INFORMATION ANALYSIS INC
Form 10QSB
August 15, 2005
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

(Mark One)

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

For the quarterly period ended June 30, 2005

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

For the transition period from _____ to _____

Commission file number 0-22405

INFORMATION ANALYSIS INCORPORATED

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

Virginia	54-1167364
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

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

(Address of principal executive offices)

(703) 383-3000

(Issuer s telephone number)

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS

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

Common Stock, par value $0.01, 10,298,015 shares as of August 3, 2005

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

Table of Contents

Information Analysis Incorporated Second Quarter 2005 Report on Form 10-QSB

INFO RMATION ANALYSIS INCORPORATED

FORM 10-QSB

Index

		Page Number
PART I.	FINANCIAL INFORMATION	
Item 1.	Financial Statements	
	Consolidated Balance Sheets as of June 30, 2005 (unaudited) and December 31, 2004	2
	Consolidated Statements of Operations and Comprehensive Income for the three months ended June 30, 2005 (unaudited) and June 30, 2004 (unaudited)	3
	Consolidated Statements of Operations and Comprehensive Income for the six months ended June 30, 2005 (unaudited) and June 30, 2004 (unaudited)	4
	Consolidated Statements of Cash Flows for the six months ended June 30, 2005 (unaudited) and June 30, 2004 (unaudited)	5
	Notes to Unaudited Consolidated Financial Statements	6
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	8
Item 3.	Controls and Procedures	12
PART II. OTHER INFORMATION		
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	12
Item 6.	Exhibits	13
SIGNATURES		13
Exhibit Index		14

Table of Contents

INFORMATION ANALYSIS INCORPORATED

CONSOLIDATED BALANCE SHEETS

	June 30, 2005 Unaudited	December 31, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	$ 80,914	$ 115,917
Accounts receivable, net	2,506,527	2,169,790
Prepaid expenses	168,452	47,579
Notes receivable	85,000	85,000
Other receivables	4,329	6,910
Total current assets	2,845,222	2,425,196
Fixed assets, net	45,583	34,551
Other assets	6,782	7,447
Investments	3,000	3,000
Total assets	$ 2,900,587	$ 2,470,194
LIABILITIES & STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 1,671,278	$ 1,566,788
Accrued payroll and related liabilities	342,233	277,172
Other accrued liabilities	196,695	64,748
Deferred revenue	168,973	83,844
Notes payable	125,000	125,000
Revolving line of credit	33,969	219,650
Total current liabilities	2,538,148	2,337,202
Total liabilities	2,538,148	2,337,202
Stockholders equity:		
Common stock, par value $0.01, 30,000,000 shares authorized; 11,802,626 shares issued, 10,298,015 outstanding at June 30, 2005, and 11,788,126 shares issued, 10,283,515 outstanding at December 31, 2004	118,026	117,881
Additional paid in capital	14,130,824	14,122,019
Accumulated deficit	(13,023,098)	(13,243,595)
Accumulated other comprehensive income	(9,000)	(9,000)
Treasury stock, 1,504,611 shares at cost	(854,313)	(854,313)
Total stockholders equity	362,439	132,992
Total liabilities and stockholders equity	$ 2,900,587	$ 2,470,194

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

Table of Contents

INFORMATION ANALYSIS INCORPORATED

CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE INCOME

	For the three months ended June 30,	
	2005 Unaudited	2004 Unaudited
Sales		
Professional fees	$ 2,371,384	$ 2,068,909
Software sales	634,397	88,533
Total sales	3,005,781	2,157,442
Cost of sales		
Cost of professional fees	1,837,147	1,661,084
Cost of software sales	563,858	71,607
Total cost of sales	2,401,005	1,732,691
Gross profit	604,776	424,751
Selling, general and administrative expenses	451,993	352,404
Income from operations	152,783	72,347
Other expenses, net	(4,589)	(13,341)
Income before provision for income taxes	148,194	59,006
Provision for income taxes		
Net income	$ 148,194	$ 59,006
Comprehensive income	$ 148,194	$ 59,006
Earnings per common share:		
Basic:		
Net income	$ 0.01	$ 0.01
Diluted:		
Net income	$ 0.01	$ 0.01
Weighted average common shares outstanding:		
Basic	10,296,527	10,283,515

Diluted	11,279,095	11,073,148

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

Table of Contents

INFORMATION ANALYSIS INCORPORATED

CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE INCOME

	For the six months ended June 30,	
	2005 Unaudited	**2004 Unaudited**
Sales		
Professional fees	$ 4,486,479	$ 4,059,448
Software sales	706,545	214,395
Total sales	5,193,024	4,273,843
Cost of sales		
Cost of professional fees	3,519,037	3,321,897
Cost of software sales	604,931	138,212
Total cost of sales	4,123,968	3,460,109
Gross profit	1,069,056	813,734
Selling, general and administrative expenses	840,379	680,512
Income from operations	228,677	133,222
Other expenses, net	(8,180)	(20,874)
Income before provision for income taxes	220,497	112,348
Provision for income taxes		
Net income	$ 220,497	$ 112,348
Comprehensive income	$ 220,497	$ 112,348
Earnings per common share:		
Basic:		
Net income	$ 0.02	$ 0.01
Diluted:		
Net income	$ 0.02	$ 0.01
Weighted average common shares outstanding:		

Basic	10,290,057	10,283,515
Diluted	11,144,494	11,021,141

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

Table of Contents

INFORMATION ANALYSIS INCORPORATED

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the six months ended June 30,	
	2005 Unaudited	**2004 Unaudited**
Cash flows from operating activities:		
Net income	$ 220,497	$ 112,348
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	10,967	10,161
Reduction of accounts payable through issuance of equity	4,500	
Amortization of capitalized software		41,724
Gain on sale of fixed assets		(1,465)
Changes in operating assets and liabilities		
Accounts receivable	(336,737)	11,021
Other receivables and prepaid expenses	(117,627)	49,918
Accounts payable and accrued expenses	301,506	153,495
Deferred revenue	85,129	(62,967)
Net cash provided by operating activities	168,235	314,235
Cash flows from investing activities:		
Purchases of fixed assets	(22,007)	(6,798)
Proceeds from sale of fixed assets		1,465
Net cash used by investing activities	(22,007)	(5,333)
Cash flows from financing activities:		
Net payments under revolving line of credit	(185,681)	(602,741)
Proceeds from exercise of stock options	4,450	
Net cash used by financing activities	(181,231)	(602,741)
Net decrease in cash and cash equivalents	(35,003)	(293,839)
Cash and cash equivalents at beginning of the period	115,917	317,921
Cash and cash equivalents at end of the period	$ 80,914	$ 24,082
Supplemental cash flow Information Interest paid	$ 11,088	$ 20,917

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

Table of Contents

PART I

Item 1. Financial Statements.

INFORMATION ANALYSIS INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

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

2. Going Concern

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. Although the Company has an accumulated deficit of $13,023,000, it achieved net income of approximately $220,000 for the six months ended June 30, 2005. The Company s financial position, however, remains challenged.

The Company s credit facility expires September 16, 2005, and is payable on demand. Should the lender demand payment, or fail to renew the credit facility upon expiration, the Company may not be able to repay the credit facility or borrow sufficient funds from another financial institution to refinance it. Management expects that the credit facility will continue to be extended under its existing terms.

Management is seeking alternative financing and capital sources to replace the existing credit facility. The Company s ability to continue operations, however, is contingent upon obtaining new financing and capital, sustaining its return to profitable operations, improving its gross margins, and reducing overhead and general and administrative costs. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

3. Stock-based Compensation

The Company has an incentive stock option plan, which became effective June 25, 1996. The plan provides for the granting of stock options to certain employees and directors. The maximum number of shares for which options may be granted under the plan is 3,075,000. Options expire no later than ten years from the date of grant or when employment ceases, whichever comes first, and vest over periods determined by the Board of Directors. The average vesting period for options granted in 2005 was eighteen months. The exercise

Table of Contents

3. Stock-based Compensation (cont.)

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

	Three months ending June 30,	
	2005	2004
Net income		
As reported	$ 148,194	$ 59,006
Pro forma	$ 145,278	$ 53,657
Net income per share basic		
As reported	$ 0.01	$ 0.01
Pro forma	$ 0.01	$ 0.00
Net income per share diluted		
As reported	$ 0.01	$ 0.01
Pro forma	$ 0.01	$ 0.00

	Six months ending June 30,	
	2005	2004
Net income		
As reported	$ 220,497	$ 112,348
Pro forma	$ 214,299	$ 100,143
Net income per share basic		
As reported	$ 0.02	$ 0.01
Pro forma	$ 0.02	$ 0.01
Net income per share diluted		
As reported	$ 0.02	$ 0.01
Pro forma	$ 0.02	$ 0.01

4. Net Income Per Share

Earnings per share are presented in accordance with SFAS No. 128, Earnings Per Share. This statement requires dual presentation of basic and diluted earnings per share on the face of the income statement. Basic earnings per share excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock, except

for periods when the Company reports a net loss because the inclusion of such items would be antidilutive.

Table of Contents

4. Net Income Per Share (cont.)

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

	Net Income	Shares	Per Share Amount
Basic net income per common share for the three months ended June 30, 2005:			
Income available to common stockholders	$ 148,194	10,290,057	$ 0.01
Effect of dilutive stock options		239,061	
Effect of dilutive warrants		121,918	
Effect of dilutive convertible notes	3,750	500,000	
Diluted net income per common share for the three months ended June 30, 2005:	$ 151,944	11,151,036	$ 0.01
Basic net income per common share for the three months ended June 30, 2004:			
Income available to common stockholders	$ 59,006	10,283,515	$ 0.01
Effect of dilutive stock options		180,942	
Effect of dilutive warrants		108,691	
Effect of dilutive convertible notes	3,750	500,000	
Diluted net income per common share for the three months ended June 30, 2004:	$ 62,756	11,073,148	$ 0.01
Basic net income per common share for the six months ended June 30, 2005:			
Income available to common stockholders	$ 220,497	10,296,527	$ 0.02
Effect of dilutive stock options		362,887	
Effect of dilutive warrants		132,693	
Effect of dilutive convertible notes	7,500	500,000	
Diluted net income per common share for the six months ended June 30, 2005:	$ 227,997	11,292,107	$ 0.02
Basic net income per common share for the six months ended June 30, 2004:			
Income available to common stockholders	$ 112,348	10,283,515	$ 0.01
Effect of dilutive stock options		143,115	
Effect of dilutive warrants		94,511	
Effect of dilutive convertible notes	7,500	500,000	
Diluted net income per common share for the six months ended June 30, 2004:	$ 119,848	11,021,141	$ 0.01

Item 2. Management s Discussion and Analysis of Financial Condition or Plan of Operation

Cautionary Statement Regarding Forward-Looking Statements

This Form 10-QSB contains forward-looking statements regarding the Company s business, customer prospects, or other factors that may affect future earnings or financial results that are subject to the safe harbor created by the Private Securities Litigation Reform Act of 1995. Such statements involve risks and uncertainties which could cause actual results to vary materially from those expressed in the forward-looking statements. Investors should read and understand the risk factors detailed in the Company s 10-KSB for the fiscal year ended December 31, 2004 and in other filings with the Securities and Exchange Commission.

8

Table of Contents

Three Months Ended June 30, 2005 Versus Three Months Ended June 30, 2004

Revenue

Our revenues in the second quarter of 2005 were $3,005,781, compared to $2,157,442 in the second quarter of 2004, an increase of 39.3%. Professional services revenue was $2,371,384 versus $2,068,909, an increase of 14.6%, and product revenue was $634,397 versus $88,533, an increase of 616.6%. The increase in professional services revenue is due primarily to new contracts on which work began after the second quarter of 2004, and on expansion of existing contracts. The increase in product revenue is primarily due to a particularly large sale of Adobe products and to sales of Micro Focus products under contracts which commenced in the second quarter of 2005. Adobe and Micro Focus products, as well as the ICONS suite of conversion tools, are generally sold in conjunction with professional services over a specified contract term. We continue to have a steady pipeline of bidding opportunities for new and follow-on business. Professional services revenues are expected to maintain their current levels or to increase in the remainder of 2005, while product revenues are more often one-time purchases (which make them less consistent and less predictable).

Gross Margins

Gross margin was $604,776, or 20.1% of sales, in the second quarter of 2005 versus $424,751, or 19.7% of sales, in the second quarter of 2004. Of the $604,776 in 2005, $534,237 was attributable to professional services and $70,539 was attributable to software sales. Our gross margin percentage was 22.5% for professional services and 11.1% for software sales for the second quarter of 2005. In the second quarter of 2004, we reported gross margins of 19.7% for professional services and 19.1% for software sales. The increase in professional services gross margin percentage is largely due to improved margins related to new commercial contracts and higher margins on some of our electronic forms services. Also, we achieved cost savings by replacing some of our independent contractors with employees on current contracts and by hiring employees to work on new contracts as opposed to utilizing independent contractors. The decrease in software sales gross margin percentage is due to a lack of sales of the higher-margin ICONS suite of software conversion tools in the second quarter of 2005. Since the capitalized cost of ICONS was fully amortized as of September 30, 2004, higher gross margins will be associated with the sales of ICONS than would have existed in prior periods.

Selling, General and Administrative

Selling, general and administrative expenses were $451,993, or 15.0% of revenues, in the second quarter of 2005 versus $352,404, or 16.3% of revenues, in the second quarter of 2004. The increase in these expenses is due to increased costs of local area network administration, including the upgrade of equipment and software, the declaration of a performance bonus for executive officers, an increase in recruiting fees, especially for personnel with security clearances, and increases in legal and accounting fees and staffing related to the additional requirements of the Sarbanes-Oxley Act of 2002. We continue to control expenses and reduce them wherever practical, and we believe that only marginal increases in expenses will result from increases in the number of contracts under which we operate. The total cost of additional Sarbanes-Oxley requirements has not yet been fully determined.

Profits

We generated income from operations of $152,783 in the second quarter of 2005 compared to $72,347 in the second quarter of 2004. Net income for the second quarter of 2005 was $148,194 versus $59,006 for the same period in 2004. The change in profitability is primarily related to increased margins on professional services sales.

Table of Contents

Six Months Ended June 30, 2005 Versus Six Months Ended June 30, 2004

Revenue

Our revenues in the first six months of 2005 were $5,193,024, compared to $4,273,843 in the first six months of 2004, an increase of 21.5%. Professional services revenue was $4,486,479 versus $4,059,448, an increase of 10.5%, and product revenue was $706,545 versus $214,395, an increase of 229.6%. The increase in professional services revenue is due primarily to new contracts on which work began after the second quarter of 2004, and on expansion of existing contracts. The increase in product revenue is primarily due to a particularly large sale of Adobe products and to sales of Micro Focus products under contracts which commenced in the second quarter of 2005. Adobe and Micro Focus products, as well as the ICONS suite of conversion tools, are generally sold in conjunction with professional services over a specified contract term. We continue to have a steady pipeline of bidding opportunities for new and follow-on business. Professional services revenues are expected to maintain their current levels or to increase in the remainder of 2005, while product revenues are more often one-time purchases (which make them less consistent and less predictable).

Gross Margins

Gross margin was $1,069,056, or 20.6% of sales, in the first six months of 2005 versus $813,734, or 19.0% of sales, in the first six months of 2004. Of the $1,069,056 in 2005, $967,442 was attributable to professional services and $101,614 was attributable to software sales. Our gross margin percentage was 21.6% for professional services and 14.4% for software sales for the first six months of 2005. In 2004, we reported gross margins of 18.2% for professional services and 35.5% for software sales. The increase in professional services gross margin percentage is largely due to improved margins related to new commercial contracts and higher margins on some of our electronic forms services. Also, we achieved cost savings by replacing some of our independent contractors with employees on current contracts and by hiring employees to work on new contracts as opposed to utilizing independent contractors. The decrease in software sales gross margin percentage is due to a lack of sales of the higher-margin ICONS suite of software conversion tools in the first six months of 2005. Since the capitalized cost of ICONS was fully amortized as of September 30, 2004, higher gross margins will be associated with the sales of ICONS than would have existed in prior periods.

Selling, General and Administrative

Selling, general and administrative expenses were $840,379, or 16.2% of revenues, in the first six months of 2005 versus $680,512, or 15.9% of revenues, in 2004. The increase in these expenses is due to increased costs of local area network administration, including the upgrade of equipment and software, the declaration of a performance bonus for executive officers, an increase in recruiting fees, especially for personnel with security clearances, and increases in legal and accounting fees and staffing related to the additional requirements of the Sarbanes-Oxley Act of 2002. We continue to control expenses and reduce them wherever practical, and we believe that only marginal increases in expenses will result from increases in the number of contracts under which we operate. The total cost of additional Sarbanes-Oxley requirements has not yet been fully determined.

Profits

We generated income from operations of $228,677 in the first six months of 2005 compared to income from operations of $133,222 in the same period in 2004. Net income for the first six months 2005 was $220,497 versus $112,348 for 2004. The increase in profitability is primarily related to increased margins on professional services sales.

Table of Contents

Business Strategy

We continue to pursue merger and acquisition opportunities as a strategy for growth.

Liquidity and Capital Resources

Through the first six months of 2005, we financed operations from current collections and through our bank line of credit. Cash and cash equivalents at June 30, 2005 were $80,914 compared to $115,917 at December 31, 2004.

We have a revolving line of credit with a bank providing for demand or short-term borrowings of up to $500,000. The line of credit is callable on demand, and next expires on September 16, 2005. We believe the line of credit will be renewed at substantially equivalent terms. As of June 30, 2005, we had $33,969 outstanding on our line of credit versus an outstanding balance of $219,650 at December 31, 2004. We believe that our profitability will continue through the remainder of 2005 and that cash flows from collections, coupled with funds drawn from our line of credit, should enable us to continue to finance our operations.

We have outstanding convertible notes in the amount of $125,000. These notes originally came due on September 30, 2004. All of the note holders offered, and we accepted, a one-year extension of the maturity of the notes. We believe that we will be able to retire the notes on the due date of September 30, 2005, if the conversion privilege has not yet been exercised.

We are in negotiations with various organizations to obtain a new line of credit. The current line of credit, or a similar new credit facility, when coupled with funds generated from operations, assuming the operations are cash flow positive, should be sufficient to meet our operating cash requirements. We may periodically be required to delay timely payments of our accounts payable. Cash flow from operations may not be sufficient to provide additional working capital necessary to repay certain past due payables.

We have no material commitments for capital expenditures.

Table of Contents

Item 3. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures. As of the end of the period covered by this report, with the participation of the Company s management, the Company s principal executive officer and principal financial officer conducted an evaluation (as required by paragraph (b) of Rule 13a-15 or Rule 15d-15 under the Exchange Act) of the Company s disclosure controls and procedures (as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Exchange Act). Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in our periodic SEC reports. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

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

PART II - OTHER INFORMATION

Table of Contents

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

See Exhibit Index on page 14.

SIGNATURES

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

Information Analysis Incorporated

(Registrant)

Date: August 10, 2005

By: /S/ Sandor Rosenberg

Sandor Rosenberg, Chairman of the Board,

Chief Executive Officer, and President

By: /S/ Richard S. DeRose

Richard S. DeRose, Executive Vice President,

Treasurer, and Chief Financial Officer

Table of Contents

Exhibit Index

Exhibit No.	Description	Location
31.1	Certification by Chief Executive Officer under Section 302 of the Sabanes-Oxley Act of 2002	Filed with this Form 10-QSB, page 15
31.2	Certification by Chief Financial Officer under Section 302 of the Sabanes-Oxley Act of 2002	Filed with this Form 10-QSB, page 16
32.1	Certification by Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed with this Form 10-QSB, page 17
32.2	Certification by Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed with this Form 10-QSB, page 18