INFORMATION ANALYSIS INC
Form 10QSB
November 13, 2006
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

(Mark One)

x QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2006

¨ 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 small business issuer as specified in its charter)

Virginia	**54-1167364**
(State or other jurisdiction of incorporation or organization)	**(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)

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 x No ¨

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

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, 11,137,371 shares as of November 3, 2006

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

Table of Contents

Information Analysis Incorporated Third Quarter 2006 Report on Form 10-QSB

INFORMATION ANALYSIS INCORPORATED

FORM 10-QSB

Index

Table of Contents

INFORMATION ANALYSIS INCORPORATED

BALANCE SHEETS

	September 30, 2006 Unaudited	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 477,295	$ 451,777
Accounts receivable, net	2,095,735	1,994,010
Prepaid expenses	421,747	183,282
Notes receivable	113,050	85,000
Other assets	11,782	
Other receivables	6,202	15,326
Total current assets	3,125,811	2,729,395
Fixed assets, net	55,574	56,825
Other assets	2,500	8,782
Total assets	$ 3,183,885	$ 2,795,002
LIABILITIES & STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 943,468	$ 1,174,677
Deferred revenue	371,395	213,876
Accrued payroll and related liabilities	248,570	321,209
Other accrued liabilities	72,179	125,048
Income taxes payable		4,500
Total current liabilities	1,635,612	1,839,310
Stockholders equity:		
Common stock, par value $0.01, 30,000,000 shares authorized; 12,779,987 shares issued, 11,137,371 outstanding at September 30, 2006, and 12,127,626 shares issued, 10,623,015 outstanding at December 31, 2005	127,799	121,276
Additional paid in capital	14,477,937	14,212,165
Accumulated deficit	(12,115,252)	(12,511,436)
Accumulated other comprehensive loss	(12,000)	(12,000)
Treasury stock, 1,642,616 shares at September 30, 2006, and 1,504,611 shares at December 31, 2005, at cost	(930,211)	(854,313)
Total stockholders equity	1,548,273	955,692
Total liabilities and stockholders equity	$ 3,183,885	$ 2,795,002

The accompanying notes are an integral part of the financial statements

2

INFORMATION ANALYSIS INCORPORATED

STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

	For the three months ended September 30, 2006 Unaudited	2005 Unaudited
Sales		
Professional fees	$ 2,180,204	$ 2,371,496
Software sales	393,443	257,566
Total sales	2,573,647	2,629,062
Cost of sales		
Cost of professional fees	1,625,815	1,752,845
Cost of software sales	182,853	208,408
Total cost of sales	1,808,668	1,961,253
Gross profit	764,979	667,809
Selling, general and administrative expenses	609,996	412,893
Income from operations	154,983	254,916
Other income (expenses), net	1,794	(4,340)
Income before provision for income taxes	156,777	250,576
Provision for income taxes		
Net income	$ 156,777	$ 250,576
Unrealized loss on available-for-sale securities		(3,000)
Comprehensive income	$ 156,777	$ 247,576
Earnings per common share:		
Basic:	$ 0.01	$ 0.02
Diluted:	$ 0.01	$ 0.02
Weighted average common shares outstanding:		
Basic	11,137,371	10,301,494
Diluted	11,478,082	10,655,071

The accompanying notes are an integral part of the financial statements

Table of Contents

INFORMATION ANALYSIS INCORPORATED

STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

	For the nine months ended September 30, 2006 Unaudited	2005 Unaudited
Sales		
Professional fees	$ 6,675,094	$ 6,857,975
Software sales	781,874	964,111
Total sales	7,456,968	7,822,086
Cost of sales		
Cost of professional fees	5,079,817	5,271,881
Cost of software sales	478,249	813,339
Total cost of sales	5,558,066	6,085,220
Gross profit	1,898,902	1,736,866
Selling, general and administrative expenses	1,507,538	1,253,272
Income from operations	391,364	483,594
Other income (expenses), net	4,820	(12,521)
Income before provision for income taxes	396,184	471,073
Provision for income taxes		
Net income	$ 396,184	$ 471,073
Unrealized loss on available-for-sale securities		(3,000)
Comprehensive income	$ 396,184	$ 468,073
Earnings per common share:		
Basic:	$ 0.04	$ 0.05
Diluted:	$ 0.03	$ 0.04
Weighted average common shares outstanding:		
Basic	10,973,470	10,293,910
Diluted	11,436,461	10,687,084

The accompanying notes are an integral part of the financial statements

INFORMATION ANALYSIS INCORPORATED

STATEMENTS OF CASH FLOWS

	For the nine months ended September 30, 2006 Unaudited	For the nine months ended September 30, 2005 Unaudited
Cash flows from operating activities:		
Net income	$ 396,184	$ 471,073
Adjustments to reconcile net income to net cash (used) provided by operating activities:		
Depreciation and amortization	23,552	16,204
Stock options compensation	24,047	3,600
Reduction of accounts payable through issuance of equity		4,500
Changes in operating assets and liabilities		
Accounts receivable	(101,725)	(1,006,045)
Other receivables and prepaid expenses	(262,891)	(648,979)
Accounts payable and accrued expenses	(361,217)	561,882
Deferred revenue	157,519	815,844
Net cash (used) provided by operating activities	(124,531)	218,079
Cash flows from investing activities:		
Purchases of fixed assets	(22,301)	(42,657)
Net cash used by investing activities	(22,301)	(42,657)
Cash flows from financing activities:		
Proceeds from exercise of stock options	172,350	4,450
Net payments under revolving line of credit		(105,924)
Maturity of convertible notes		(45,000)
Net cash provided (used) by financing activities	172,350	(146,474)
Net increase in cash and cash equivalents	25,518	28,948
Cash and cash equivalents at beginning of the period	451,777	115,917
Cash and cash equivalents at end of the period	$ 477,295	$ 144,865
Supplemental cash flow Information		
Interest paid	$ 608	$ 13,195

The accompanying notes are an integral part of the financial statements

Table of Contents

PART I

Item 1. Financial Statements.

INFORMATION ANALYSIS INCORPORATED

NOTES TO FINANCIAL STATEMENTS

1. Basis of Presentation

The accompanying 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, 2005 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. Summary of Significant Accounting Policies

Operations

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

The Company provides services under various pricing arrangements. Revenue from cost-plus-fixed-fee contracts is recognized on the basis of reimbursable contract costs incurred during the period, plus a percentage of the fixed fee. Revenue from firm-fixed-price contracts is recognized as work is performed, with costs and estimated profits recorded on the basis of direct and indirect costs incurred. Revenue from time and material contracts is recognized on the basis of hours utilized, plus other reimbursable contract costs incurred during the period. Contract losses, if any, are accrued when their occurrence becomes known and the amount of the loss is reasonably determinable. Changes in job performance, job conditions and estimated profitability, including final contract settlements, may result in revisions to costs and income and are recognized in the period in which the revisions are determined.

Revenue from software sales is recognized upon delivery, when collection of the receivable is probable. Maintenance revenue is recognized ratably over the maintenance period.

2. Summary of Significant Accounting Policies (cont.)

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.

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. 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 and $129,617 at September 30, 2006 and 2005, respectively.

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, 2006, the Company had the stock-based compensation plans described below. Total compensation expense related to these plans was $24,047 and $11,626 for the nine months ended September 30, 2006 and 2005, respectively, of which $520 and $3,942, respectively, related to options awarded to non-employees. Total compensation expense related to these plans was $19,889 and $1,796 for the three months ended September 30, 2006 and 2005, respectively, of which $0 and $114, respectively, related to options awarded to non-employees. The 2005 stock-based compensation expense includes pro forma expense information presented in the financial statements under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees .

Table of Contents

Information Analysis Incorporated Third Quarter 2006 Report on Form 10-QSB
2. Summary of Significant Accounting Policies (cont.)

Prior to January 1, 2006, the Company accounted for employee stock-based compensation in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees , (APB 25), under which no expense was recognized for options issued to employees where the exercise price was equal to or greater than the market value of the underlying security. Expense was recognized in the financial statements for options issued to employees where the option price was below the fair value of the underlying security, for options issued to non-employees, and for options and warrants issued in connection with financing and equity transactions (collectively referred to as compensatory options). Expense recognized for non-employee options was measured based on management s estimate of grant date fair value using the Black-Scholes model as service performance is completed. Any resulting compensation expense was recognized ratably over the related service period.

Prior to January 1, 2006, the Company provided pro forma disclosure of compensation amounts in accordance with Statement of Financial Accounting Standard No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (SFAS 148), as if the fair value method defined by SFAS 123 had been applied to its stock-based compensation to employees. The pro forma table below reflects net loss and basic and diluted net loss per share for the nine months and three months ended September 30, 2005, as though the Company had adopted the fair value recognition provision of SFAS 123, as follows:

	Nine months	**Three months**
Net income, as reported	$ 471,073	$ 250,576
Stock-based employee compensation cost that would have been included in the determination of net income if the fair-value method had been applied to all awards	(8,026)	(1,796)
Pro forma net income	$ 463,047	$ 248,780
Net income per share, as reported	$ 0.05 basic	$ 0.02 basic
	0.04 diluted	0.02 diluted
Net income per share, pro forma	$ 0.04 basic	$ 0.02 basic
	0.04 diluted	0.02 diluted

The following assumptions were used in the Black-Scholes option pricing model to estimate expense included in the foregoing pro forma disclosure:

	Nine months	**Three months**
Risk free interest rate	1.89% - 4.72%	1.89% - 4.72%
Dividend yield	0%	0%
Expected term	3-10 years	3-10 years
Expected volatility	0.841 1.324	0.841 1.324

The Company uses the Black-Scholes model to estimate grant date fair value. Under the modified prospective transition method adopted by the Company, the Company did not recognize any stock-based compensation expense for the first half of 2006 relating to option awards granted prior to January 1, 2006, as all of these option grants were 100% vested. 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 one to two years.

Table of Contents

Information Analysis Incorporated Third Quarter 2006 Report on Form 10-QSB

2. Summary of Significant Accounting Policies (cont.)

As a result of adopting SFAS 123R, net income decreased by $23,527 for the nine months ended September 30, 2006, and $19,889 for the three months ended September 30, 2006, as compared to if the Company had continued to account for stock-based compensation under APB 25. The impact on both basic and diluted loss per share attributable to common stockholders was immaterial.

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 since September 2001, 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 the first half of 2006 is 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. In addition, the Company has estimated a forfeiture rate based on historical data and current assumptions.

During the nine months ended September 30, 2006, the Company granted options to certain employees to purchase an aggregate of 125,000 shares of the Company s common stock, with a per share weighted average fair value of $0.32. During the three months ended September 30, 2006, the Company granted options to certain employees to purchase an aggregate of 7,000 shares of the Company s common stock, with a per share weighted average fair value of $0.31. Also during the nine months ended September 30, 2006, the Company granted options to non-employee consultants to purchase 1,000 shares of the Company s common stock, with a per share fair value of $0.52 at the measurement date. During the three months ended September 30, 2005, the Company did not grant any options to employees but granted options to certain non-employee consultants to purchase an aggregate of 10,000 shares of the Company s common stock, with a per share weighted average fair value of $0.36. The fair value of option awards granted in the third quarter of 2006 was estimated using the Black Sholes option pricing model with the following assumptions and weighted average fair values as follows:

	Nine months	**Three Months**
Risk free interest rate	4.35% - 5.07%	4.82%
Dividend yield	0%	0%
Expected term	2-5 years	2-5 years
Expected volatility	0.894 - 0.990	0.894

The Company had a stock option plan, which became effective June 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 when employment ceases, whichever comes first, and vest over periods determined by the Board of Directors. The average vesting period for options granted to employees under the 1996 Plan in the nine months ended September 30, 2006 and 2005, and in the three months ended September 30, 2005, was zero months. The exercise price of each option equals the quoted market price of the Company s stock on the date of grant.

Table of Contents

Information Analysis Incorporated Third Quarter 2006 Report on Form 10-QSB
2. Summary of Significant Accounting Policies (cont.)

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 and directors. The maximum number of shares for which equity awards may be granted under the 2006 Plan is 950,000. Options under the 2006 Plan expire no later than ten years from the date of grant or when employment ceases, whichever comes first, and vest over periods determined by the Board of Directors. The average vesting period for options granted to employees under the 2006 Plan in the nine months ended September 30, 2006, and in the three months ended September 30, 2006, was eighteen months. The exercise price of each option equals 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, 2006, and changes during the three months and nine months ended September 30, 2006 were as follows:

	Options outstanding	
	Number of shares	Weighted average price per share
Balance at December 31, 2005	1,963,350	$ 0.87
Options granted	7,500	0.70
Options exercised, expired or forfeited	235,000	0.44
Balance at March 31, 2006	1,735,850	0.93
Options granted	112,000	0.54
Options exercised, expired or forfeited	674,150	0.44
Balance at June 30, 2006	1,173,700	$ 1.17
Options granted	7,000	0.54
Options exercised, expired or forfeited	33,300	0.44
Balance at September 30, 2006	1,147,400	$ 1.19
Vested and expected to vest at September 30, 2006	1,067,400	$ 1.24

The following table summarizes information about options at September 30, 2006:

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
1,147,400	$ 1.19	4.76	$ 144,940	1,067,400	$ 1.24	4.39	$ 144,420

Nonvested stock awards as of September 30, 2006 and changes during the three months and nine months ended September 30, 2006 were as follows:

	Nonvested	
	Number of shares	Weighted average grant date fair value
Balance at December 31, 2005	0	$ 0.00
Granted	7,500	0.53
Vested	1,500	0.52

Balance at March 31, 2006	6,000		0.53
Granted	112,000		0.31
Vested	0		n/a
Balance at June 30, 2006	118,000	$	0.32
Granted	7,000		0.31
Vested	45,000		0.27
Balance at September 30, 2006	80,000	$	0.34

Table of Contents

Information Analysis Incorporated Third Quarter 2006 Report on Form 10-QSB
2. Summary of Significant Accounting Policies (cont.)

As of September 30, 2006, unrecognized compensation cost associated with non-vested share based employee and non-employee compensation approximated, $16,213 and $0, respectively, which is expected to be recognized over a weighted average period of 6 months.

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, notes receivable, accounts payable, and notes payable. Management believes the carrying value of financial instruments approximates their fair market value, unless disclosed otherwise in the accompanying notes.

3. 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 income per common share for the three months ended September 30, 2006:			
Income available to common stockholders	$ 156,777	11,137,371	$ 0.01
Effect of dilutive stock options		262,978	
Effect of dilutive warrants		77,733	
Diluted net income per common share for the three months ended September 30, 2006:	$ 156,777	11,478,082	$ 0.01
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

3. Earnings Per Share (cont.)

Basic net income per common share for the nine months ended September 30, 2006:			
Income available to common stockholders	$ 396,184	10,973,470	$ 0.04
Effect of dilutive stock options		366,706	
Effect of dilutive warrants		96,285	
Diluted net income per common share for the nine months ended September 30, 2006:	$ 396,184	11,436,491	$ 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

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 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, 2005 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;
- 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;
- our failure to adequately protect our intellectual property; and
- the limited public market for our common stock.

Our Business

Founded in 1979, Information Analysis Incorporated is in the business of modernizing client information systems. Since our inception, we have performed software development and conversion projects for over 100 commercial and government customers including Computer Sciences Corporation, IBM, Computer Associates, MCI, Sprint, Citibank, U.S. Department of Homeland Security, U.S. Department of Agriculture, U.S.

Department of Energy, U.S. Army, U.S. Air Force, Veterans Administration, and the Federal Deposit Insurance Corporation. Today, we primarily apply our technology, services and experience to legacy software migration and to developing web-based solutions for agencies of the federal government.

Table of Contents

Nine Months Ended September 30, 2006 Versus Nine Months Ended September 30, 2005

Revenue

Our revenues in the first nine months of 2006 were $7,456,968, compared to $7,822,086 in the 2005, a decrease of 4.7%. Professional services revenue was $6,675,094 versus $6,857,975, a decrease of 2.7%, and product revenue was $781,874 versus $964,111, a decrease of 18.9%. The decrease in professional services revenue is due to the expiration of some older contracts and the reduction in scope of one of our contracts. These decreases were offset in part by new contracts and by increases in rates and scope on existing contracts. The decrease in product revenue is due to fluctuation in one-time sales of Adobe and Micro Focus products. Adobe and Micro Focus products, as well as our ICONS suite of software conversion tools, are generally sold in conjunction with professional services.

Gross Margins

Gross margin was $1,898,902, or 25.5% of sales, in the first three quarters of 2006 versus $1,736,866, or 22.2% of sales, in the first three quarters of 2005. Of the $1,898,902 in 2006, $1,595,277 was attributable to professional services and $303,625 was attributable to software sales. Our gross margin percentage was 23.9% for professional services and 38.8% for software sales for 2006. In 2005, we reported gross margins of 23.1% for professional services and 15.6% for software sales. Our increase in software sales gross margin percentage was attributed to our strengthening of Adobe supply channels and the collection of fees resulting from referral arrangements, for which we incur little or no direct costs.

Selling, General and Administrative

Selling, general and administrative expenses were $1,507,538, or 20.2% of revenues, in the first nine months of 2006 versus $1,253,272, or 16.0% of revenues, in the first nine months of 2005. The increase is largely due to increases in legal and consulting fees, incentives, recruiting fees, and costs of fringe benefits, and to recognizing stock compensation expense for incentive stock options.

Profits

We generated income from operations of $391,364, or 5.2% of revenue, in the first nine months of 2006 compared to $483,594, or 6.2% of revenue, in the first nine months of 2005. Net income for the first nine months of 2006 was $396,184, or 5.3% of revenue, versus $471,073, or 6.0% of revenue, for the same period in 2005. The decreases in net income and net income percentage are generally due to increases in our selling, general and administrative expenses, offset in part by an increase in our gross margin.

Table of Contents

Information Analysis Incorporated Third Quarter 2006 Report on Form 10-QSB

Three Months Ended September 30, 2006 Versus Three Months Ended September 30, 2005

Revenue

Our revenues in the third quarter of 2006 were $2,573,647, compared to $2,629,062 in the third quarter of 2005, a decrease of 2.1%. Professional services revenue was $2,180,204 versus $2,371,496, a decrease of 8.1%, and product revenue was $393,443 versus $257,566, an increase of 52.8%. The decrease in professional services revenue is due to the expiration of some older contracts, the less predictable nature of the timing of short-term contracts, and the reduction in scope of one of our contracts. These decreases were offset in part by new contracts and by increases in rates and scope on existing contracts. The increase in product revenue is due to fluctuation in one-time sales of Adobe and Micro Focus products. Adobe and Micro Focus products, as well as our ICONS suite of software conversion tools, are generally sold in conjunction with professional services.

Gross Margins

Gross margin was $764,979, or 29.7% of sales, in the third quarter of 2006 versus $667,809, or 25.4% of sales, in the third quarter of 2005. Of the $764,979 in 2006, $554,389 was attributable to professional services and $210,590 was attributable to software sales. Our gross margin percentage was 25.4% for professional services and 53.5% for software sales for the third quarter of 2006. In the third quarter of 2005, we reported gross margins of 26.1% for professional services and 19.1% for software sales. Our increase in software sales gross margin percentage was attributed to our strengthening of Adobe supply channels and the collection of fees resulting from referral arrangements, for which we incur little or no direct costs.

Selling, General and Administrative

Selling, general and administrative expenses were $609,996, or 23.7% of revenues, in the third quarter of 2006 versus $412,893, or 15.7% of revenues, in the third quarter of 2005. The increase is largely due to increases in legal and consulting fees, incentives, recruiting fees, and costs of fringe benefits, and to recognizing stock compensation expense for incentive stock options.

Profits

We generated income from operations of $154,983, or 6.0% of revenue, in the third quarter of 2006 compared to $254,917, or 9.7% of revenue, in the third quarter of 2005. Net income for the third quarter of 2006 was $156,777, or 6.1% of revenue, versus $250,576, or 9.5% of revenue, for the same period in 2005. The decreases in net income and net income percentage are generally due to increases in our selling, general and administrative expenses, offset in part by an increase in our gross margin.

Liquidity and Capital Resources

Through the first nine months of 2006, we financed operations from cash balances, collections and current operations. Cash and cash equivalents at September 30, 2006 were $477,295 compared to $451,777 at December 31, 2005.

We have a revolving line of credit with a bank providing for demand or short-term borrowings of up to $1,000,000. This line of credit became effective December 20, 2005, and expires on May 1, 2007. We did not require borrowings against this line of credit during the first three quarters of 2006 to finance our operations.

The line of credit, when coupled with funds generated from operations, assuming the operations generate positive cash flow, should be sufficient to meet our operating cash requirements through the next twelve months, based on our current operation plan.

At September 30, 2006, as well as at December 31, 2005, we had no outstanding balance on our line of credit. We believe that our profitability will continue through the remainder of 2006 and that cash flows generated from operations should enable us to continue to finance our operations.

We presently lease our corporate offices on a contractual basis with a timeframe commitment through February 2007 with an option to extend the lease for two years. We believe that our existing offices will be sufficient to meet the Company s foreseeable facility requirement. Should the Company need additional space to accommodate increased activities, management believes it can secure such additional space on reasonable terms.

We have no material commitments for capital expenditures.

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.

Table of Contents

(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.

PART II - OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits: See Exhibit Index on page 17.

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 8, 2006

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

Exhibit Index

Exhibit No.	Description	Location
31.1	Certification by Chief Executive Officer under Section 302 of the Sabanes-Oxley Act of 2002	Filed with this Form 10-QSB, page 18
31.2	Certification by Chief Financial Officer under Section 302 of the Sabanes-Oxley Act of 2002	Filed with this Form 10-QSB, page 19
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 20
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 21