639, or 14.9% of sales for software sales. The gross margin on professional services sales decreased due to the decreases in professional services revenue as described above. The gross margin percentage for professional services remained constant at 44.5%. The decrease in gross margin on software product and maintenance sales was due to the decreases in the related revenue as described above, though the gross margin as a percentage of sales increased due to changes in the ratio in the mix of product lines sold. Software product sales and associated margins are subject to considerable fluctuation from period to period, based on the product mix sold.

#### Selling, General and Administrative

Selling, general and administrative expenses, exclusive of sales commissions, were \$1,199,281, or 25.5% of revenues, in the first nine months of 2011 versus \$1,156,857, or 20.5% of revenues, in the first nine months of 2010. These expenses increased due to increases in business promotion costs, costs of bids and proposals, and reporting costs (XBRL), and bad debt write-offs.

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Commission expense was \$504,906, or 10.7% of revenues, in the first nine months of 2011 versus \$627,540, or 11.1% of revenues, in the first nine months of 2010. This decrease of \$122,634, or 19.5%, is due to a decreases in incentives earned by our sales and marketing personnel, which fluctuate with sales and gross margins at varying rates for each salesperson.

#### Net income

Net income for the nine months ended September 30, 2011, was \$101,320, or 2.2% of revenue, versus \$224,595, or 4.0% of revenue, for the same period in 2010. The decrease in profitability is due to decreases in revenue and increases in selling, general and administrative expenses.

#### Liquidity and Capital Resources

In the first nine months of 2011, we reported income from operations of \$95,320 and net income of \$101,320. Our December 31, 2010 cash and cash equivalents balances, when combined with our cash flow from operations during the first nine months of 2011, were sufficient to provide financing for our operations. Net cash used by combining our operating, investing, and financing activities in the first nine months was \$21,124, which when subtracted from a beginning balance of \$1,968,077 at December 31, 2010, yielded cash and cash equivalents of \$1,946,953 at September 30, 2011. Our accounts receivable balances increased \$973,631 in the first nine months of 2011, after allowing for \$52,376 for bad debt expense. Our accounts payable balances increased \$704,989 in the first nine months of 2011. Our current ratio, or the ratio of current assets to current liabilities, decreased to 1.78 from 2.23, due largely receivable and payable balances in both current assets and current liabilities related to a software maintenance contract.

We have a revolving line of credit with a bank providing for demand or short-term borrowings of up to \$1,000,000. The line became effective December 20, 2005, and expires on December 1, 2011. As of September 30, 2011, no amounts were outstanding under this line of credit. At September 30, 2011, \$1,000,000 was available under this line of credit based on our outstanding accounts receivable.

Given our current cash position and operating plan, we anticipate that we will be able to meet our cash requirements for the next twelve months and beyond.

We presently lease our corporate offices on a contractual basis with certain timeframe commitments and obligations. We believe that our existing offices will be sufficient to meet our foreseeable facility requirement. Should we need additional space to accommodate increased activities, management believes we can secure such additional space on reasonable terms.

We have no material commitments for capital expenditures.

#### ITEM 4. CONTROLS AND PROCEDURES

##### Evaluation of Disclosure Controls and Procedures

Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, and people performing similar functions, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), as of the end of the period reported in this quarterly report (the "Evaluation Date"). Based upon this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the Evaluation Date, our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in the reports that we file or

submit under the Exchange Act was recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information required to be disclosed was accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.



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### Changes in Internal Controls

There were no changes in our internal control over financial reporting during the quarter ended September 30, 2011 that have materially affected, or are reasonably likely to affect, our internal control over financial reporting.

### Inherent Limitations on Effectiveness of Controls.

Because of the inherent limitations in all control systems, no control system can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. These inherent limitations include the realities that judgments in decision making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of a person, by collusion of two or more people or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected. Notwithstanding these limitations, with the changes referenced above, we believe that our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives.

## PART II - OTHER INFORMATION

### ITEM 1A. RISK FACTORS

“Item 1A. Risk Factors” of our annual report on Form 10-K for the year ended December 31, 2010 includes a discussion of our risk factors. There have been no material changes from the risk factors described in our annual report on Form 10-K for the year ended December 31, 2010.

### ITEM 6. EXHIBITS

31.1 Certification of Chief Executive Officer Pursuant to Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934

31.2 Certification of Chief Financial Officer Pursuant to Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934

32.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

In accordance with the requirements of the Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Information Analysis Incorporated  
(Registrant)

Date: November 14, 2011

By: /s/ Sandor Rosenberg  
Sandor Rosenberg,  
Chairman of the Board, Chief  
Executive Officer, and President

By: /s/ Richard S. DeRose  
Richard S. DeRose,  
Executive Vice President, Treasurer,  
and Chief Financial Officer