

INFORMATION ANALYSIS INC
Form 10-Q
November 14, 2012

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

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

OR

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

For the transition period from _____ to _____

Commission File Number 000-22405

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

Virginia
(State or other jurisdiction of incorporation
or organization)

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

11240 Waples Mill Road
Suite 201
Fairfax, Virginia 22030

(703) 383-3000
(Registrant's telephone number, including area code)

Not applicable
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to

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submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

As of November 7, 2012, 11,201,760 shares of common stock, par value \$0.01 per share, of the registrant were outstanding.

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INFORMATION ANALYSIS INCORPORATED
FORM 10-Q

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INFORMATION ANALYSIS INCORPORATED
BALANCE SHEETS
(Unaudited)

| | September 30, 2012 | December 31, 2011 |
|-----------------------------|-----------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 2,312,035 | \$ 1,280,926 |
| Accounts receivable, net | 936,097 | 2,889,658 |
| Prepaid expenses | 158,177 | 787,290 |
| Note receivable- employee | 2,389 | 6,668 |
| Total current assets | 3,408,698 | 4,964,542 |
| Fixed assets, net | 36,085 | 40,440 |
| Note receivable- employee | 4,496 | 4,287 |
| Other assets | 6,281 | 6,281 |
| Total assets | \$ 3,455,560 | \$ 5,015,550 |

LIABILITIES & STOCKHOLDERS' EQUITY

| | | |
|---|---------------------|---------------------|
| Current liabilities: | | |
| Accounts payable | \$ 91,661 | \$ 998,160 |
| Commissions payable | 794,448 | 679,498 |
| Accrued payroll and related liabilities | 278,499 | 247,885 |
| Deferred revenue | 130,250 | 939,783 |
| Other accrued liabilities | 42,651 | 107,235 |
| Income taxes payable | -- | 2,800 |
| Total current liabilities | 1,337,509 | 2,975,361 |
| Stockholders' equity: | | |
| Common stock, par value \$0.01, 30,000,000 shares authorized; 12,844,376 and 12,839,376 shares issued, 11,201,760 and 11,196,760 shares outstanding as of September 30, 2012 and December 31, 2011, respectively | 128,443 | 128,393 |
| Additional paid-in capital | 14,579,624 | 14,574,128 |
| Accumulated deficit | (11,659,805) | (11,732,121) |
| Treasury stock, 1,642,616 shares at cost | (930,211) | (930,211) |
| Total stockholders' equity | 2,118,051 | 2,040,189 |
| Total liabilities and stockholders' equity | \$ 3,455,560 | \$ 5,015,550 |

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)

| | For the three months ended September 30, | |
|--|---|-------------|
| | 2012 | 2011 |
| Sales | | |
| Professional fees | \$1,363,421 | \$1,329,592 |
| Software sales | 372,354 | 333,108 |
| Total sales | 1,735,775 | 1,662,700 |
| Cost of sales | | |
| Cost of professional fees | 818,926 | 702,017 |
| Cost of software sales | 347,011 | 278,239 |
| Total cost of sales | 1,165,937 | 980,256 |
| Gross profit | 569,838 | 682,444 |
| Selling, general and administrative expenses | 388,913 | 434,295 |
| Commissions on sales | 139,148 | 186,909 |
| Income from operations | 41,777 | 61,240 |
| Other income, net | 1,645 | 1,893 |
| Income before provision for income taxes | 43,422 | 63,133 |
| Provision for income taxes | -- | -- |
| Net income | \$43,422 | \$63,133 |
| Comprehensive income | \$43,422 | \$63,133 |
| Earnings per common share: | | |
| Basic: | \$0.00 | \$0.01 |
| Diluted: | \$0.00 | \$0.01 |
| Weighted average common shares outstanding: | | |
| Basic | 11,201,760 | 11,196,760 |
| Diluted | 11,214,921 | 11,233,313 |

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)

| | For the nine months ended September 30, | |
|--|--|-------------|
| | 2012 | 2011 |
| Sales | | |
| Professional fees | \$3,891,417 | \$3,580,792 |
| Software sales | 1,792,939 | 1,126,126 |
| Total sales | 5,684,356 | 4,706,918 |
| Cost of sales | | |
| Cost of professional fees | 2,194,556 | 1,986,998 |
| Cost of software sales | 1,670,544 | 920,413 |
| Total cost of sales | 3,865,100 | 2,907,411 |
| Gross profit | 1,819,256 | 1,799,507 |
| Selling, general and administrative expenses | 1,261,325 | 1,199,281 |
| Commissions on sales | 490,317 | 504,906 |
| Income from operations | 67,614 | 95,320 |
| Other income, net | 4,702 | 6,000 |
| Income before provision for income taxes | 72,316 | 101,320 |
| Provision for income taxes | -- | -- |
| Net income | \$72,316 | \$101,320 |
| Comprehensive income | \$72,316 | \$101,320 |
| Earnings per common share: | | |
| Basic: | \$0.01 | \$0.01 |
| Diluted: | \$0.01 | \$0.01 |
| Weighted average common shares outstanding: | | |
| Basic | 11,199,442 | 11,196,760 |
| Diluted | 11,213,794 | 11,220,295 |

The accompanying notes are an integral part of the financial statements

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INFORMATION ANALYSIS INCORPORATED
STATEMENTS OF CASH FLOWS

(Unaudited)

For the ninemonths ended
September 30,
2012 2011

Cash flows from operating activities:

| | | |
|---|-------------|-------------|
| Net income | \$72,316 | \$101,320 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 20,714 | 13,786 |
| Stock option compensation | 5,197 | 5,774 |
| Bad debt expense | 1,020 | 52,376 |
| Changes in operating assets and liabilities | | |
| Accounts receivable | 1,952,541 | (1,026,007) |
| Other receivables and prepaid expenses | 629,113 | (184,842) |
| Accounts payable and accrued expenses | (940,470) | 708,950 |
| Commissions payable | 114,950 | 135,951 |
| Deferred revenue | (809,533) | 174,378 |
| Income taxes payable | (2,800) | -- |
| Net cash provided by(used in) operating activities | 1,043,048 | (18,314) |
| Cash flows from investing activities: | | |
| Payments received on note receivable - employee | 14,168 | 4,807 |
| Increase in note receivable - employee | (10,098) | -- |
| Acquisition of furniture and equipment | (16,359) | (7,617) |
| Net cash used in investing activities | (12,289) | (2,810) |
| Cash flows from financing activities: | | |
| Proceeds from exercise of stock options | 350 | -- |
| Net cash provided by financing activities | 350 | -- |
| Net increase (decrease) in cash and cash equivalents | 1,031,109 | (21,124) |
| Cash and cash equivalents, beginning of the period | 1,280,926 | 1,968,077 |
| Cash and cash equivalents, end of the period | \$2,312,035 | \$1,946,953 |
| Supplemental cash flow information | | |
| Interest paid | \$-- | \$-- |
| Income taxes paid | \$2,800 | \$-- |

The accompanying notes are an integral part of the financial statements

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INFORMATION ANALYSIS INCORPORATED

NOTES TO FINANCIAL STATEMENTS

1. Basis of Presentation

The accompanying unaudited financial statements have been prepared in conformity with generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions for Form 10-Q and Article 8-03 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the Securities Exchange Commission. In the opinion of management, the unaudited financial statements include all adjustments necessary (which are of a normal and recurring nature) for the fair and not misleading presentation of the results of the interim periods presented. These unaudited financial statements should be read in conjunction with our audited financial statements for the year ended December 31, 2011 included in the Annual Report on Form 10-K filed by the Company with the Securities and Exchange Commission on March 31, 2012. The results of operations for any interim period are not necessarily indicative of the results of operations for any other interim period or for a full fiscal year.

2. Summary of Significant Accounting Policies

Operations

Information Analysis Incorporated (“IAI”, or 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 recognizes revenue when a contract has been executed, the contract price is fixed and determinable, delivery of services or products has occurred, and collectability of the contract price is considered probable and can be reasonably estimated. Revenue is earned under time and materials and fixed-price contracts. For sales of third-party software products, revenue is recognized upon delivery with any maintenance related revenues recognized ratably over the maintenance period.

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 any given reporting period.

For fixed-price contracts in which the Company is paid a specific amount to be available to provide a particular service for a stated period of time, revenue is recognized ratably over the service period. The Company applies this method of revenue recognition to sales of maintenance contracts on third-party software sales, such as 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.

On a transaction by transaction basis, the Company determines if the revenue should be recorded on a gross or net basis based on authoritative guidance issued by the Financial Accounting Standards Board (the "FASB"). The Company considers the following factors to determine the gross versus net presentation: if the Company (i) acts as principal in the transaction; (ii) takes title to the products; (iii) has risks and rewards of ownership, such as the risk of loss for collection, delivery or return; and (iv) acts as an agent or broker (including performing services, in substance, as an agent or broker) with compensation on a commission or fee basis. 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. 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 and 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. Revenue derived for facilitating a sales transaction of Adobe products in which a customer introduced by the Company makes a purchase directly from the Company's supplier or another designated reseller is recognized net when the commission payment is received. Since the Company is not a direct party in the sales transaction, payment by the supplier is the Company's confirmation that the sale occurred.

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2. Summary of Significant Accounting Policies (continued)

For software and software-related multiple element arrangements, the Company must: (1) determine whether and when each element has been delivered; (2) determine whether undelivered products or services are essential to the functionality of the delivered products and services; (3) determine the fair value of each undelivered element using vendor-specific objective evidence ("VSOE"), and (4) allocate the total price among the various elements. Changes in assumptions or judgments or changes to the elements in a software arrangement could cause a material increase or decrease in the amount of revenue that the Company reports in a particular period.

The Company determines VSOE for each element based on historical stand-alone sales to third parties or from the stated renewal rate for the elements contained in the initial arrangement. The Company has established VSOE for its third-party software maintenance and support services.

The Company's contracts with agencies of the U.S. federal 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, ratably throughout the contract as the services are provided, or subject to funds made available incrementally by legislators. In evaluating the probability of funding for purposes of assessing collectability of the contract price, the Company considers its previous experiences with its customers, communications with its customers regarding funding status, and the Company's knowledge of available funding for the contract or program. If funding is not assessed as probable, revenue recognition is deferred until realization is deemed probable.

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

Government Contracts

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

Accounts Receivable

Accounts receivable consist of trade accounts receivable and do not bear interest. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company reviews its allowance for doubtful accounts monthly. Accounts with receivable balances past due over 90 days are reviewed individually for collectability. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance sheet credit exposure related to its customers. The Company's allowance for doubtful accounts at September 30, 2012 was \$0 and at December 31, 2011 was \$141,721.

Note Receivable - employee

The note receivable - employee balance consists of a note issued to a non-officer employee of the Company. The note bears interest compounded at 3.5% and requires equal semi-monthly payments. During the third quarter of 2012, the maturity of the note was amended from August 10, 2013 to July 10, 2015, and the semi-monthly payments were

adjusted accordingly.

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2. Summary of Significant Accounting Policies (continued)

Stock-Based Compensation

Total compensation expense was \$1,834 and \$928 for the quarters ended September 30, 2012 and 2011, respectively, of which \$0 related to options awarded to non-employees in both periods. For the nine months ended September 30, 2012 and 2011, total compensation expense was \$5,197 and \$5,774, respectively, of which \$550 and \$0, respectively, related to options awarded to non-employees. The Company estimates the fair value of options granted using a Black-Scholes valuation model to establish the expense. When stock-based compensation is awarded to employees, the expense is recognized ratably over the vesting period. When stock-based compensation is awarded to non-employees, the expense is recognized over the period of performance.

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.

Subsequent Events

The Company has evaluated the period from September 30, 2012, the date of the financial statements, through the date of the issuance and filing of the financial statements, and has determined that no material subsequent events have occurred that would affect the information presented in these financial statements or require additional disclosure.

3. Stock Options

There were no option awards granted to employees and no option awards granted to non-employees in the three months ended September 30, 2012 and 2011. There were 102,500 option awards granted to employees and 5,000 option awards granted to non-employees in the nine months ended September 30, 2012 and there were 45,500 option awards granted to employees and no option awards granted to non-employees in the nine months ended September 30, 2011. The fair values of option awards granted in the nine months ended September 30, 2012 and 2011, were estimated using a Black-Scholes option pricing model using the following assumptions:

| | Nine Months ended September 30, | |
|-------------------------|------------------------------------|------------------|
| | 2012 | 2011 |
| Risk free interest rate | 0.75 – 2.31 % | 1.65 – 2.30 % |
| Dividend yield | 0 % | 0 % |
| Expected term | 5-10 years | 5 years |
| Expected volatility | 62.8 – 67.9 % | 61.7 – 61.9 % |

The status of the options issued as of September 30, 2012, and changes during the nine months ended September 30, 2012 and 2011, were as follows:

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3. Stock Options (continued)

| | Options outstanding | |
|---|---------------------|----------------------------------|
| | Number of shares | Weighted average price per share |
| Balance at December 31, 2011 | 1,003,000 | \$ 0.31 |
| Options granted | 65,000 | 0.15 |
| Options exercised, expired or forfeited | 28,000 | 0.36 |
| Balance at March 31, 2012 | 1,040,000 | \$ 0.30 |
| Options granted | 42,500 | 0.15 |
| Options exercised | 5,000 | 0.07 |
| Options expired or forfeited | 20,000 | 0.20 |
| Balance at June 30, 2012 | 1,057,500 | \$ 0.29 |
| Options exercised, expired or forfeited | 27,000 | 0.30 |
| Balance at September 30, 2012 | 1,030,500 | \$ 0.29 |

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

The following table summarizes information about options at September 30, 2012:

| 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 |
| 1,030,500 | \$0.29 | 4.56 | \$ 1,770 | 920,250 | \$0.31 | 3.98 | \$ 1,770 |

Nonvested stock awards as of September 30, 2012 and changes during the nine months ended September 30, 2012, were as follows:

| Nonvested | |
|------------------|------------------|
| Number of shares | Weighted average |
| | |

| | | grant date fair value |
|-------------------------------|---------|--------------------------|
| Balance at December 31, 2011 | 60,000 | \$ 0.09 |
| Granted | 65,000 | 0.08 |
| Vested | 18,500 | 0.11 |
| Expired before vesting | 6,000 | 0.09 |
| Balance at March 31, 2012 | 100,500 | \$ 0.08 |
| Granted | 42,500 | 0.08 |
| Vested | 22,750 | 0.09 |
| Expired before vesting | 10,000 | 0.08 |
| Balance at June 30, 2012 | 110,250 | \$ 0.08 |
| Balance at September 30, 2012 | 110,250 | \$ 0.08 |

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3. Stock Options (continued)

As of September 30, 2012 and 2011, unrecognized compensation cost associated with non-vested share-based employee and non-employee compensation totaled \$4,765 and \$3,157, respectively, which are expected to be recognized over weighted average periods of 6 months and 8 months, respectively.

4. Earnings Per Share

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

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

| | Net Income | Shares | Per Share Amount |
|--|------------|------------|------------------|
| Basic net income per common share for the three months ended September 30, 2012: | | | |
| Income available to common stockholders | \$43,422 | 11,201,760 | \$0.00 |
| Effect of dilutive stock options | -- | 13,161 | -- |
| Diluted net income per common share for the three months ended September 30, 2012: | \$43,422 | 11,214,921 | \$0.00 |
| Basic net income per common share for the nine months ended September 30, 2012: | | | |
| Income available to common stockholders | \$72,316 | 11,199,442 | \$0.01 |
| Effect of dilutive stock options | -- | 14,352 | -- |
| Diluted net income per common share for the nine months ended September 30, 2012: | \$72,316 | 11,213,794 | \$0.01 |
| Basic net income per common share for the three months ended September 30, 2011: | | | |
| Income available to common stockholders | \$63,133 | 11,196,760 | \$0.01 |
| Effect of dilutive stock options | -- | 36,553 | -- |
| Diluted net income per common share for the three months ended September 30, 2011: | \$63,133 | 11,233,313 | \$0.01 |
| Basic net income per common share for the nine months ended September 30, 2011: | | | |
| Income available to common stockholders | \$101,320 | 11,196,760 | \$0.01 |
| Effect of dilutive stock options | -- | 23,535 | -- |
| Diluted net income per common share for the nine months ended September 30, 2011: | \$101,320 | 11,220,295 | \$0.01 |

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

Cautionary Statement Regarding Forward-Looking Statements

This Form 10-Q contains forward-looking statements regarding our business, customer prospects, or other factors that may affect future earnings or financial results that are subject to the safe harbor created by the Private Securities Litigation Reform Act of 1995. Such statements involve risks and uncertainties which could cause actual results to vary materially from those expressed in the forward-looking statements. Investors should read and understand the risk factors detailed in our Form 10-K for the fiscal year ended December 31, 2011 and in other filings with the Securities and Exchange Commission.

We operate in a rapidly changing environment that involves a number of risks, some of which are beyond our control. This list highlights some of the risks which may affect future operating results. These are the risks and uncertainties we believe are most important for you to consider. Additional risks and uncertainties, not presently known to us, which we currently deem immaterial or which are similar to those faced by other companies in our industry or business in general, may also impair our business operations. If any of the following risks or uncertainties actually occurs, our business, financial condition and operating results would likely suffer. These risks include, among others, the following:

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

In some cases, you can identify forward-looking statements by terms such as “may,” “will,” “should,” “could,” “would,” “expect,” “plans,” “anticipates,” “believes,” “estimates,” “projects,” “predicts,” “intends,” “potential” and similar expressions intended to identify forward-looking statements. These statements reflect our current views with respect to future events and are based on assumptions and subject to risks and uncertainties. Given these uncertainties, you should not place undue reliance on these forward-looking statements. We discuss many of these risks in greater detail under the heading “Risk Factors” in Item 1A. Also, these forward-looking statements represent our estimates and assumptions only as of the date of this report. Except as required by law, we assume no obligation to update any forward-looking statements after the date of this report.

Our Business

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

Three of our customers, one of which is a U.S. government agency with which we contract directly and two of which are companies with which we contract for services to U.S. government agencies represent material portions of our revenue. These customers accounted for 31.4% (direct) and 21.5%, and 19.7% (under subcontract) of revenue in the first nine months of 2012.

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Three Months Ended September 30, 2012 versus Three Months Ended September 30, 2011

Revenue

Our revenues in the third quarter of 2012 were \$1,735,775, compared to \$1,662,700 in 2011, an increase of 4.4%. Professional services revenue was \$1,363,421 versus \$1,329,592, an increase of 2.5%, and software product and maintenance revenue was \$372,354 versus \$333,108, an increase of 11.8%. The increase in professional services revenue was due to a new contract and to increases in activity in some of our existing contracts in excess of the contracts that expired, were completed, and that decreased activity since September 30, 2011. The increase in our software product and maintenance revenue was primarily due to new product and maintenance orders that were received after September 30, 2011, for which the revenue recognized during the third quarter of 2012 exceeded that of the expiring maintenance contracts for which revenue was recognized during the same period in 2011. Software product sales and associated margins are subject to considerable fluctuation from period to period, based on the product mix sold.

Gross Margins

Gross margin was \$569,838, or 32.8% of sales, in the third quarter of 2012 versus \$682,444, or 41.0% of sales, in the third quarter of 2011. For the quarter ended September 30, 2012, \$544,495 of the gross margin was attributable to professional services at a gross margin percentage of 39.9%, and \$25,343 of the gross margin was attributable to software sales at a gross margin percentage of 6.8%. In the same quarter in 2011, we reported gross margins of \$627,575, or 47.2% of sales for professional services and \$54,869, or 16.5% of sales for software sales. Gross margin on professional services decreased in terms of both dollars and as a percentage of sales due to the expiration of or decreased activity of some more profitable services contracts, as well as a shift on certain contracts in the ratio of services work invoiced as fixed price per unit to work invoiced as time and materials. Gross margin on software sales decreased in terms of both dollars and as a percentage of sales, despite increases in revenue, due to narrower margins on existing product lines and more competitive bidding processes. 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 Expenses

Selling, general and administrative expenses, exclusive of sales commissions, were \$388,913, or 22.4% of revenues, in the third quarter of 2012 versus \$434,295, or 26.1% of revenues, in the third quarter of 2011. These expenses decreased \$45,383, or 10.4%, due largely to decreases in bad debt expense, net of increases in fringe benefits applied to overhead and administrative labor and recruiting expenses.

Commission expense was \$139,148, or 8.0% of revenues, in the third quarter of 2012 versus \$186,909, or 11.2% of revenues, in the third quarter of 2011. This decrease of \$47,761, or 25.6%, is due to the decreases in gross margins and operating income on commissionable contracts, which drive commission earned at varying rates for each salesperson.

Net Income

Net income for the three months ended September 30, 2012, was \$43,422, or 2.5% of revenue, versus net income of \$63,133, or 3.8% of revenue, for the same period in 2011. The decrease in net income despite an increase in revenue is due to the expiration of and decreases in activity of higher margin contracts for professional services, shifts in the types of services provided under some professional services contracts, and decreasing margins on software and maintenance sales resulting from the way suppliers do business and customer utilization of more competitive bidding processes.

Nine Months Ended September 30, 2012 versus Nine Months Ended September 30, 2011

Revenue

Our revenues in the first nine months of 2012 were \$5,684,356, compared to \$4,706,918 in 2011, an increase of 20.8%. Professional services revenue was \$3,891,417 versus \$3,580,792, an increase of 8.7%, and software product and maintenance revenue was \$1,792,939 versus \$1,126,126, an increase of 59.2%. The increase in professional services revenue was due to the addition of a new contract and to increases in activity in some of our existing contracts in excess of the contracts that expired, were completed, and that decreased activity since September 30, 2011. The increase in our software product and maintenance revenue was primarily due to a few new product and maintenance orders that were received after September 30, 2011. Software product sales and associated margins are subject to considerable fluctuation from period to period, based on the product mix sold.

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Gross Margins

Gross margin was \$1,819,256, or 32.0% of sales, in the first nine months of 2012 versus \$1,799,507, or 38.2% of sales, in the first nine months of 2011. For the nine months ended September 30, 2012, \$1,696,861 of the gross margin was attributable to professional services at a gross margin percentage of 43.6%, and \$122,395 of the gross margin was attributable to software sales at a gross margin percentage of 6.8%. In the same period in 2011, we reported gross margins of \$1,593,794, or 44.5% of sales for professional services and \$205,713, or 18.3% of sales for software sales. Gross margin on professional services increased in terms of dollars due to the increases in revenue, but decreased as a percentage of sales due to the expiration of or decreased activity of some more profitable services contracts, as well as a shift on certain contracts in the ratio of services work invoiced as fixed price per unit to work invoiced as time and materials. Gross margin on software sales decreased in terms of both dollars and as a percentage of sales, despite increases in revenue, due to narrower margins on existing product lines and more competitive bidding processes. 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 Expenses

Selling, general and administrative expenses, exclusive of sales commissions, were \$1,261,325, or 22.2% of revenues, in the first nine months of 2012 versus \$1,199,281, or 25.5% of revenues, in the first nine months of 2011. These expenses increased \$62,044, or 5.2%, due largely to increases in overhead and administrative labor and fringe benefits applied to overhead labor, offset by decreases in bad debt expenses.

Commission expense was \$490,317, or 8.6% of revenues, in the first nine months of 2012 versus \$504,906, or 10.7% of revenues, in the first nine months of 2011. This decrease of \$14,589, or 2.9 is due to the decreases in gross margins and operating income on commissionable contracts, which drive commission earned at varying rates for each salesperson.

Net Income

Net income for the nine months ended September 30, 2012, was \$72,316, or 1.3% of revenue, versus net income of \$101,320, or 2.2 % of revenue, for the same period in 2011. The decrease in net income is due to decreases in margins on product and maintenance sales, for which sales increased while gross margins decreased.

Liquidity and Capital Resources

Our cash and cash equivalents balance, when combined with our cash flow from operations during the first nine months of 2012, were sufficient to provide financing for our operations. Our net cash provided by combining our operating, investing, and financing activities in the first nine months of 2012 was \$1,031,109. Our net cash provided, when added to a beginning balance of \$1,280,926 yielded cash and cash equivalents of \$2,312,035 as of September 30, 2012. Our accounts receivable balances decreased \$1,953,561 and our accounts payable balances decreased \$906,499, primarily due to product-related invoices that were outstanding at the prior year end. We had no non-current liabilities as of September 30, 2012.

We have a revolving line of credit with a bank providing for demand or short-term borrowings of up to \$1,000,000. The line became effective December 20, 2005, and expires on December 1, 2012. As of September 30, 2012, no amounts were outstanding under this line of credit. At September 30, 2012, \$596,000 was available under this line of credit based on our outstanding accounts receivable.

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

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

We have no material commitments for capital expenditures.

We have no off-balance sheet arrangements.

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ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, and people performing similar functions, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), as of March 31, 2012 (the "Evaluation Date"). Based upon this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the Evaluation Date, our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and (ii) is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

Changes in Internal Controls over Financial Reporting

There were no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations on Effectiveness of Controls

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

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PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 1A. RISK FACTORS

“Item 1A. Risk Factors” of our annual report on Form 10-K for the year ended December 31, 2011 includes a discussion of our risk factors. There have been no material changes from the risk factors described in our annual report on Form 10-K for the year ended December 31, 2011.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

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

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

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

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

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SIGNATURES

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

Information Analysis Incorporated
(Registrant)

Date: November 14, 2012

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

Date: November 14, 2012

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