

INFORMATION ANALYSIS INC  
Form 10QSB  
August 14, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-QSB**

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(Mark One)

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

For the quarterly period ended June 30, 2007

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

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

Commission file number 0-22405

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**INFORMATION ANALYSIS INCORPORATED**

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

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

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

(Address of principal executive offices)

(703) 383-3000

(Issuer's telephone number)

**54-1167364**  
(IRS Employer

Identification No.)

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

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

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

**APPLICABLE ONLY TO CORPORATE ISSUERS**

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

Common Stock, par value \$0.01, 11,196,760 shares as of August 10, 2007

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

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**PART I****Item 1. Financial Statements.****INFORMATION ANALYSIS INCORPORATED****BALANCE SHEETS****(Unaudited)**

|   | June 30, 2007       | December 31, 2006   |
|---|---------------------|---------------------|
| <b>ASSETS</b>   |                     |                     |
| Current assets:   |                     |                     |
| Cash and cash equivalents   | \$ 920,817          | \$ 808,358          |
| Accounts receivable, net  | 1,843,124           | 1,757,506           |
| Prepaid expenses  | 319,237             | 382,095             |
| Notes receivable  | 115,550             | 115,550             |
| Other receivables   | 4,308               | 6,427               |
| Other assets  | 4,300               | 4,300               |
| <b>Total current assets</b>   | <b>3,207,336</b>    | <b>3,074,236</b>    |
| Fixed assets, net   | 68,749              | 67,317              |
| Other assets  | 8,782               | 8,782               |
| <b>Total assets</b>   | <b>\$ 3,284,867</b> | <b>\$ 3,150,335</b> |
| <b>LIABILITIES &amp; STOCKHOLDERS EQUITY</b>  |                     |                     |
| Current liabilities:  |                     |                     |
| Accounts payable  | \$ 668,380          | \$ 643,838          |
| Deferred revenue  | 356,089             | 513,522             |
| Accrued payroll and related liabilities   | 292,909             | 264,660             |
| Other accrued liabilities   | 150,835             | 53,354              |
| <b>Total current liabilities</b>  | <b>1,468,213</b>    | <b>1,475,374</b>    |
| Stockholders' equity:   |                     |                     |
| Common stock, par value \$0.01, 30,000,000 shares authorized;<br>12,839,376 shares issued, 11,196,760 outstanding | 128,393             | 128,393             |
| Additional paid in capital  | 14,515,363          | 14,485,770          |
| Accumulated deficit   | (11,896,891)        | (12,008,991)        |
| Treasury stock, 1,642,616 shares at cost  | (930,211)           | (930,211)           |
| <b>Total stockholders' equity</b>   | <b>1,816,654</b>    | <b>1,674,961</b>    |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$ 3,284,867</b> | <b>\$ 3,150,335</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</b> |              |
|--|-----------------------------------|--------------|
|  | <b>June 30,</b>                   |              |
|  | <b>2007</b>                       | <b>2006</b>  |
| Sales  |                                   |              |
| Professional fees                            | \$ 1,776,628                      | \$ 2,298,862 |
| Software sales                               | 779,907                           | 269,948      |
| Total sales                                  | 2,556,535                         | 2,568,810    |
| Cost of sales                                |                                   |              |
| Cost of professional fees                    | 1,363,057                         | 1,703,225    |
| Cost of software sales                       | 640,612                           | 225,050      |
| Total cost of sales                          | 2,003,669                         | 1,928,275    |
| Gross profit                                 | 552,866                           | 640,535      |
| Selling, general and administrative expenses | 542,154                           | 488,817      |
| Income from operations                       | 10,712                            | 151,718      |
| Other income, net                            | 6,415                             | 1,957        |
| Income before provision for income taxes     | 17,127                            | 153,675      |
| Provision for income taxes                   |                                   |              |
| Net income                                   | \$ 17,127                         | \$ 153,675   |
| Comprehensive income                         | \$ 17,127                         | \$ 153,675   |
| Earnings per common share:                   |                                   |              |
| Basic:                                       | \$ 0.00                           | \$ 0.01      |
| Diluted:                                     | \$ 0.00                           | \$ 0.01      |
| Weighted average common shares outstanding:  |                                   |              |
| Basic  | 11,196,760                        | 11,035,507   |
| Diluted                                      | 11,398,487                        | 11,504,714   |

*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 six months ended</b> |              |
|--|---------------------------------|--------------|
|  | <b>June 30,</b>                 |              |
|  | <b>2007</b>                     | <b>2006</b>  |
| Sales  |                                 |              |
| Professional fees                            | \$ 3,676,966                    | \$ 4,494,890 |
| Software sales                               | 1,485,274                       | 388,431      |
| Total sales                                  | 5,162,240                       | 4,883,321    |
| Cost of sales                                |                                 |              |
| Cost of professional fees                    | 2,820,885                       | 3,454,001    |
| Cost of software sales                       | 1,182,330                       | 295,397      |
| Total cost of sales                          | 4,003,215                       | 3,749,398    |
| Gross profit                                 | 1,159,025                       | 1,133,923    |
| Selling, general and administrative expenses | 1,059,110                       | 897,541      |
| Income from operations                       | 99,915                          | 236,382      |
| Other income, net                            | 12,185                          | 3,025        |
| Income before provision for income taxes     | 112,100                         | 239,407      |
| Provision for income taxes                   |                                 |              |
| Net income                                   | \$ 112,100                      | \$ 239,407   |
| Comprehensive income                         | \$ 112,100                      | \$ 239,407   |
| Earnings per common share:                   |                                 |              |
| Basic:                                       | \$ 0.01                         | \$ 0.02      |
| Diluted:                                     | \$ 0.01                         | \$ 0.02      |
| Weighted average common shares outstanding:  |                                 |              |
| Basic  | 11,196,760                      | 10,890,164   |
| Diluted                                      | 11,401,905                      | 11,399,119   |

*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 six months ended</b> |             |
|---|---------------------------------|-------------|
|   | <b>June 30,</b>                 |             |
|   | <b>2007</b>                     | <b>2006</b> |
| Cash flows from operating activities:   |                                 |             |
| Net income  | \$ 112,100                      | \$ 239,407  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |             |
| Depreciation and amortization   | 17,378                          | 15,075      |
| Stock compensation  | 29,593                          | 4,158       |
| Changes in operating assets and liabilities                                       |                                 |             |
| Accounts receivable   | (85,618)                        | (238,927)   |
| Other receivables and prepaid expenses  | 64,977                          | (155,423)   |
| Accounts payable and accrued expenses   | 150,272                         | (31,027)    |
| Deferred revenue  | (157,433)                       | 226,440     |
| Net cash provided by operating activities   | 131,269                         | 59,703      |
| Cash flows from investing activities:   |                                 |             |
| Purchases of fixed assets   | (18,810)                        | (15,833)    |
| Net cash used by investing activities   | (18,810)                        | (15,833)    |
| Cash flows from financing activities:   |                                 |             |
| Proceeds from exercise of stock options   |                                 | 172,350     |
| Net cash provided by financing activities   |                                 | 172,350     |
| Net increase in cash and cash equivalents   | 112,459                         | 216,220     |
| Cash and cash equivalents at beginning of the period                              | 808,358                         | 451,777     |
| Cash and cash equivalents at end of the period                                    | \$ 920,817                      | \$ 667,997  |
| Supplemental cash flow Information  |                                 |             |
| Interest paid   | \$                              | \$ 608      |

*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 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, 2006 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. 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.

Revenue on time and materials contracts are 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 or level of effort, the Company recognizes revenue for the number of units delivered in any given fiscal period. For fixed price contracts in which the Company is paid a specific amount to provide a particular service for a stated period of time, revenue is recognized ratably over the service period.

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

For fixed price contracts that provide for the delivery of a specific product with related customer acceptance provisions, revenues are recognized upon product delivery and customer acceptance. A portion of the Company's fixed price contracts involve the design and development of complex, client systems. For those contracts that are within scope of AICPA Statement of Position (SOP) 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, revenue is recognized on the percentage-of-completion method using costs incurred in relation to total estimated costs. For those contracts that are within the scope of SOP 97-2, Software Revenue Recognition, our revenues associated with the customized software product are recognized when (1) pervasive evidence of an arrangement exists; (2) delivery has occurred; (3) our price to the customer is fixed and determinable; and (4) collectibility is probable.

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.

Contract revenue recognition inherently involves estimation, including the contemplated level of effort to accomplish the tasks under the contract, the cost of the effort, and an ongoing assessment of progress toward completing the contract. From time to time, as part of the normal management processes, facts develop that require revisions to estimated total costs or revenues expected. The cumulative impact of any revisions to estimates and the full impact of anticipated losses on any type of contract are recognized in the period in which they become known.

**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 at June 30, 2007 and December 31, 2006.

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

**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 June 30, 2007, the Company had the stock-based compensation plans described in Note 3 below. Total compensation expense related to these plans was \$25,964 and \$3,354 for the three months ended June 30, 2007 and 2006, respectively, of which \$4,800 and \$0, respectively, related to options awarded to non-employees. Total compensation expense related to these plans was \$29,593 and \$3,638 for the six months ended June 30, 2007 and 2006, respectively, of which \$5,520 and \$520, respectively, related to options awarded to non-employees.

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 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 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.

**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.

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**3. Stock Options and Warrants**

During the six months ended June 30, 2007, the Company granted options to certain employees to purchase an aggregate of 209,000 shares of the Company's common stock, with a per share weighted average fair value of \$0.25, and granted options to non-employee consultants to purchase 17,000 shares of the Company's common stock, with a per share fair value of \$0.32 at the measurement date. During the three months ended June 30, 2007, the Company granted options to certain employees to purchase an aggregate of 202,000 shares of the Company's common stock, with a per share weighted average fair value of \$0.25, and granted options to non-employee consultants to purchase 15,000 shares of the Company's common stock, with a per share fair value of \$0.32 at the measurement date. During the six months ended June 30, 2006, the Company granted options to certain employees to purchase an aggregate of 118,000 shares of the Company's common stock, with a per share weighted average fair value of \$0.32, and 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 June 30, 2006, the Company granted options to certain employees to purchase an aggregate of 112,000 shares of the Company's common stock, with a per share weighted average fair value of \$0.31, and 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. The fair values of option awards granted in the six months and three months ending June 30, 2007 and 2006, were estimated using the Black Sholes option pricing model with the following assumptions:

|                         | Six Months |            | Three Months |            |
|-------------------------|------------|------------|--------------|------------|
|                         | 2007       | 2006       | 2007         | 2006       |
| Risk free interest rate | 4.48-5.03% | 4.35-5.07% | 4.48-5.03%   | 4.90-5.07% |
| Dividend yield          | 0%         | 0%         | 0%           | 0%         |
| Expected term           | 5-10 years | 2-5 years  | 5-10 years   | 2-5 years  |
| Expected volatility     | 71.1-73.5% | 93.8-99.0% | 73.5%        | 93.8%      |

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 within prescribed time periods 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 for the six months ended and the three months ended June 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.

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 period for options granted to employees under the 2006 Plan for the six months ended June 30, 2007, was seven months and for the three months ended June 30, 2007, was six months. The exercise price of each option equals the quoted market price of the Company's stock on the date of grant.

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

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

|   | 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                             |

The following table summarizes information about options at June 30, 2007:

| 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 |
| 1,157,800    | \$ 0.93                         | 6.0  | \$ 89,640                 | 913,800      | \$ 1.06                         | 5.0  | \$ 87,300                 |

Nonvested stock awards as of June 30, 2007 and changes during the six months ended June 30, 2007 were as follows:

|                              | Nonvested        |  |
|------------------------------|------------------|--|
|                              | Number of shares | Weighted average grant date fair value |
| 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                      | 1,000            | 0.40                                   |
| Balance at June 30, 2007     | 244,000          | 0.27                                   |

As of June 30, 2007, unrecognized compensation cost associated with non-vested share based employee and non-employee compensation approximated \$34,993, which is expected to be recognized over weighted average periods of 3 months.





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**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<br>Income | Shares     | Per Share<br>Amount |
|---|---------------|------------|---------------------|
| Basic net income per common share for the three months ended June 30, 2007:   |               |            |                     |
| Income available to common stockholders                                       | \$ 17,127     | 11,196,760 | \$                  |
| Effect of dilutive stock options  |               | 190,047    |                     |
| Effect of dilutive warrants   |               | 11,680     |                     |
| Diluted net income per common share for the three months ended June 30, 2007: | \$ 17,127     | 11,398,487 | \$                  |
| Basic net income per common share for the three months ended June 30, 2006:   |               |            |                     |
| Income available to common stockholders                                       | \$ 153,675    | 11,035,507 | \$ 0.01             |
| Effect of dilutive stock options  |               | 362,839    |                     |
| Effect of dilutive warrants   |               | 106,368    |                     |
| Diluted net income per common share for the three months ended June 30, 2006: | \$ 153,675    | 11,504,714 | \$ 0.01             |
| Basic net income per common share for the six months ended June 30, 2007:     |               |            |                     |
| Income available to common stockholders                                       | \$ 112,100    | 11,196,760 | \$ 0.01             |
| Effect of dilutive stock options  |               | 193,461    |                     |
| Effect of dilutive warrants   |               | 11,684     |                     |
| Diluted net income per common share for the six months ended June 30, 2007:   | \$ 112,100    | 11,401,905 | \$ 0.01             |
| Basic net income per common share for the six months ended June 30, 2006:     |               |            |                     |
| Income available to common stockholders                                       | \$ 239,407    | 10,890,164 | \$ 0.02             |
| Effect of dilutive stock options  |               | 397,710    |                     |
| Effect of dilutive warrants   |               | 111,245    |                     |
| Diluted net income per common share for the six months ended June 30, 2006:   | \$ 239,407    | 11,399,119 | \$ 0.02             |

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**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, 2006 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;

the limited public market for our common stock; and

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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. Since its 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. 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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**Three Months Ended June 30, 2007 Versus Three Months Ended June 30, 2006**

*Revenue*

Our revenues in the second quarter of 2007 were \$2,556,535, compared to \$2,568,810 in 2006, a decrease of 0.5%. Professional services revenue was \$1,776,628 versus \$2,298,862, a decrease of 22.7%, and software product revenue was \$779,907 versus \$269,948, an increase of 188.9%. The decrease in professional services revenue is due to the expiration of certain contracts. The increase in software product revenue is due to fluctuation in one-time sales of Adobe and Micro Focus products, as well as an overall increase in revenue on maintenance contracts for 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 \$552,866, or 21.6% of sales, in the second quarter of 2007 versus \$640,535, or 24.9% of sales, in the second quarter of 2006. Of the \$552,866 in 2007, \$413,571 was attributable to professional services and \$139,295 was attributable to software sales. Our gross margin percentage was 23.3% for professional services and 17.9% for software sales for the three months ended June 30, 2007. In the same quarter in 2006, we reported gross margins of \$595,637, or 25.9% of sales for professional services and \$44,898, or 16.6% of sales for software sales. Professional services gross margin decreased due to the expiration of certain contracts. Our increase in gross margin on software sales is due to increased Micro Focus and Adobe product and maintenance sales during the three months ended June 30, 2007. Software product sales and associated margins are subject to considerable fluctuation from period to period.

*Selling, General and Administrative*

Selling, general and administrative expenses were \$542,154, or 21.2% of revenues, in the second quarter of 2007 versus \$488,817, or 19.0% of revenues, in the second quarter of 2006. The increase is due to salesperson commissions on product sales, recruiting fees, stock compensation expense, administrative salaries, and rent.

*Profits*

Net income for the three months ended June 30, 2007, was \$17,127, or 0.7% of revenue, versus \$153,675, or 6.0% of revenue, for the same period in 2006. The decrease in net income is due to increases in our selling, general and administrative expenses.

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Second Quarter 2007 Report on Form 10-QSB

**Six Months Ended June 30, 2007 Versus Six Months Ended June 30, 2006**

*Revenue*

Our revenues in the first half of 2007 were \$5,162,240, compared to \$4,883,321 in 2006, an increase of 5.7%. Professional services revenue was \$3,676,966 versus \$4,494,890, a decrease of 18.2%, and software product revenue was \$1,485,274 versus \$388,431, an increase of 282.4%. The decrease in professional services revenue is due to the expiration of certain contracts. The increase in software product revenue is due to fluctuation in one-time sales of Adobe and Micro Focus products, as well as an overall increase in revenue on maintenance contracts for 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 \$1,159,025, or 22.5% of sales, in the first half of 2007 versus \$1,133,923, or 23.2% of sales, in the first half of 2006. Of the \$1,159,025 in 2007, \$856,081 was attributable to professional services and \$302,944 was attributable to software sales. Our gross margin percentage was 23.3% for professional services and 20.4% for software sales for 2007. In 2006, we reported gross margins of \$1,040,889, or 23.2% of sales for professional services and \$93,034, or 24.0% of sales for software sales. Our decrease in gross margin on software sales is due to increases in sales of both Micro Focus and Adobe products and maintenance, and the decrease in gross margin percentage is due to fluctuations in margins on product and maintenance sales. Software product sales and associated margins are subject to considerable fluctuation from period to period.

*Selling, General and Administrative*

Selling, general and administrative expenses were \$1,059,110, or 20.5% of revenues, in the first half of 2007 versus \$897,541, or 18.4% of revenues, in the first half of 2006. The increase is due to salesperson commissions on product sales, recruiting fees, stock compensation expense, administrative salaries, and rent.

*Profits*

Net income for the six months ended June 30, 2007 was \$112,100, or 2.2% of revenue, versus \$239,407, or 4.9% of revenue, for the same period in 2006. The decrease in net income is due to increases in our selling, general and administrative expenses.

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### **Liquidity and Capital Resources**

Our profits, when combined with our beginning cash and cash equivalents balance, were sufficient to provide financing for our operations. Our increase in cash was \$112,459, due to cash provided by operating activities less cash used by investing activities. When this increase in cash was added to a beginning balance of \$808,358, cash and cash equivalents at June 30, 2007, were \$920,817. Our accounts receivable balance increased by \$85,618 during the six months ended June 30, 2007. This increase is primarily due to a certain short-term fixed price subcontract for which billing was completed in our first quarter but payments were not received until our third quarter.

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 May 1, 2008. As of June 30, 2007, no amounts were outstanding under this line of credit.

Based on our current operating plan, the line of credit, when coupled with funds generated from operations, should be sufficient to meet our operating cash requirements through the expiration date of the line of credit.

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.

### **Recently issued accounting pronouncements**

In July 2006, the FASB issued FASB Interpretation No.48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement 109* ( FIN 48 ) which clarifies the accounting for uncertainty in income taxes recognized in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 is a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. If an income tax position exceeds a more likely than not (greater than 50%) probability of success upon tax audit, the company will recognize an income tax benefit in its financial statements. Additionally, companies are required to accrue interest and related penalties, if applicable, on all tax exposures consistent with jurisdictional tax laws. We adopted FIN 48 for the fiscal year beginning January 1, 2007. The application of FIN 48 did not have a material effect on our financial condition or results of operations.

In September 2006, the FASB issued SFAS No. 157 *Fair Value Measurements* ( SFAS 157 ), which defines fair value, establishes a framework for consistently measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS No. 157 is effective for the Company beginning January 1, 2008, and the provisions of SFAS No. 157 will be applied prospectively as of that date. The Company is currently evaluating the effect that adoption of this statement will have on its financial position or results of operations.

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In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ( SFAS 159 ) which allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. Subsequent changes in fair value of these financial assets and liabilities would be recognized in earnings when they occur. SFAS 159 is effective for the Company's financial statements for the year beginning January 1, 2008, with earlier adoption permitted. The Company is currently evaluating the effect and timing that adoption of this statement will have on its financial position and results of operations.

**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(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 significant deficiencies or material weaknesses in the Company's internal controls. Accordingly, no corrective actions were required or undertaken.

**PART II - OTHER INFORMATION****Item 4. Submission of Matters to a Vote of Security Holders**

- (a) On June 12, 2007, we held our Annual Meeting of Stockholders.
- (c) 1. The vote for the election of Directors, to serve until the next annual meeting of stockholders and until their successors have been elected and qualified, was as follows:
- (i) Charles A. May, Jr. - 8,755,188 FOR, 352,991 WITHHELD
  - (ii) Sandor Rosenberg - 9,084,588 FOR, 23,591 WITHHELD
  - (iii) Bonnie K. Wachtel - 8,672,188 FOR, 435,991 WITHHELD
  - (iv) James D. Wester - 8,799,188 FOR, 328,991 WITHHELD
2. The vote for ratification of the selection of Reznick Group, P.C., as our Independent Public Accountants for 2006 was as follows:
- 9,094,315 FOR, 6,900 AGAINST, 6,954 ABSTAIN





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

Exhibits: See Exhibit Index on page 18.

**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: August 14, 2007

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 Sabanes-Oxley Act of 2002   | Filed with this Form 10-QSB, page 19 |
| 31.2               | Certification by Chief Financial Officer under Section 302 of the Sabanes-Oxley Act of 2002   | Filed with this Form 10-QSB, page 20 |
| 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 21 |
| 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 22 |