INFORMATION ANALYSIS INC
Form 10-Q
November 15, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2010

¨ **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	**54-1167364**
(State or other jurisdiction of incorporation or organization)	**(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 þ 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). 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. (Check one):

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

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

As of November 12, 2010, 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

FORM 10-Q

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INFORMATION ANALYSIS INCORPORATED

BALANCE SHEETS

(Unaudited)

	September 30, 2010	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,877,097	$ 1,478,504
Accounts receivable, net	1,666,971	940,206
Prepaid expenses	760,878	688,914
Note receivable - employee	6,383	
Total current assets	4,311,329	3,107,624
Fixed assets, net	34,539	36,434
Note receivable - employee	12,585	
Other assets	6,281	6,281
Total assets	$ 4,364,734	$ 3,150,339
LIABILITIES & STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 731,885	$ 89,560
Deferred revenue	805,504	779,367
Other accrued liabilities	620,580	306,910
Accrued payroll and related liabilities	251,995	254,918
Total current liabilities	2,409,964	1,430,755
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	14,563,977	14,553,386
Accumulated deficit	(11,807,389)	(12,031,984)
Treasury stock, 1,642,616 shares at cost	(930,211)	(930,211)
Total stockholders equity	1,954,770	1,719,584
Total liabilities and stockholders equity	$ 4,364,734	$ 3,150,339

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,	
	2010	**2009**
Sales		
Professional fees	$ 1,293,060	$ 1,302,031
Software sales	658,451	686,375
Total sales	1,951,511	1,988,406
Cost of sales		
Cost of professional fees	722,483	751,295
Cost of software sales	593,119	580,411
Total cost of sales	1,315,602	1,331,706
Gross profit	635,909	656,700
Selling, general and administrative expenses	596,122	535,944
Income from operations	39,787	120,756
Other income, net	2,596	1,353
Income before provision for income taxes	42,383	122,109
Provision for income taxes		
Net income	$ 42,383	$ 122,109
Earnings per common share:		
Basic:	$ 0.00	$ 0.01
Diluted:	$ 0.00	$ 0.01
Weighted average common shares outstanding:		
Basic	11,196,760	11,196,760
Diluted	11,224,521	11,208,403

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,	
	2010	**2009**
Sales		
Professional fees	$ 3,921,041	$ 3,601,267
Software sales	1,733,906	1,186,080
Total sales	5,654,947	4,787,347
Cost of sales		
Cost of professional fees	2,178,008	2,295,532
Cost of software sales	1,475,267	930,711
Total cost of sales	3,653,275	3,226,243
Gross profit	2,001,672	1,561,104
Selling, general and administrative expenses	1,784,397	1,503,324
Income from operations	217,275	57,780
Other income, net	7,320	7,968
Income before provision for income taxes	224,595	65,748
Provision for income taxes		
Net income	$ 224,595	$ 65,748
Earnings per common share:		
Basic:	$ 0.02	$ 0.01
Diluted:	$ 0.02	$ 0.01
Weighted average common shares outstanding:		
Basic	11,196,760	11,196,760
Diluted	11,216,833	11,207,820

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,	
	2010	**2009**
Cash flows from operating activities:		
Net income	$ 224,595	$ 65,748
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Stock option compensation	10,591	2,673
Depreciation and amortization	17,898	24,692
Bad debt expense	13,257	3,186
Changes in operating assets and liabilities		
Accounts receivable	(740,022)	(486,320)
Other assets and prepaid expenses	(71,964)	277,179
Accounts payable and accrued expenses	953,072	(78,458)
Deferred revenue	26,137	(402,806)
Income taxes payable		(1,971)
Net cash provided by (used in) operating activities	433,564	(596,077)
Cash flows from investing activities:		
Acquisition of furniture and equipment	(16,003)	(11,309)
Net cash used in investing activities	(16,003)	(11,309)
Cash flows from financing activities:		
Loan to employee	(18,968)	
Net cash used in financing activities	(18,968)	
Net increase (decrease) in cash and cash equivalents	398,593	(607,386)
Cash and cash equivalents, beginning of the period	1,478,504	1,549,335
Cash and cash equivalents, end of the period	$ 1,877,097	$ 941,949
Supplemental cash flow Information		
Interest paid	$	$

The accompanying notes are an integral part of the financial statements

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Information Analysis Incorporated Third Quarter 2010 Report on Form 10-Q

PART I

Item 1. Financial Statements.

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, 2009 included in the Annual Report on Form 10-K filed by the Company with the Securities and Exchange Commission on March 31, 2010. 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.

2. Summary of Significant Accounting Policies (continued)

The Company s contracts with agencies of the 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.

Government Contracts

Company sales to departments or agencies of the United States 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 $31,087 at September 30, 2010 and $29,918 at December 31, 2009.

Note Receivable

Note receivable consists of a note to a non-officer employee of the Company. It 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.

Stock-Based Compensation

At September 30, 2010, the Company had the stock-based compensation plans described in Note 3 below. Total compensation expense related to these plans was $1,786 and $638 for the quarters ended September 30, 2010 and 2009, respectively, of which $0 related to options awarded to non-employees. For the nine months ended September 30, 2010 and 2009, total compensation expense related to these plans was $10,591 and $2,673, respectively, of which $5,250 and $0, respectively, related to options awarded to non-employees. The Company estimates the fair value of options granted to establish the expense using the Black-Scholes valuation model.

2. Summary of Significant Accounting Policies (continued)

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 not yet adopted

In April 2010, the FASB issued Update no. 2010-17, which amends the authoritative guidance for revenue recognition related to the milestone method. This update provides that an entity can make an accounting policy election to recognize a payment that is contingent upon the achievement of a substantive milestone in its entirety as revenue in the period in which the milestone is achieved. The milestone method is not required and is not the only acceptable method of revenue recognition for milestone payments. This update is effective in fiscal years beginning on or after June 15, 2010 and can be applied prospectively or retrospectively. Early adoption is permitted. The Company is currently evaluating the effect the adoption of this update will have, if any, on its financial position, results of operations or cash flows.

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

In October 2009, the FASB issued Update No. 2009-14, which amends the Software topic of the Codification. The amendments in this update change the accounting model for revenue arrangements that include both tangible products and software elements. Tangible products containing software components and non-software components that function together to deliver the tangible product s essential functionality are no longer within the scope of the existing software revenue guidance of the Codification. In addition, the amendments in this update require that hardware components of a tangible product containing software components always be excluded from the software revenue guidance. In that regard, the amendments provide additional guidance on how to determine which software, if any, relating to the tangible product also would be excluded from the scope of the software revenue guidance. The amendments also provide guidance on how a vendor should allocate arrangement consideration to deliverables in an arrangement that includes both tangible products and software. The amendments also provide further guidance on how to allocate arrangement consideration when an arrangement includes deliverables both included and excluded from the scope of the software revenue guidance. These amendments will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010, with early adoption permitted. The Company is currently evaluating the impact the adoption of this update might have on its results of operations and financial condition.

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.

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2. Summary of Significant Accounting Policies (continued)

Fair Market Value of Financial Instruments

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

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. The fair values of option awards granted in the three months ended and the nine months ended September 30, 2010 and 2009 were estimated using the Black-Scholes option pricing model under the following assumptions:

	Three Months ended September 30,		Nine Months ended September 30,			
	2010	2009	2010		2009	
Risk free interest rate	n/a	2.46%	2.42	3.66%	1.60	3.72%
Dividend yield	n/a	0%	0%		0%	
Expected term	n/a	5 years	5-10 years		5-10 years	
Expected volatility	n/a	61.4%	63.0	97.6%	59.1	105.6%

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. There were no options granted under 2006 Plan during the three months ended September 30, 2010. The average vesting period for options granted to employees under the 2006 Plan in the three months ended September 30, 2009, was eighteen months, and average vesting periods for options granted to employees in the nine months ended September 30, 2010 and 2009, were fourteen months and eighteen months, respectively. The exercise price of each option equals 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 568,500 and 622,000 unexpired exercisable options remaining from the 1996 Plan at September 30, 2010 and December 31, 2009,

respectively.

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3. Stock Options and Warrants (continued)

The status of the options issued under the foregoing option plans as of September 30, 2010, and changes during the nine months ended September 30, 2010 and 2009, were as follows:

	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
Balance at December 31, 2008	1,089,000	$ 0.35
Options granted	12,500	0.07
Options exercised, expired or forfeited	21,000	0.40
Balance at March 31, 2009	1,080,500	0.35
Options granted	21,000	0.09
Options exercised, expired or forfeited	83,000	0.57
Balance at June 30, 2009	1,018,500	$ 0.34
Options granted	1,500	0.15
Options exercised, expired or forfeited	1,000	0.17
Balance at September 30, 2009	1,019,000	$ 0.33

The following table summarizes information about options at September 30, 2010:

Options outstanding				Options exercisable			
Total shares	Weighted average exercise price	Weighted average remaining contractual life in years	Aggregate intrinsic value	Total shares	Weighted average exercise price	Weighted average remaining contractual life in years	Aggregate intrinsic value
1,072,000	$ 0.30	4.76	$ 8,635	980,750	$ 0.32	4.35	$ 5,118

Nonvested stock awards as of September 30, 2010 and changes during the nine months ended September 30, 2010, were as follows:

	Nonvested	
	Number of shares	Weighted average grant date fair value
Balance at December 31, 2009	56,250	$ 0.08
Granted	98,000	0.12
Vested	8,250	0.07
Expired before vesting	750	0.04
Balance at March 31, 2010	145,250	0.11
Granted	10,000	0.10
Vested	23,250	0.10
Balance at June 30, 2010	132,000	$ 0.11
Vested	40,750	0.14
Balance at September 30, 2010	91,250	$ 0.09

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3. Stock Options and Warrants (continued)

As of September 30, 2010 and 2009, unrecognized compensation cost associated with non-vested share-based employee and non-employee compensation totaled $3,360 and $1,773, respectively, which are expected to be recognized over weighted average periods of 5 months and 6 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, 2010, nor in fiscal year 2009. As of September 30, 2010 and 2009, outstanding warrants were 0 and 12,000, respectively. The purchase price for shares issued upon exercise of the warrants outstanding in 2009 was $0.01 per share. These warrants were immediately exercisable.

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, 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 three months ended September 30, 2009:			
Income available to common stockholders	$ 122,109	11,196,760	$ 0.01
Effect of dilutive stock options		500	
Effect of dilutive stock warrants		11,143	
Diluted net income per common share for the three months ended September 30, 2009:	$ 122,109	11,208,403	$ 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
Basic net income per common share for the nine months ended September 30, 2009:			
Income available to common stockholders	$ 65,748	11,196,760	$ 0.01
Effect of dilutive stock options		60	
Effect of dilutive stock warrants		11,000	
Diluted net income per common share for the nine months ended September 30, 2009:	$ 65,748	11,207,820	$ 0.01

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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, 2009 and in other filings with the Securities and Exchange Commission. These risks include, among others, the following:

- 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;
- changes in the way the US government contracts with businesses and changes in the budgetary priorities;
- non-performance by our subcontractors and suppliers;
- terms specific to US government contracts;
- our dependence on key personnel;
- our failure to adequately integrate businesses we may acquire;
- fluctuations in our results of operations and its 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 is in the business of modernizing client information systems. 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.

Two of our customers, one of which is a government agency with which we contract directly and one of which is a company with which we contract for services to government agencies, represent material portions of our revenue. These customers accounted for 31.3% and 16.0% of revenue in the first nine months, respectively.

Three Months Ended September 30, 2010 versus Three Months Ended September 30, 2009

Revenue

Our revenues in the third quarter of 2010 were $1,951,511, compared to $1,988,406 in 2009, a decrease of 1.9%. Professional services revenue was $1,293,060 versus $1,302,031, a decrease of 0.7%, and software product and maintenance revenue was $658,451 versus $686,375, a decrease of 4.1%. The decrease in software sales revenue is due to a decrease in product orders and the non-renewal of several maintenance contracts under one of our product lines, mostly offset by increases in maintenance contracts on another product line. 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 $635,909, or 32.6% of sales, in the third quarter of 2010 versus $656,700, or 33.0% of sales, in the third quarter of 2009. $570,577 of the gross margin was attributable to professional services at a gross margin percentage of 44.1%, and $65,332 of the gross margin was attributable to software sales at a gross margin percentage of 9.9%. In the same quarter in 2009, we reported gross margins of $550,736, or 42.3% of sales for professional services and $105,964, or 15.4% of sales for software sales. Professional services gross margin and gross margin as a percentage of sales increased due mainly to the addition of some contracts with higher margins than those that expired. Forms services contracts generally

include fixed price elements whose margins increase when we establish operating efficiencies with individual customers. We expect to continue to add professional services contracts with higher margins. Our decrease in gross margin and gross margin as a percentage of sales on software sales is due to the combination of a decrease in software sales and the addition of a contract which includes a zero-margin third party software maintenance component. 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 were $596,122, or 30.5% of revenues, in the third quarter of 2010 versus $535,944, or 27.0% of revenues, in the third quarter of 2009. This increase of $60,178, or 11.2%, is due to an increase in incentives earned by our sales and marketing personnel, which fluctuate with sales and gross margins at varying rates for each person, offset by decreases in overhead and administrative salaries, recruiting costs, advertising and promotion, and external legal and accounting fees.

Net income

Net income for the three months ended September 30, 2010, was $42,383, or 2.2% of revenue, versus net income of $122,109, or 6.1% of revenue, for the same period in 2009. The decrease in profitability is primarily due to the increase in commissions on sales and the change in product mix of software sales.

Nine Months Ended September 30, 2010 versus Nine Months Ended September 30, 2009

Revenue

Our revenues in the first nine months of 2010 were $5,654,947, compared to $4,787,347 in 2009, an increase of 18.1%. Professional services revenue was $3,921,041 versus $3,601,267, an increase of 8.9%, and software product and maintenance revenue was $1,733,906 versus $1,186,080, an increase of 46.2%. The increase in professional services revenue is due to an increase in our electronic forms-related services. We established forms services relationships with several new agencies. The increase in software product and maintenance revenue is primarily due to several substantial software maintenance sales. 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 $2,001,672, or 35.4% of sales, in the first nine months of 2010 versus $1,561,104, or 32.6% of sales, in the first nine months of 2009. $1,743,033 of the gross margin was attributable to professional services at a gross margin percentage of 44.5%, and $258,639 of the gross margin was attributable to software sales at a gross margin percentage of 14.9%. In the same period in 2009, we reported gross margins of $1,305,735, or 36.3% of sales for professional services and $255,369, or 21.5% of sales for software sales. Professional services gross margin and gross margin as a percentage of sales increased due mainly to the addition of new forms services contracts, some of which are shorter-term contracts. Forms services contracts generally include fixed price elements whose margins increase when we establish operating efficiencies with individual customers. Gross margin as a percentage of sales also increased due to the expiration of some other professional services contracts with very modest margins. We expect to continue to add professional services contracts with higher margins. Our increase in the dollar value of gross margin on software sales is related to the increase in software sales revenue, as well commissions received on our efforts in facilitating software sales between two other parties. The decrease in gross margin as a percentage of software sales is due to limited margins on some of our sales due to competition and supplier pricing. 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 were $1,784,397, or 31.6% of revenues, in the first nine months of 2010 versus $1,503,324, or 31.4% of revenues, in the first nine months of 2009. This increase of $281,073, or 18.7%, is due almost entirely to the increase in incentives earned by our marketing personnel as a result of our increases in both revenue and gross margin on services.

Net income

Net income for the nine months ended September 30, 2010, was $224,595, or 4.0% of revenue, versus $65,748, or 1.4% of revenue, for the same period in 2009. The increase in profitability is due to the addition of forms services contracts, which generally include fixed price elements, and the operating efficiencies we establish on these fixed-price forms-related contracts. Net income increases are also attributed to an increase in software sales and higher margins on professional services sales.

Liquidity and Capital Resources

In the first nine months of 2010, we had operating income of $217,275 and net income of $224,595. Our December 31, 2009 cash and cash equivalents balance, when combined with our cash flow from operations during the first nine months of 2010, were sufficient to provide financing for our operations. Net cash provided by operating and investing activities in the first nine months was $398,593, which when added to a beginning balance of $1,478,504 at December 31, 2009, yielded cash and cash equivalents of $1,877,097 at September 30, 2010. Our accounts receivable balances increased $726,765 in the first nine months. Our accounts payable balances increased $642,325. Our current ratio, or the ratio of current assets to current liabilities, decreased to 1.79 from 2.17 due to the increases in both accounts receivable and accounts payable caused by a few significant software product and maintenance orders. If the effects of these orders are removed from both receivables and payables, the current ratio at September 30, 2010, would be 2.14.

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, 2010. As of September 30, 2010, no amounts were outstanding under this line of credit. At September 30, 2010, $1,000,000 was available under this line of credit based on our outstanding accounts receivable.

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

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 4T. 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.

Changes in Internal Controls

There were no changes in our internal controls over financial reporting during the quarter ended September 30, 2010 that have materially affected, or are reasonably likely to affect, our internal control over financial reporting.

In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law. This legislation includes an exemption for companies with less than $75 million in market capitalization (non-accelerated filers) to Section 404(b) of the Sarbanes-Oxley Act of 2002, which requires an external auditor s report on the effectiveness of a registrant s internal control over financial reporting. The Securities and Exchange Commission (the SEC) has not published a final rule on this new law. The Company is in the process of determining the effects, if any, of this new law.

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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, 2009 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, 2009.

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

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 15, 2010

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