

INFORMATION ANALYSIS INC  
Form 10QSB  
November 14, 2005  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-QSB**

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(Mark One)

**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 number 0-22405

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**INFORMATION ANALYSIS INCORPORATED**

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

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**Virginia**  
(State or other jurisdiction of  
incorporation or organization)

**54-1167364**  
(IRS Employer  
Identification No.)

**11240 Waples Mill Road, Suite 201, Fairfax, VA 22030**

(Address of principal executive offices)

**(703) 383-3000**

(Issuer's telephone number)

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

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Check whether the issuer (1) 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

**APPLICABLE ONLY TO CORPORATE ISSUERS**

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

Common Stock, par value \$0.01, 10,618,015 shares as of October 31, 2005

Transitional Small Business Disclosure Format (Check one): Yes  No

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**INFORMATION ANALYSIS INCORPORATED**

**FORM 10-QSB**

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**INFORMATION ANALYSIS INCORPORATED****CONSOLIDATED BALANCE SHEETS**

	September 30, 2005 Unaudited	December 31, 2004
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 144,865	\$ 115,917
Accounts receivable, net	2,425,835	2,169,790
Prepaid expenses	157,231	47,579
Notes receivable	85,000	85,000
Other receivables	13,688	6,910
<b>Total current assets</b>	<b>2,826,619</b>	<b>2,425,196</b>
Fixed assets, net	61,004	34,551
Other assets	8,782	7,447
Investments		3,000
<b>Total assets</b>	<b>\$ 2,896,405</b>	<b>\$ 2,470,194</b>
<b>LIABILITIES &amp; STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,296,945	\$ 1,566,788
Accrued payroll and related liabilities	349,294	277,172
Other accrued liabilities	293,136	64,748
Deferred revenue	149,688	83,844
Revolving line of credit	113,726	219,650
Notes payable		125,000
<b>Total current liabilities</b>	<b>2,202,789</b>	<b>2,337,202</b>
<b>Total liabilities</b>	<b>2,202,789</b>	<b>2,337,202</b>
Stockholders' equity:		
Common stock, par value \$0.01, 30,000,000 shares authorized; 12,122,626 shares issued, 10,618,015 outstanding at September 30, 2005, and 11,788,126 shares issued, 10,283,515 outstanding at December 31, 2004	121,226	117,881
Additional paid in capital	14,211,225	14,122,019
Accumulated deficit	(12,772,522)	(13,243,595)
Accumulated other comprehensive income	(12,000)	(9,000)
Treasury stock, 1,504,611 shares at cost	(854,313)	(854,313)
<b>Total stockholders' equity</b>	<b>693,616</b>	<b>132,992</b>

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Total liabilities and stockholders equity	\$ 2,896,405	\$ 2,470,194
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*The accompanying notes are an integral part of the consolidated financial statements*

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**INFORMATION ANALYSIS INCORPORATED**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**AND COMPREHENSIVE INCOME**

	<b>For the three months ended September 30,</b>	
	<b>2005 Unaudited</b>	<b>2004 Unaudited</b>
Sales		
Professional fees	\$ 2,371,496	\$ 2,255,127
Software sales	257,566	183,313
<b>Total sales</b>	<b>2,629,062</b>	<b>2,438,440</b>
Cost of sales		
Cost of professional fees	1,752,845	1,776,572
Cost of software sales	208,408	175,866
<b>Total cost of sales</b>	<b>1,961,253</b>	<b>1,952,438</b>
Gross profit	667,809	486,002
Selling, general and administrative expenses	(412,893)	(416,803)
Other operating income		289,902
<b>Income from operations</b>	<b>254,916</b>	<b>359,101</b>
Other expenses, net	(4,340)	(5,009)
<b>Income before provision for income taxes</b>	<b>250,576</b>	<b>354,092</b>
Provision for income taxes		
<b>Net income</b>	<b>\$ 250,576</b>	<b>\$ 354,092</b>
Unrealized loss on available-for-sale securities	(3,000)	
<b>Comprehensive income</b>	<b>\$ 247,576</b>	<b>\$ 354,092</b>
Earnings per common share:		
Basic:		
Net income	\$ 0.02	\$ 0.03
Diluted:		
Net income	\$ 0.02	\$ 0.03

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	<u>                    </u>	<u>                    </u>
Weighted average common shares outstanding:		
Basic	10,301,494	10,283,515
Diluted	10,655,071	11,019,408

*The accompanying notes are an integral part of the consolidated financial statements*

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**INFORMATION ANALYSIS INCORPORATED**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**AND COMPREHENSIVE INCOME**

	<b>For the nine months ended September 30,</b>	
	<b>2005 Unaudited</b>	<b>2004 Unaudited</b>
Sales		
Professional fees	\$ 6,857,975	\$ 6,314,575
Software sales	964,111	397,707
<b>Total sales</b>	<b>7,822,086</b>	<b>6,712,282</b>
Cost of sales		
Cost of professional fees	5,271,881	5,098,468
Cost of software sales	813,339	314,078
<b>Total cost of sales</b>	<b>6,085,220</b>	<b>5,412,546</b>
Gross profit	1,736,866	1,299,736
Selling, general and administrative expenses	(1,253,272)	(1,097,314)
Other operating income		289,902
<b>Income from operations</b>	<b>483,594</b>	<b>492,324</b>
Other expenses, net	(12,521)	(25,884)
<b>Income before provision for income taxes</b>	<b>471,073</b>	<b>466,440</b>
Provision for income taxes		
<b>Net income</b>	<b>\$ 471,073</b>	<b>\$ 466,440</b>
Unrealized loss on available-for-sale securities	(3,000)	
<b>Comprehensive income</b>	<b>\$ 468,073</b>	<b>\$ 466,440</b>
Earnings per common share:		
Basic:		
Net income	\$ 0.05	\$ 0.05
Diluted:		
Net income	\$ 0.04	\$ 0.04



	<u>                    </u>	<u>                    </u>
Weighted average common shares outstanding:		
Basic	10,293,910	10,283,515
Diluted	10,687,084	11,009,825

*The accompanying notes are an integral part of the consolidated financial statements*

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**INFORMATION ANALYSIS INCORPORATED**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	For the nine months ended September 30,	
	2005 Unaudited	2004 Unaudited
Cash flows from operating activities:		
Net income	\$ 471,073	\$ 466,440
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	16,204	15,992
Non-cash option expense	3,600	
Reduction of accounts payable through issuance of equity	4,500	
Amortization of capitalized software		62,583
Gain on sale of fixed assets		(1,465)
Changes in operating assets and liabilities		
Accounts receivable	(1,006,045)	(313,769)
Other receivables and prepaid expenses	(648,979)	29,515
Accounts payable and accrued expenses	561,882	289,177
Deferred revenue	815,844	(72,049)
Net cash provided by operating activities	218,079	476,424
Cash flows from investing activities:		
Purchases of fixed assets	(42,656)	(16,313)
Proceeds from sale of fixed assets		1,465
Net cash used by investing activities	(42,656)	(14,848)
Cash flows from financing activities:		
Net payments under revolving line of credit	(105,924)	(689,017)
Maturity of convertible notes	(45,000)	
Proceeds from exercise of stock options	4,450	
Net cash used by financing activities	(146,474)	(689,017)
Net increase (decrease) in cash and cash equivalents	28,948	(227,441)
Cash and cash equivalents at beginning of the period	115,917	317,921
Cash and cash equivalents at end of the period	\$ 144,865	\$ 90,480
Supplemental cash flow Information		
Interest paid	\$ 13,195	\$ 31,666



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**PART I**

**Item 1. Financial Statements.**

**INFORMATION ANALYSIS INCORPORATED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation**

The accompanying consolidated financial statements have been prepared by Information Analysis Incorporated ( "IAI" or the "Company" ) pursuant to the rules and regulations of the Securities and Exchange Commission. Financial information included herein is unaudited; however, in the opinion of management, all adjustments (which include normal recurring adjustments) considered necessary for a fair presentation have been made. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted pursuant to such rules and regulations, but the Company believes that the disclosures made are adequate to make the information presented not misleading. For more complete financial information, these financial statements should be read in conjunction with the audited financial statements and notes thereto for the year ended December 31, 2004 included in the Company's annual report on Form 10-KSB. Results for interim periods are not necessarily indicative of the results for any other interim period or for the full fiscal year.

**2. Going Concern**

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. Although we have an accumulated deficit of \$12,773,000, we achieved net income of approximately \$471,000 for the nine months ended September 30, 2005. Our financial position, however, remains challenged.

Our credit facility expires December 16, 2005, and is not expected to be renewed by the current lender. We are in negotiations with other lenders for a new credit facility or alternative financing. Should we fail to secure a successor credit facility, we may periodically be required to delay timely payments of our accounts payable.

In addition to obtaining new financing and sources of capital, our ability to continue operations is contingent upon sustaining our profitable operations, improving our gross margins, and reducing overhead and general and administrative costs. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

**3. Stock-based Compensation**

The Company has an incentive stock option plan, which became effective June 25, 1996. The plan provides for the granting of stock options to certain employees and directors. The maximum number of shares for which options may be granted under the plan is 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. The average vesting period for options granted in 2005 was eighteen months. The exercise

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**3. Stock-based Compensation (cont.)**

price of each option equals the quoted market price of the Company's stock on the date of grant. The stock option plan is accounted for under Accounting Principles Board (APB) Opinion No. 25. Accordingly, no compensation has been recognized for the plan. Had compensation cost for the plan been determined based on the estimated fair value of the options at the grant date consistent with the method of Statement of Financial Accounting Standards (SFAS) No. 123, the Company's net income and earnings per share would have been:

		<b>Three months ending</b>	
		<b>September 30,</b>	
		<b>2005</b>	<b>2004</b>
Net income	As reported	\$ 250,576	\$ 354,092
	Pro forma	\$ 248,780	\$ 350,835
Net income	As reported	\$ 0.02	\$ 0.03
per share basic	Pro forma	\$ 0.02	\$ 0.03
Net income	As reported	\$ 0.02	\$ 0.03
per share diluted	Pro forma	\$ 0.02	\$ 0.03
		<b>Nine months ending</b>	
		<b>September 30,</b>	
		<b>2005</b>	<b>2004</b>
Net income	As reported	\$ 470,073	\$ 466,440
	Pro forma	\$ 463,047	\$ 450,978
Net income	As reported	\$ 0.05	\$ 0.05
per share basic	Pro forma	\$ 0.04	\$ 0.04
Net income	As reported	\$ 0.04	\$ 0.04
per share diluted	Pro forma	\$ 0.04	\$ 0.04

**4. Net Income Per Share**

Earnings per share are presented in accordance with SFAS No. 128, Earnings Per Share. This statement requires dual presentation of basic and diluted earnings per share on the face of the income statement. 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.

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**4. Net Income Per Share (cont.)**

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

	<u>Net Income</u>	<u>Shares</u>	<u>Per Share Amount</u>
Basic net income per common share for the three months ended September 30, 2005:			
Income available to common stockholders	\$ 250,576	10,301,494	\$ 0.02
Effect of dilutive stock options		234,196	
Effect of dilutive warrants		119,381	
Diluted net income per common share for the three months ended September 30, 2005:	\$ 250,576	10,655,071	\$ 0.02
Basic net income per common share for the three months ended September 30, 2004:			
Income available to common stockholders	\$ 354,092	10,283,515	\$ 0.03
Effect of dilutive stock options		145,676	
Effect of dilutive warrants		90,217	
Effect of dilutive convertible notes	3,750	500,000	
Diluted net income per common share for the three months ended September 30, 2004:	\$ 357,842	11,019,408	\$ 0.03
Basic net income per common share for the nine months ended September 30, 2005:			
Income available to common stockholders	\$ 471,073	10,293,910	\$ 0.05
Effect of dilutive stock options		271,657	
Effect of dilutive warrants		121,517	
Diluted net income per common share for the nine months ended September 30, 2005:	\$ 471,073	10,687,084	\$ 0.04
Basic net income per common share for the nine months ended September 30, 2004:			
Income available to common stockholders	\$ 466,440	10,283,515	\$ 0.05
Effect of dilutive stock options		131,799	
Effect of dilutive warrants		94,511	
Effect of dilutive convertible notes	11,250	500,000	
Diluted net income per common share for the nine months ended September 30, 2004:	\$ 477,690	11,009,825	\$ 0.04

**Item 2. Management's Discussion and Analysis of Financial Condition or Plan of Operation****Cautionary Statement Regarding Forward-Looking Statements**

This Form 10-QSB contains forward-looking statements regarding the Company's 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 the Company's 10-KSB for the fiscal year ended December 31, 2004 and in other filings with the Securities and Exchange Commission.





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### **Three Months Ended September 30, 2005 Versus Three Months Ended September 30, 2004**

#### *Revenue*

Our revenues in the third quarter of 2005 were \$2,629,062, compared to \$2,438,440 in the third quarter of 2004, an increase of 7.8%. Professional services revenue was \$2,371,496 versus \$2,255,127, an increase of 5.2%, and product revenue was \$257,566 versus \$183,313, an increase of 40.5%. The increase in professional services revenue is due primarily to new contracts on which work began in 2005. The increase in product revenue is primarily due to sales of Micro Focus products under contracts which commenced in 2005. Adobe and Micro Focus products, as well as our ICONS suite of software conversion tools, are generally sold in conjunction with professional services over a specified contract term. We continue to have a steady pipeline of bidding opportunities for new and follow-on business. Professional services revenues are expected to maintain their current levels in the remainder of 2005, and product revenues, which are largely driven by one-time purchases, will increase due to a large product order in the fourth quarter of 2005 of \$750,000.

#### *Gross Margins*

Gross margin was \$667,809, or 25.4% of sales, in the third quarter of 2005 versus \$486,002, or 19.9% of sales, in the third quarter of 2004. Of the \$667,809 in 2005, \$618,651 was attributable to professional services and \$49,158 was attributable to software sales. Our gross margin percentage was 26.1% for professional services and 19.1% for software sales for the third quarter of 2005. In the third quarter of 2004, we reported gross margins of 21.2% for professional services and 4.1% for software sales. The increase in professional services gross margin percentage is largely due to improved margins related to new commercial contracts and higher margins on some of our electronic forms services. Also, we achieved cost savings by replacing some of our independent contractors with employees on current contracts and by hiring employees to work on new contracts as opposed to utilizing independent contractors. The increase in software sales gross margin percentage is due to sales of higher-margin software products.

#### *Selling, General and Administrative*

Selling, general and administrative expenses were \$412,893, or 15.7% of revenues, in the third quarter of 2005 versus \$416,803, or 17.1% of revenues, in the third quarter of 2004. We continue to control expenses and reduce them wherever practical, and we believe that only marginal increases in expenses will result from increases in the number of contracts under which we operate. We anticipate an increase in expenses beginning in 2006 resulting from our need to comply with Section 404 of the Sarbanes Oxley Act. We have not yet determined the projected level of such increase.

#### *Profits*

We generated income from operations of \$254,916 in the third quarter of 2005 compared to \$359,101 in the third quarter of 2004. Net income for the third quarter of 2005 was \$250,576 versus \$354,092 for the same period in 2004. In the third quarter of 2004, however, we recovered past due receivables, all of which had been fully reserved, of \$289,902, net of collection costs. When we compare net income without regard to the

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effect of the recovery of the past due receivables, the net income for the third quarter of 2005 increased by \$186,386 compared to the third quarter of 2004. This increase is primarily related to increased margins on professional services sales.

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**Nine Months Ended September 30, 2005 Versus Nine Months Ended September 30, 2004**

*Revenue*

Our revenues in the first nine months of 2005 were \$7,822,086, compared to \$6,712,282 in the first nine months of 2004, an increase of 16.5%. Professional services revenue was \$6,857,975 versus \$6,314,575, an increase of 8.6%, and product revenue was \$964,111 versus \$397,707, an increase of 142.4%. The increase in professional services revenue is due primarily to new contracts on which work began in 2005. The increase in product revenue is primarily due to a particularly large sale of Adobe products and to sales of Micro Focus products under contracts which commenced in 2005. Adobe and Micro Focus products, as well as our ICONS suite of software conversion tools, are generally sold in conjunction with professional services over a specified contract term. We continue to have a steady pipeline of bidding opportunities for new and follow-on business. Professional services revenues are expected to maintain their current levels in the remainder of 2005, and product revenues, which are largely driven by one-time purchases, will increase due to a large product order in the fourth quarter of 2005.

*Gross Margins*

Gross margin was \$1,736,866, or 22.2% of sales, in the first nine months of 2005 versus \$1,299,736, or 19.4% of sales, in the first nine months of 2004. Of the \$1,736,866 in 2005, \$1,586,094 was attributable to professional services and \$150,772 was attributable to software sales. Our gross margin percentage was 23.1% for professional services and 15.6% for software sales for the first nine months of 2005. In 2004, we reported gross margins of 19.3% for professional services and 21.0% for software sales. The increase in professional services gross margin percentage is largely due to improved margins related to new commercial contracts and higher margins on some of our electronic forms services.

*Selling, General and Administrative*

Selling, general and administrative expenses were \$1,253,272, or 16.0% of revenues, in the first nine months of 2005 versus \$1,097,314, or 16.3% of revenues, in 2004. The increase in these expenses is due to increased costs of local area network administration, including the upgrade of equipment and software, and the declaration of performance bonuses for executive officers. We continue to control expenses and reduce them wherever practical, and we believe that only marginal increases in expenses will result from increases in the number of contracts under which we operate.

*Profits*

We generated income from operations of \$483,594 in the first nine months of 2005 compared to income from operations of \$492,324 in the same period in 2004. Net income for the first nine months 2005 was \$470,073 versus \$466,440 for 2004. In the third quarter of 2004, however, we recovered past due receivables, all of which had been fully reserved, of \$289,902, net of collection costs. When we compare net income without regard to the effect of the recovery of the past due receivables, the net income for the first nine months of 2005 increased by \$293,535 compared to the first nine months of 2004. This increase is primarily related to increased margins on professional services sales.



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**Liquidity and Capital Resources**

Through the first nine months of 2005, we financed operations from current collections and through our bank line of credit. Cash and cash equivalents at September 30, 2005 were \$144,865 compared to \$115,917 at December 31, 2004.

We have a revolving line of credit with a bank providing for demand or short-term borrowings of up to \$500,000. The line of credit is callable on demand, and next expires on December 16, 2005. We do not expect our current lender to renew our credit facility. We are in negotiations with other lenders for a new credit facility or alternative financing. We believe we will have a new credit facility in place before the current expiration date. Should we fail to secure a successor credit facility, we may periodically be required to delay timely payments of our accounts payable.

As of September 30, 2005, we had \$113,726 outstanding on our line of credit versus an outstanding balance of \$219,650 at December 31, 2004. We believe that our profitability will continue through the remainder of 2005 and that cash flows from collections should enable us to continue to finance our operations. Cash flow from operations may not be sufficient to provide additional working capital necessary to repay certain past due payables.

We have no material commitments for capital expenditures.

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**Item 3. Controls and Procedures**

(a) Evaluation of Disclosure Controls and Procedures. As of the end of the period covered by this report, with the participation of the Company's management, the Company's principal executive officer and principal financial officer conducted an evaluation (as required by paragraph (b) of Rule 13a-15 or Rule 15d-15 under the Exchange Act) of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Exchange Act). Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in our periodic SEC reports. The design of any system of controls 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.

(b) Changes in Internal Control over Financial Reporting. There have been no significant changes in the Company's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Rule 13a-15 or Rule 15d-15 under the Exchange Act that occurred during the Company's last fiscal quarter that has materially affected, or is reasonably likely to affect, the Company's internal control over financial reporting. There have been no significant changes subsequent to the date of the evaluation, nor were there any significant deficiencies or material weaknesses in the Company's internal controls. Accordingly, no corrective actions were required or undertaken.

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**PART II - OTHER INFORMATION**

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

- (a) On September 30, 2005, \$125,000 of convertible notes we issued in 2001 matured. Holders of \$80,000 of the notes converted their notes into 320,000 shares of our common stock at a price of \$.25 per share. The remaining \$45,000 which were not converted were paid in full. We relied upon Section 4(2) of the Securities Act of 1933, as amended, to exempt the issuance of the notes and the shares issued upon conversion of the notes from the registration requirements of such act.

**Item 6. Exhibits and Reports on Form 8-K**

- (a) Exhibits:

See Exhibit Index on page 14.

**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 7, 2005

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

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**Exhibit Index**

<b><u>Exhibit No.</u></b>	<b><u>Description</u></b>	<b><u>Location</u></b>
31.1	Certification by Chief Executive Officer under Section 302 of the Sabanes-Oxley Act of 2002	Filed with this Form 10-QSB, page 15
31.2	Certification by Chief Financial Officer under Section 302 of the Sabanes-Oxley Act of 2002	Filed with this Form 10-QSB, page 16
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	Filed with this Form 10-QSB, page 17
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	Filed with this Form 10-QSB, page 18