

INFORMATION ANALYSIS INC

Form 10-Q

November 14, 2008

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2008

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

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

Commission file number 0-22405

**INFORMATION ANALYSIS INCORPORATED**

(Exact name of registrant 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**  
(Address of principal executive offices)

**22030**  
(Zip Code)

**(703) 383-3000**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant (1) 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 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  (Do not check if a smaller reporting company)

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

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY

PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes  No

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate 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, 11,196,760 shares as of November 12, 2008

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**INFORMATION ANALYSIS INCORPORATED****BALANCE SHEETS****(Unaudited)**

	<b>September 30, 2008</b>	<b>December 31, 2007</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 1,100,986	\$ 1,222,742
Accounts receivable, net	1,154,016	1,560,030
Prepaid expenses	519,607	462,802
Other assets	4,300	4,300
Other receivables	505	2,630
<b>Total current assets</b>	<b>2,779,414</b>	<b>3,252,504</b>
Fixed assets, net	63,462	79,145
Other assets	8,782	8,782
<b>Total assets</b>	<b>\$ 2,851,658</b>	<b>\$ 3,340,431</b>
<b>LIABILITIES &amp; STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 518,516	\$ 720,830
Deferred revenue	438,205	393,974
Accrued payroll and related liabilities	212,398	257,649
Other accrued liabilities	25,482	45,585
Income taxes payable	3,500	3,500
<b>Total current liabilities</b>	<b>1,198,101</b>	<b>1,421,538</b>
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	14,548,943	14,545,367
Accumulated deficit	(12,093,568)	(11,824,656)
Treasury stock, 1,642,616 shares at cost	(930,211)	(930,211)
<b>Total stockholders' equity</b>	<b>1,653,557</b>	<b>1,918,893</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 2,851,658</b>	<b>\$ 3,340,431</b>

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

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

(Unaudited)

	<b>For the three months ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
Sales		
Professional fees	\$ 1,261,155	\$ 1,687,846
Software sales	334,739	947,408
Total sales	1,595,894	2,635,254
Cost of sales		
Cost of professional fees	870,538	1,272,031
Cost of software sales	234,692	748,973
Total cost of sales	1,105,230	2,021,004
Gross profit	490,664	614,250
Selling, general and administrative expenses	567,384	527,017
(Loss) income from operations	(76,720)	87,233
Other income, net	5,659	7,944
(Loss) income before provision for income taxes	(71,061)	95,177
Provision for income taxes		
Net (loss) income	\$ (71,061)	\$ 95,177
Comprehensive (loss) income	\$ (71,061)	\$ 95,177
Earnings (loss) per common share:		
Basic:	(\$ 0.01)	\$ 0.01
Diluted:	(\$ 0.01)	\$ 0.01
Weighted average common shares outstanding:		
Basic	11,196,760	11,196,760
Diluted	11,196,760	11,414,922

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



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

(Unaudited)

	<b>For the nine months ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
Sales		
Professional fees	\$ 4,093,179	\$ 5,364,812
Software sales	949,294	2,432,682
Total sales	5,042,473	7,797,494
Cost of sales		
Cost of professional fees	3,027,293	4,092,917
Cost of software sales	681,189	1,931,303
Total cost of sales	3,708,482	6,024,220
Gross profit	1,333,991	1,773,274
Selling, general and administrative expenses	1,618,459	1,586,128
(Loss) income from operations	(284,468)	187,146
Other income, net	15,556	20,131
(Loss) income before provision for income taxes	(268,912)	207,277
Provision for income taxes		
Net (loss) income	\$ (268,912)	\$ 207,277
Comprehensive (loss) income	\$ (268,912)	\$ 207,277
Earnings (loss) per common share:		
Basic:	\$ (0.02)	\$ 0.02
Diluted:	\$ (0.02)	\$ 0.02
Weighted average common shares outstanding:		
Basic	11,196,760	11,196,760
Diluted	11,196,760	11,408,401

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





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

(Unaudited)

	<b>For the nine months ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Cash flows from operating activities:</b>		
Net (loss) income	\$ (268,912)	\$ 207,277
<b>Adjustments to reconcile net (loss) income to net cash (used) provided by operating activities:</b>		
Depreciation and amortization	27,081	25,855
Stock compensation	3,576	56,839
<b>Changes in operating assets and liabilities</b>		
Accounts receivable	406,014	(1,562)
Other receivables and prepaid expenses	(54,680)	33,552
Accounts payable and accrued expenses	(267,668)	186,363
Deferred revenue	44,231	(32,069)
<b>Net cash (used) provided by operating activities</b>	<b>(110,358)</b>	<b>476,255</b>
<b>Cash flows from investing activities:</b>		
Purchases of fixed assets	(11,398)	(21,154)
<b>Net cash used by investing activities</b>	<b>(11,398)</b>	<b>(21,154)</b>
<b>Cash flows from financing activities:</b>		
Net cash provided by financing activities		
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(121,756)</b>	<b>455,101</b>
Cash and cash equivalents at beginning of the period	1,222,742	808,358
<b>Cash and cash equivalents at end of the period</b>	<b>\$ 1,100,986</b>	<b>\$ 1,263,459</b>
<b>Supplemental cash flow Information</b>		
Interest paid	\$	\$

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

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**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 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, 2007 included in the Annual Report on Form 10-KSB filed by the Company with the Securities and Exchange Commission on April 15, 2008. 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****Recent Accounting Pronouncements**

In September 2006, FASB issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 does not impose fair value measurements on items not already accounted for at fair value; rather it applies, with certain exceptions, to other accounting pronouncements that either require or permit fair value measurements. Under SFAS No. 157, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the principal or most advantageous market. The standard clarifies that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In February 2008, the FASB issued FASB Staff Position No. 157-2, Effective Date of FASB Statement No. 157 ( FSP FAS 157-2 ), which delays the effective date of SFAS No. 157 for all non-financial assets and liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis, until fiscal years beginning after November 15, 2008. These non-financial items include assets and liabilities such as non-financial assets and liabilities assumed in a business combination, reporting units measured at fair value in a goodwill impairment test and asset retirement obligations initially measured at fair value. The Company adopted the provisions of SFAS No. 157 for financial assets and liabilities recognized at fair value on a recurring basis effective January 1, 2008. The partial adoption of SFAS No. 157 did not have a material impact on the Company's Financial Statements. The Company does not expect the adoption of the remaining provisions of SFAS 157 to have a material effect on the Company's Consolidated Financial Statements. This standard requires that a Company measure its financial assets and liabilities using inputs from the three levels of the fair value hierarchy. A financial asset or liability classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement. The three levels are as follows:

- Level 1 Inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.



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**2. Summary of Significant Accounting Policies (continued)**

Level 2 Inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability and inputs that are derived principally from or corroborated by observable market data by correlation or other means (market corroborated inputs).

Level 3 Unobservable inputs reflect the Company's judgments about the assumptions market participants would use in pricing the asset or liability since limited market data exists. The Company develops these inputs based on the best information available, including the Company's own data.

Financial assets accounted for at fair value on a recurring basis at September 30, 2008 include cash equivalents of \$736,619.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS No. 159), which provides companies with an option to report selected financial assets and liabilities at fair value. SFAS No. 159's objective is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. Generally accepted accounting principles have required different measurement attributes for different assets and liabilities that can create artificial volatility in earnings. SFAS No. 159 helps to mitigate this type of accounting-induced volatility by enabling companies to report related assets and liabilities at fair value, which would likely reduce the need for companies to comply with detailed rules for hedge accounting. SFAS No. 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company's choice to use fair value on its earnings. SFAS No. 159 also requires companies to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. SFAS No. 159 does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in SFAS No. 157 and SFAS No. 107. SFAS No. 159 is effective for the Company as of January 1, 2008. The adoption of SFAS No. 159 did not have any impact on the Company's results of operations or financial position.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (SFAS No. 141(R)). SFAS 141(R) requires the acquiring entity in a business combination to recognize the full fair value of assets acquired and liabilities assumed in the transaction (whether a full or partial acquisition); establishes the acquisition date fair value as the measurement objective for all assets acquired and liabilities assumed; requires expensing of most transaction and restructuring costs; and requires the acquirer to disclose to investors and other users all of the information needed to evaluate and understand the nature and financial effect of the business combination. SFAS No. 141(R) applies to all transactions or other events in which the Company obtains control of one or more businesses, including those sometimes referred to as true mergers or mergers of equals and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after January 1, 2009.

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**2. Summary of Significant Accounting Policies (continued)**

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* an amendment of Accounting Research Bulletin No. 51 ( SFAS No. 160 ). SFAS No. 160 requires reporting entities to present noncontrolling (minority) interests as equity (as opposed to as a liability or mezzanine equity) and provides guidance on the accounting for transactions between an entity and noncontrolling interests. SFAS No. 160 applies prospectively as of January 1, 2009, except for the presentation and disclosure requirements which will be applied retrospectively for all periods presented.

In March 2008, the FASB issued SFAS 161, *Disclosures About Derivative Instruments and Hedging Activities* an amendment of FASB Statement No. 133 . SFAS 161 expands the disclosure requirements in SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, regarding an entity's derivative instruments and hedging activities. SFAS 161 is effective for fiscal years beginning after November 1, 2008. We do not expect the adoption of SFAS 161 to have a material effect on our financial statements.

In May 2008, the FASB issued FASB Staff Position APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash Upon Conversion (Including Partial Cash Settlement)* . FSP APB 14-1 specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate on the instrument's issuance date when interest cost is recognized in subsequent periods. FSP APB 14-1 will be effective for financial statements issued for fiscal years beginning after December 15, 2008 and the interim periods within those fiscal years, and would be applied retrospectively to all periods presented. Early adoption is not permitted. We do not expect the adoption of FSP APB 14-1 to have a material effect on our financial statements.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, which has been established by the FASB as a framework for entities to identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with US GAAP. SFAS No. 162 is not expected to result in a change in current practices. SFAS No. 162 is effective 60 days following the Securities and Exchange Commission's ( SEC ) approval of the Public Company Accounting Oversight Board's ( PCAOB ) amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. Accordingly, we will adopt SFAS No. 162 within the required period.

**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 collectibility of the contract price is considered probable and can be reasonably estimated. Revenue is earned under time and materials and fixed price contracts. For resales of software products, revenue is recognized upon delivery.

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**2. Summary of Significant Accounting Policies (continued)**

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 resale 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.

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 guidance from the Financial Accounting Standards Board Emerging Issues Task Force (EITF) Abstract 99-19. 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.

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 collectibility 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. Audits by DCAA were completed through the year ended December 31, 1997. No amounts were changed as a result of the audits. Since the Company has entered into no cost plus fixed fee contracts since 1997, management is of the opinion that any disallowance of costs for subsequent fiscal years by government auditors, other than amounts already provided, will not materially affect the Company's financial statements.

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**2. Summary of Significant Accounting Policies (continued)****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 are recorded at the invoiced amount and do not bear interest. Accounts receivable reported on the Company's balance sheets include unbilled accounts receivable of \$40,538 and \$102,526 as of September 30, 2008 and December 31, 2007, respectively. 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 does not have any off-balance sheet credit exposure related to its customers. The allowance for doubtful accounts totaled \$0 at September 30, 2008 and December 31, 2007.

**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**

On January 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123R (SFAS 123R), using the modified prospective transition method. The following disclosures are also provided pursuant to the requirements of SFAS 123R.

At September 30, 2008, the Company had the stock-based compensation plans described in Note 3 below. Total compensation expense related to these plans was \$1,189 and \$27,246 for the three months ended September 30, 2008 and 2007, respectively, of which \$0 and \$495, respectively, related to options awarded to non-employees. For the nine months ended September 30, 2008 and 2007, total compensation expense related to these plans was \$3,576 and \$56,839, respectively, of which \$0 and \$6,015, respectively, related to options awarded to non-employees.

The Company uses the Black-Scholes model to estimate grant date fair value. Stock-based compensation expense for all share-based payment awards granted after January 1, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. The Company recognizes these 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.

Each reporting period, the Company evaluates the model input assumptions used in estimating grant date fair value. The Company concluded that its historical realized volatility, calculated using historical stock prices of the Company over the five years preceding the reporting period in which the options were issued, is an appropriate measure of expected volatility. In addition, the Company also examines its historical pattern of option exercises in an effort to identify a discernable pattern and concluded that the expected terms for employee options awarded in the periods presented herein are estimated to be five years. The interest rate used in the pricing model is based on the U.S. Treasury yield curve in effect at the time of the grant on issues with remaining terms equal to the estimated expected term used in the model. The Company has estimated a forfeiture rate based on historical data and current assumptions.

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**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.

**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 uses the Black-Scholes model to estimate grant date fair value. Stock-based compensation expense for all share-based payment awards granted after January 1, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. The Company recognizes these 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.

As part of its SFAS 123R adoption the Company evaluated the model input assumptions used in estimating grant date fair value. The Company concluded that its historical realized volatility, calculated using historical stock prices of the Company over the five years preceding the issue, is an appropriate measure of expected volatility. In addition, the Company also examined its historical pattern of option exercises in an effort to identify a discernable pattern and concluded that the expected term for options awarded in 2008 and in 2007 is estimated to be five years, with the exception of non-statutory stock options, which have an expected term equal to the term of the option, since these do not expire when employment ceases. The interest rate used in the pricing model is based on the U.S. Treasury yield curve in effect at the time of the grant on issues with remaining terms equal to the estimated expected term used in the model. In addition, the Company has estimated a forfeiture rate based on historical data and current assumptions.

During the nine months ended September 30, 2008, the Company granted options to certain employees to purchase an aggregate of 41,500 shares of the Company's common stock, with a per share weighted average fair value of \$0.13 at the measurement date, and did not grant options to non-employee consultants. During the nine months ended September 30, 2007, the Company granted options to certain employees to purchase an aggregate of 213,250 shares of the Company's common stock, with a per share weighted average fair value of \$0.25. Also during the nine months ended September 30, 2007, the Company granted options to non-employee consultants to purchase 18,500 shares of the Company's common stock, with a per share fair value of \$0.33 at the measurement date.

During the three months ended September 30, 2008, the Company granted options to certain employees to purchase an aggregate of 10,000 shares of the Company's common stock, with a per share weighted average fair value of \$0.08 at the measurement date, and did not grant options to non-employee consultants. During the three months ended September 30, 2007, the Company granted



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**3. Stock Options and Warrants (continued)**

options to certain employees to purchase an aggregate of 4,250 shares of the Company's common stock, with a per share weighted average fair value of \$0.24. Also during the three months ended September 30, 2007, the Company granted options to non-employee consultants to purchase 1,500 shares of the Company's common stock, with a per share fair value of \$0.33 at the measurement date.

The fair values of option awards granted in the nine months and in the three months ended September 30, 2008 and 2007, were estimated using the Black Scholes option pricing model with the following assumptions:

	Nine Months		Three Months	
	2008	2007	2008	2007
Risk free interest rate	2.78	4.20	3.30%	4.88%
Dividend yield	0%		0%	
Expected term	5 years	5-10 years	5 years	5-10 years
Expected volatility	61.2	66.5	64.4%	73.5%
			61.2%	66.5%

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 employees, directors and certain non-employees. 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 within prescribed time periods 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 for the nine months ended September 30, 2008 and 2007, were eighteen months and seven months, respectively. The average vesting periods for options granted to employees under the 2006 Plan for the three months ended September 30, 2008 and 2007, were eighteen months and fifteen months, respectively. The exercise price of each option equals the quoted market price of the Company's stock on the date of grant.

The Company had a stock option plan, which became effective September 25, 1996, and expired May 29, 2006 (the 1996 Plan). The plan provided for the granting of stock options to employees 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 within prescribed time periods when employment ceases, whichever comes first, and vested over periods determined by the Board of Directors. The exercise price of each option was equal to the quoted market price of the Company's stock on the date of grant.

Option activity under the foregoing option plans as of September 30, 2008, and changes during the nine months ended September 30, 2008 and 2007, were as follows:

	Options outstanding	
	Number of shares	Weighted average price per share
Balance at December 31, 2007	1,109,000	\$ 0.41
Options granted	4,000	0.28
Options exercised, expired or forfeited	8,500	0.51
Balance at March 31, 2008	1,104,500	0.41
Options granted	27,500	0.27
Options exercised, expired or forfeited	3,000	0.36
Balance at June 30, 2008	1,129,000	0.40

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Options granted	10,000	0.14
Options exercised, expired or forfeited		n/a
Balance at September 30, 2008	1,139,000	0.40

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**3. Stock Options and Warrants (continued)**

	Options outstanding Number of shares	Weighted average price per share
Balance at December 31, 2006	955,800	\$ 1.28
Options granted	9,000	0.42
Options exercised, expired or forfeited	10,800	1.31
Balance at March 31, 2007	954,000	1.27
Options granted	217,000	0.40
Options exercised, expired or forfeited	13,200	17.48
Balance at June 30, 2007	1,157,800	0.93
Options granted	5,750	0.42
Options exercised, expired or forfeited	26,300	11.73
Balance at September 30, 2007	1,137,250	0.67

The following table summarizes information about options at September 30, 2008:

Total shares	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
1,139,000	\$ 0.40	5.1	\$ 30	1,092,000	\$ 0.41	4.9	\$ 30

Nonvested stock awards as of September 30, 2008, and changes during the nine months ended September 30, 2008 and 2007, were as follows:

	Nonvested Number of shares	Weighted average grant date fair value
Balance at December 31, 2007	25,500	\$ 0.34
Granted	4,000	0.16
Vested	3,500	0.33
Expired before vesting	1,500	0.21
Balance at March 31, 2008	24,500	0.32
Granted	27,500	0.14
Vested	11,000	0.44
Expired before vesting	2,000	0.26
Balance at June 30, 2008	39,000	0.29

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Granted	10,000	0.08
Vested	2,000	0.28
Balance at September 30, 2008	47,000	0.14

	<b>Nonvested</b>	
	<b>Number of shares</b>	<b>Weighted average grant date fair value</b>
Balance at December 31, 2006	35,000	\$ 0.44
Granted	9,000	0.28
Vested	5,000	0.46
Balance at March 31, 2007	39,000	0.40
Granted	217,000	0.25
Vested	11,000	0.46
Expired before vesting	1,000	0.40
Balance at June 30, 2007	244,000	0.27
Granted	5,750	0.27
Vested	4,250	0.30
Expired before vesting	2,000	0.31
Balance at September 30, 2007	243,500	0.27

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**3. Stock Options and Warrants (continued)**

As of September 30, 2008, unrecognized compensation cost associated with non-vested share based employee compensation approximated \$4,025, which is expected to be recognized over weighted average periods of 7 months.

**4. Earnings 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.

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

	Net Income	Shares	Per Share Amount
Basic net loss per common share for the three months ended September 30, 2008:			
Income available to common stockholders	\$ (71,061)	11,196,760	\$ (0.01)
Effect of dilutive stock options and warrants			
Diluted net loss per common share for the three months ended September 30, 2008:	\$ (71,061)	11,196,760	\$ (0.01)
Basic net income per common share for the three months ended September 30, 2007:			
Income available to common stockholders	\$ 95,177	11,196,760	\$ 0.01
Effect of dilutive stock options		206,462	
Effect of dilutive warrants		11,700	
Diluted net income per common share for the three months ended September 30, 2007:	\$ 95,177	11,414,922	\$ 0.01
Basic net loss per common share for the nine months ended September 30, 2008:			
Income available to common stockholders	\$ (268,912)	11,196,760	\$ (0.02)
Effect of dilutive stock options and warrants			
Diluted net loss per common share for the nine months ended September 30, 2008:	\$ (268,912)	11,196,760	\$ (0.02)
Basic net income per common share for the nine months ended September 30, 2007:			
Income available to common stockholders	\$ 207,277	11,196,760	\$ 0.02
Effect of dilutive stock options		199,949	
Effect of dilutive warrants		11,692	
Diluted net income per common share for the nine months ended September 30, 2007:	\$ 207,277	11,408,401	\$ 0.02

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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-KSB for the fiscal year ended December 31, 2007 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;

changes in Accounting Principles Generally Accepted in the United States;

the exercise of outstanding options and warrants;

our failure to adequately protect our intellectual property;

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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.

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Third Quarter 2008 Report on Form 10-Q

**Three Months Ended September 30, 2008 Versus Three Months Ended September 30, 2007***Revenue*

Our revenues in the third quarter of 2008 were \$1,595,894, compared to \$2,635,254 in 2007, a decrease of 39.4%. Professional services revenue was \$1,261,155 versus \$1,687,846, a decrease of 25.3%, and software product revenue was \$334,739 versus \$947,408, a decrease of 64.7%. The decrease in professional services revenue is primarily due to the expiration of contracts. Our new and continuing contracts did not produce sufficient levels of activity and revenue to offset the reductions of the levels of activity and the revenues from our expired contracts. The decrease in software product revenue is due to a decrease in one-time sales of Micro Focus products of \$706,115, offset by an increase in ongoing maintenance revenue of \$24,832, and a decrease in one-time sales of Adobe products of approximately \$13,242, offset by an increase in maintenance revenue, both ongoing and for prior periods, of \$81,855. Software product sales are subject to considerable fluctuation from period to period, based on the aggregate of demand, customer funding, and customer lead time. Revenue on maintenance contracts for Adobe software products increased 60.8% due largely to sales of maintenance contracts for which maintenance had previously expired, requiring customers to pay for the software updates related to prior maintenance periods in order to be eligible for ongoing maintenance renewals and software updates, while revenue on maintenance contracts on Micro Focus software products increased 26.5%. During the third quarter, we entered into agreements to sell and service additional software products, for which we expect to see sales in the coming quarters.

*Gross Margins*

Gross margin was \$490,664, or 30.7% of sales, in the third quarter of 2008 versus \$614,250, or 23.3% of sales, in the third quarter of 2007. Of the \$490,664 in 2008, \$390,617 was attributable to professional services and \$100,047 was attributable to software sales. Our gross margin percentage was 31.0% for professional services and 29.9% for software sales for the three months ended September 30, 2008. In the same quarter in 2007, we reported gross margins of \$415,815, or 24.6% of sales for professional services and \$198,435, or 20.9% of sales for software sales. Professional services gross margin decreased due to the expiration of certain contracts. Our decrease in gross margin on software sales is due to decreases in one-time sales of both Micro Focus and Adobe products, which are subject to significant fluctuation from period to period. In addition, gross margin on Adobe maintenance sales increased 63.1%, while gross margin on Micro Focus maintenance sales increased by 44.6%. Gross margin as a percentage of sales improved due to the expiration of a few lesser-margin professional services contracts and due to the shift in product sales from software product, which is generally sold at lesser margins, to software maintenance contract renewals on prior product sales. 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 \$567,384, or 35.6% of revenues, in the third quarter of 2008 versus \$527,017, or 20.0% of revenues, in the third quarter of 2007. This increase is primarily due to increases in sales personnel, marketing activities, and overhead labor, offset by decreases in stock compensation expense, incentives, and legal expenses.

*Profits*

Net loss for the three months ended September 30, 2008, was \$71,061, or (4.5%) of revenue, versus net income of \$95,177, or 3.6% of revenue, for the same period in 2007. The decrease in net income is due to decreases in our professional services sales, as several contracts have expired since third quarter 2007, and decreases in our software product sales, which is subject to considerable fluctuation from period to period.



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Third Quarter 2008 Report on Form 10-Q

**Nine Months Ended September 30, 2008 Versus Nine Months Ended September 30, 2007***Revenue*

Our revenues in the first nine months of 2008 were \$5,042,473, compared to \$7,797,494 in 2007, a decrease of 35.3%. Professional services revenue was \$4,093,179 versus \$5,364,812, a decrease of 23.7%, and software product revenue was \$949,294 versus \$2,432,682, a decrease of 61.0%. The decrease in professional services revenue is primarily due to the expiration of contracts. Our new and continuing contracts did not produce sufficient levels of activity and revenue to offset the reductions of the levels of activity and the revenues from our expired contracts. The decrease in software product revenue is due to a decrease in one-time sales of Micro Focus products of \$1,291,550, offset by an increase in ongoing maintenance revenue of \$152,008, and a decrease in one-time sales of Adobe products of \$294,124, coupled with a decrease in ongoing maintenance revenue of \$49,722. Software product sales are subject to considerable fluctuation from period to period, based on the aggregate of demand, customer funding, and customer lead time. Revenue on maintenance contracts for Adobe software products decreased 9.2% due to the expiration of one large contract, offset by an increase in sales of maintenance contracts for which maintenance had previously expired, requiring customers to pay for the software updates related to prior maintenance periods in order to be eligible for ongoing maintenance renewals and software updates. Revenue on maintenance contracts on Micro Focus software products increased 72.8%.

*Gross Margins*

Gross margin was \$1,333,991, or 26.5% of sales, in the first nine months of 2008 versus \$1,773,274, or 22.7% of sales, in the first nine months of 2007. Of the \$1,333,991 in 2008, \$1,065,886 was attributable to professional services and \$268,105 was attributable to software sales. Our gross margin percentage was 26.0% for professional services and 28.2% for software sales for the nine months ended September 30, 2008. In the same period in 2007, we reported gross margins of \$1,271,895, or 23.7% of sales for professional services and \$501,379, or 20.6% of sales for software sales. Professional services gross margin decreased due to the expiration of certain contracts. Our decrease in gross margin on software sales is due to decreases in one-time sales of both Micro Focus and Adobe products, which are subject to significant fluctuation from period to period. Gross margin on Adobe maintenance sales remained basically unchanged, though sales decreased by \$49,722. Gross margin on Micro Focus maintenance sales increased by 116.7%. Gross margin as a percentage of sales improved due to the expiration of a few lesser-margin professional services contracts and due to the shift in product sales from software product, which is generally sold at lesser margins, to software maintenance contract renewals on prior product sales. 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 \$1,618,459, or 32.1% of revenues, in the nine months ended September 30, 2008, versus \$1,586,128, or 20.3% of revenues, in the same period in 2007. This increase is primarily due to increases in sales personnel, marketing activities, overhead labor, legal and accounting, and severance, offset by decreases in stock compensation expense, incentives, and recruiting fees.

*Profits*

Net loss for the nine months ended September 30, 2008, was \$268,912, or (5.3%) of revenue, versus net income of \$207,277, or 2.7% of revenue, for the same period in 2007. The decrease in net income is due to decreases in our professional services sales, as several contracts have expired since third quarter 2007, and decreases in our software product sales, which is subject to considerable fluctuation from period to period.

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**Liquidity and Capital Resources**

Our cash flow from operations, when combined with our beginning cash and cash equivalents balance, were sufficient to provide financing for our operations. Our decrease in cash was \$121,756, due to cash used by operating activities and cash used by investing activities. When this decrease in cash was taken from a beginning balance of \$1,222,742, it yielded cash and cash equivalents of \$1,100,986 at September 30, 2008. Our accounts receivable balance at September, 30 2008, was \$1,154,016, a decrease of 26.0% from the balance at December 31, 2007.

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 August 1, 2009. As of September 30, 2008, and December 31, 2007, no amounts were outstanding under this line of credit.

We anticipate that we will be able to meet our cash requirements for at least 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**

(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(f) or Rule 15d-15(f) 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 material weaknesses in the Company's internal controls.

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**PART II - OTHER INFORMATION**

**Item 6. Exhibits**

(a) Exhibits: See Exhibit Index on page 20.

**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, 2008

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>Exhibit No.</b>	<b>Description</b>	<b>Location</b>
31.1	Certification by Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002	Filed with this Form 10-Q, page 21
31.2	Certification by Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002	Filed with this Form 10-Q, page 22
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-Q, page 23
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-Q, page 24