

ANDREA ELECTRONICS CORP  
Form 10QSB  
May 15, 2006

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**  
**FORM 10-QSB**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
for the quarterly period ended March 31, 2006

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (NO FEE REQUIRED)**

for the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-4324

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**ANDREA ELECTRONICS CORPORATION**

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

**New York**  
(State or other jurisdiction of

**11-0482020**  
(I.R.S. employer identification no.)

incorporation or organization)

**65 Orville Drive, Bohemia, New York**  
(Address of principal executive offices)

**11716**  
(Zip Code)

Issuer's telephone number, including area code: **631-719-1800**

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

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Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: As of May 10, 2006, there are 58,283,575 common shares outstanding.

Transitional Small Business Disclosure format (check one) Yes  No

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**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

|   | <b>March 31,</b>    | <b>December 31,</b> |
|---|---------------------|---------------------|
|   | <b>2006</b>         | <b>2005</b>         |
|   | <b>(unaudited)</b>  | <b>(audited)</b>    |
| <b>ASSETS</b>   |                     |                     |
| Current Assets  |                     |                     |
| Cash and cash equivalents   | \$ 370,695          | \$ 418,597          |
| Accounts receivable, net of allowance for doubtful accounts of \$18,394 and \$18,856, respectively  | 635,063             | 605,963             |
| Inventories, net  | 739,159             | 679,002             |
| Prepaid expenses and other current assets   | 417,251             | 218,621             |
| <b>Total current assets</b>   | <b>2,162,168</b>    | <b>1,922,183</b>    |
| Property and equipment, net   | 27,961              | 34,238              |
| Intangible assets, net  | 3,769,096           | 3,886,493           |
| Other assets, net   | 12,864              | 12,864              |
| <b>Total assets</b>   | <b>\$ 5,972,089</b> | <b>\$ 5,855,778</b> |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                     |                     |
| Current Liabilities:  |                     |                     |
| Trade accounts payable  | \$ 638,865          | \$ 460,144          |
| Short-term portion of capital lease   | 12,191              | 12,191              |
| Other current liabilities   | 442,910             | 457,212             |
| <b>Total current liabilities</b>  | <b>1,093,966</b>    | <b>929,547</b>      |
| Capital Lease   | 2,290               | 5,338               |
| <b>Total liabilities</b>  | <b>1,096,256</b>    | <b>934,885</b>      |
| Commitments and contingencies   |                     |                     |
| Shareholders' equity  |                     |                     |
| Preferred stock, \$.01 par value; authorized: 2,497,500 shares; none issued and outstanding   |                     |                     |
| Series C Convertible Preferred Stock, net, \$.01 par value; authorized: 1,500 shares; issued and outstanding: 105.7 shares; liquidation value: \$1,057,015  | 1                   | 1                   |
| Series D Convertible Preferred Stock, net, \$.01 par value; authorized: 2,500,000 shares; issued and outstanding: 1,328,572; liquidation value: \$1,328,572 | 13,286              | 13,286              |
| Common stock, \$.01 par value; authorized: 200,000,000 shares; issued and outstanding: 58,283,575   | 582,836             | 582,836             |
| Additional paid-in capital  | 76,269,936          | 76,263,536          |
| Deferred stock compensation   | (14,340)            | (16,666)            |
| Accumulated deficit   | (71,975,886)        | (71,922,100)        |
| <b>Total shareholders' equity</b>   | <b>4,875,833</b>    | <b>4,920,893</b>    |
| <b>Total liabilities and shareholders' equity</b>   | <b>\$ 5,972,089</b> | <b>\$ 5,855,778</b> |



## ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

|  | For the Three Months Ended |                   |
|--|----------------------------|-------------------|
|  | March 31,<br>2006          | March 31,<br>2005 |
| Revenues   |                            |                   |
| Product revenues   | \$ 926,667                 | \$ 830,667        |
| License revenues   | 126,658                    | 2,499             |
| Amortization of license revenues   |                            | 408,443           |
| Revenues   | 1,053,325                  | 1,241,609         |
| Cost of revenues   | 497,357                    | 462,986           |
| Gross margin   | 555,968                    | 778,623           |
| Research and development expenses  | 133,535                    | 204,324           |
| General, administrative and selling expenses                             | 476,077                    | 760,770           |
| Loss from operations   | (53,644)                   | (186,471)         |
| Other expense  |                            |                   |
| Interest income, net   | (142)                      | 2,253             |
| Loss on disposal of property and equipment, net                          |                            | (52,839)          |
| Other expense  | (142)                      | (50,586)          |
| Net loss   | \$ (53,786)                | \$ (237,057)      |
| Basic and diluted weighted average shares                                | 58,283,575                 | 57,883,575        |
| Basic and diluted net loss per share attributable to common shareholders | \$ (.00)                   | \$ (.00)          |

See Notes to Condensed Consolidated Financial Statements.

## ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

FOR THE THREE MONTHS ENDED MARCH 31, 2006

(UNAUDITED)

|   |             |             |             |             | Common      |             |               |              |                 |  | Total        |
|---|-------------|-------------|-------------|-------------|-------------|-------------|---------------|--------------|-----------------|--|--------------|
|   | Series C    | Series      | Series D    |             | Stock       | Common      | Additional    | Deferred     |                 |  | Shareholders |
|   | Convertible | C           | Convertible | Series D    | Shares      | Stock       | Paid-In       | Stock        | Accumulated     |  | Equity       |
|   | Preferred   | Convertible | Preferred   | Convertible | Outstanding | Outstanding | Capital       | Compensation | Deficit         |  |              |
|   | Stock       | Preferred   | Stock       | Preferred   | Outstanding | Stock       | Capital       | Compensation | Deficit         |  | Equity       |
|   | Outstanding | Stock       | Outstanding | Stock       | Outstanding | Stock       | Capital       | Compensation | Deficit         |  | Equity       |
| Balance, January 1, 2006                    | 105.701477  | \$ 1        | 1,328,572   | \$ 13,286   | 58,283,575  | \$ 582,836  | \$ 76,263,536 | \$ (16,666)  | \$ (71,922,100) |  | \$ 4,920,893 |
| Stock Option Grants                         |             |             |             |             |             |             | 6,400         | (6,400)      |                 |  |              |
| Amortization of Deferred Stock compensation |             |             |             |             |             |             |               | 8,726        |                 |  | 8,726        |
| Net loss                                    |             |             |             |             |             |             |               |              | (53,786)        |  | (53,786)     |
| Balance, March 31, 2006                     | 105.701477  | \$ 1        | 1,328,572   | \$ 13,286   | 58,283,575  | \$ 582,836  | \$ 76,269,936 | \$ (14,340)  | \$ (71,975,886) |  | \$ 4,875,833 |

See Notes to Condensed Consolidated Financial Statements.

## ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

|  | For the Three Months Ended |                |
|--|----------------------------|----------------|
|  | March 31, 2006             | March 31, 2005 |
| Cash flows from operating activities:  |                            |                |
| Loss from continuing operations  | \$ (53,786)                | \$ (237,057)   |
| Adjustments to reconcile net loss to net cash used in continuing operations: |                            |                |
| Depreciation and amortization  | 123,899                    | 135,808        |
| Non-cash stock compensation expense  | 8,726                      | 7,500          |
| Provision for bad debt   | (462)                      | (149)          |
| Inventory reserve  | (208)                      | (191,616)      |
| Loss on disposal of property and equipment, net                              |                            | 52,839         |
| Change in:   |                            |                |
| Accounts receivable  | (28,638)                   | 261,353        |
| Inventories  | (59,949)                   | 217,008        |
| Prepaid expenses and other current assets                                    | (198,630)                  | (58,905)       |
| Other assets, net  |                            | 21,085         |
| Trade accounts payable   | 178,721                    | 243,461        |
| Accrued restructuring charges  |                            |                |
| Deferred revenue   |                            | (408,443)      |
| Other current and long term liabilities                                      | (14,302)                   | (456,396)      |
| Net cash used in operating activities  | (44,629)                   | (413,512)      |
| Cash flows from investing activities:  |                            |                |
| Proceeds from sale of property and equipment                                 |                            | 9,000          |
| Patents and trademarks   | (225)                      | (1,105)        |
| Net cash (used in) provided by investing activities                          | (225)                      | 7,895          |
| Cash flows from financing activities:  |                            |                |
| Payment of Capital Lease   | (3,048)                    |                |
| Net cash used in financing activities  | (3,048)                    |                |
| Net decrease in cash and cash equivalents                                    | (47,902)                   | (405,617)      |
| Cash and cash equivalents, beginning of period                               | 418,597                    | 826,910        |
| Cash and cash equivalents, end of period                                     | \$ 370,695                 | \$ 421,293     |

See Notes to Condensed Consolidated Financial Statements.

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**ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES**

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

**Note 1. Basis of Presentation and Management Liquidity Plans**

Basis of Presentation - The accompanying unaudited condensed consolidated financial statements include the accounts of Andrea Electronics Corporation and its subsidiaries ( Andrea ). All intercompany balances and transactions have been eliminated in consolidation.

These unaudited, condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepting in the United States of America for interim financial information and with the instructions to Form 10-QSB. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for the fiscal year. For further information, refer to the consolidated financial statements and accompanying footnotes included in Andrea s annual report on Form 10-KSB for the year ended December 31, 2005.

Management s Liquidity Plans - As of March 31, 2006, Andrea had working capital of \$1,068,202 and cash on hand of \$370,695. Andrea incurred a loss from operations of \$53,644 for the quarter ended March 31, 2006. Andrea plans to continue to improve its cash flows during 2006 by placing heightened emphasis on its sales and marketing efforts.

As of May 10, 2006, Andrea has approximately \$180,000 (unaudited) of cash. Management believes that Andrea has sufficient liquidity available to operate through at least March 2007.

While Andrea continues to explore opportunities to increase sales in new business areas, the Company is also examining additional opportunities for cost reduction, production efficiencies and further diversification of its business. In the first quarter of 2005, Andrea made significant changes in its facilities (See Note 6). By Andrea assigning its lease in Melville, New York , and entering into a new lease in Bohemia, New York, the closing of its facility in Israel, the movement of the Company s facility in Utah and other related operational expense reductions, effective April 2005, Andrea reduced its annual cash expenses by approximately \$1.1 million. Although the Company has improved cash flows by reducing overall expenses, to the extent that the Company s revenues decline or remain flat, additional liquidity might be required in 2007. Accordingly, if Andrea fails to develop additional revenues from sales of its products or to generate adequate funding from operations, or if Andrea fails to obtain additional financing through a capital transaction or other type of financing, Andrea will be required to continue to significantly reduce its operating expenses and/or operations or Andrea may have to relinquish its products, technologies or markets which could have a materially adverse effect on revenue and operations. Andrea has no commitment for additional financing and may experience difficulty in obtaining additional financing on favorable terms, if at all.

**Note 2. Summary of Significant Accounting Policies**

Use of Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period.

Among other things, estimates are used in accounting for allowances for bad debts, inventory obsolescence, product warranty, depreciation, deferred income taxes, expected realizable values for assets (primarily intangible assets), contingencies, revenue recognition, future cash flow as well as the recording and presentation of convertible preferred stock. Estimates and assumptions are periodically reviewed and the effects of any material revisions are reflected in the condensed consolidated financial statements in the period that they are determined to be necessary. Actual results could differ from those estimates and assumptions.

Revenue Recognition - Non software-related revenue, which is generally comprised of microphones and microphone connectivity product revenues, is recognized when title and risk of loss pass to the customer, which is generally upon shipment. With respect to licensing revenues, Andrea recognizes revenue in accordance with Statement of Position ( SOP ) 97-2, Software Revenue Recognition, as amended, and Staff Accounting Bulletin Topic 13 Revenue Recognition. License revenue is recognized based on the terms and conditions of individual contracts. In addition, fee based services, which are short-term in nature, are generally performed on a time-and-material basis under separate service



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arrangements and the corresponding revenue is generally recognized as the services are performed.

Loss Per Share - Basic loss per share is computed by dividing the net loss applicable to common shares by the weighted average number of common shares outstanding during the period. Diluted loss attributable to common shares adjusts basic loss per share for the effects of convertible securities, stock options and other potentially dilutive financial instruments, only in the periods in which such effect is dilutive. The shares issuable upon the exercise of stock options, warrants and convertible preferred stock are excluded from the calculation of net loss per share as their effect would be antidilutive.

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Securities that could potentially dilute basic earnings per share ( EPS ) in the future that were not included in the computation of the diluted EPS because to do so would have been anti-dilutive for the periods presented, consist of the following:

|  |            |
|--|------------|
| Total potential common shares as of March 31, 2006:                |            |
| Options to purchase common stock                                   | 4,427,500  |
| Series C Convertible Preferred Stock and related accrued dividends | 4,836,010  |
| Series D Convertible Preferred Stock and related Warrants (Note 4) | 10,472,632 |
| Total potential common shares as of March 31, 2006                 | 19,736,142 |

**Stock-Based Compensation** - At March 31, 2006, Andrea had two stock-based employee compensation plans. Prior to 2006, in accordance with SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, which amended SFAS No. 123, Accounting for Stock-Based Compensation, Andrea followed the intrinsic value method in accounting for its stock-based employee compensation arrangements as defined by Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, and Financial Accounting Standards Board ( FASB ) Interpretation No. ( FIN ) 44, Accounting for Certain Transactions Involving Stock Compensation. Under the intrinsic value method, no compensation expense was recognized through December 31, 2005 for options granted to employees, as all options granted under those plans have an exercise price equal to the market value of the underlying common stock on the date of grant.

In December 2004, the FASB issued SFAS No. 123R Share-Based Payment. SFAS No. 123R eliminates the alternative to use APB Opinion No. 25 s intrinsic value method of accounting that was provided in SFAS No. 123 as originally issued. SFAS No. 123R requires entities to recognize the cost of employee services in exchange for awards of equity instruments based on the grant-date fair value of those awards (with limited exceptions). That cost will be recognized over the period during which the employee is required to provide the service in exchange for the award. No compensation cost is recognized for equity instruments for which employees do not render the requisite service. SFAS No. 123R requires entities to initially measure the cost of employee services received in exchange for an award of liability instruments based on its current fair value; the fair value of the award will be re-measured at each reporting date through the settlement date. Changes in the fair value during the requisite service period will be recognized as compensation cost over that period. The grant date fair value of employee share options and similar instruments will be estimated using the Black-Scholes option-pricing model adjusted for the unique characteristics of those instruments. SFAS No. 123R is effective as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. The Company has adopted this pronouncement effective January 1, 2006. The Company adopted the modified prospective transition method. The adoption of SFAS No. 123R did not effect the Company s cash flows or financial position, but has had an adverse impact on results of operations. The result of adoption of this pronouncement was \$3,725 of compensation expense for the quarter ended March 31, 2006.

The effect of expensing stock options on the Company s results of operations using a Black-Scholes option-pricing model is presented in the following pro forma table:

|  | <b>For the Three<br/>Months Ended<br/>March 31, 2005</b> |
|--|--|
| Net loss attributable to common shareholders as reported   | \$ (237,057)   |
| Deduct: Total stock-based employee compensation expense determined under fair value-based method | 9,349  |
| <b>Pro forma net loss attributable to common shareholders</b>                                    | <b>\$ (246,406)</b>                                      |
| Basic and diluted net loss attributable to common shareholders per share as reported             | \$ (.00)   |
| <b>Basic and diluted pro forma net loss attributable to common shareholders per share</b>        | <b>\$ (.00)</b>  |

There were 60,000 and 0 stock options granted during the three-month periods ended March 31, 2006 and 2005, respectively.

The fair values of the stock options granted were estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions for the three-month period ended March 31, 2006:

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|                          | <b>March 31, 2006</b> |
|--------------------------|-----------------------|
| Expected life in years   | 7                     |
| Risk-free interest rates | 4.46%                 |
| Volatility               | 219.6%                |
| Dividend yield           | 0%                    |

Cash and Cash Equivalents - Cash and cash equivalents include cash and highly liquid investments with original maturities of three months or less. Andrea has cash deposits in excess of the maximum amounts insured by FDIC at March 31, 2006 and 2005.

**Concentration of Credit Risk** - Andrea is a manufacturer of audio communications equipment for several industries. Revenues related to the recognition of the deferred revenue as well as other service related revenues to one customer were approximately 9% and 39% of the total net revenues for the three months ended March 31, 2006 and 2005, respectively and accounted for 13% of total accounts receivable at March 31, 2006. Sales of noise canceling products were significant to one customer and its affiliates, accounting for approximately 21% and 8% of the total revenues for the three months ended March 31, 2006 and 2005, respectively and accounted for 30% of total accounts receivable at March 31, 2006.

During the three months ended March 31, 2006 and 2005, Andrea purchased a substantial portion of its finished goods from two suppliers. Purchases from these two suppliers amounted to 63% and 10% for the three months ended March 31, 2006 and 48% and 35% for the three months ended March 31, 2005, of total purchases. At March 31, 2006, the amounts due to these suppliers in accounts payable were \$418,243 and \$212, respectively.

**Allowance for Doubtful Accounts** - The allowance for doubtful accounts reflects management's best estimate of probable losses inherent in the account receivable balance. Management determines the allowance based on known troubled accounts, historical experience, and other currently available evidence.

**Inventories** - Inventories are stated at the lower of cost (on a first-in, first-out) or market basis.

|                                | March 31,<br>2006 | December 31,<br>2005 |
|--------------------------------|-------------------|----------------------|
|                                | (unaudited)       | (audited)            |
| Raw materials                  | \$ 122,565        | \$ 112,929           |
| Finished goods                 | 1,290,203         | 1,239,890            |
|                                | 1,412,768         | 1,352,819            |
| Less: reserve for obsolescence | (673,609)         | (673,817)            |
|                                | \$ 739,159        | \$ 679,002           |

#### **Intangible and Long-Lived Assets**

Andrea accounts for its long-lived assets in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets for purposes of determining and measuring impairment of its long-lived assets (primarily intangible assets) other than goodwill. Andrea's policy is to periodically review the value assigned to its long-lived assets to determine if they have been permanently impaired by adverse conditions which may affect Andrea. If Andrea identifies a permanent impairment such that the carrying amount of Andrea's long lived assets are not recoverable using the sum of an undiscounted cash flow projection (gross margin dollars from product sales), a new cost basis for the impaired asset will be established. This new cost basis will be net of any recorded impairment.

At March 31, 2006, management compared the sum of Andrea's undiscounted cash flow projections (gross margin dollars from product sales) of the Andrea DSP Microphone and Audio Software core technology to the carrying value of that technology. The results of this test indicated that there was no impairment. However, this process utilized probability weighted undiscounted cash flow projections which include a significant amount of management's judgment and estimates as to future revenue. If these probability weighted projections do not come to fruition, the Company could be required to record an impairment charge in the near term and such impairment could be material.

Andrea amortizes its core technology, patents and trademarks on a straight-line basis over the estimated useful lives of its intangible assets that range from 15 to 17 years. For the three-month periods ended March 31, 2006 and 2005, amortization expense was \$117,622 and \$117,455, respectively.

#### **Note 3. Series C Redeemable Convertible Preferred Stock**

On October 10, 2000, Andrea issued and sold in a private placement \$7,500,000 of Series C Redeemable Convertible Preferred Stock (the Series C Preferred Stock). As of December 31, 2003, there were 677.187593 shares of Series C Preferred Stock outstanding, which was recorded net of

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the unaccreted present value of the transaction costs of \$79,273. Each of these shares of Series C Preferred Stock had a stated value of \$10,000 plus a 5% per annum increase in the stated value, which sum was convertible into Common Stock at a conversion price of \$0.30. This conversion price was subject to change based on various events, including the announcement of a major transaction or upon certain triggering events. In addition, upon announcement of a major transaction or upon certain triggering events, as defined, the investors had the right to require Andrea to redeem all or a portion of the investors' Series C Preferred Stock at a defined redemption price. If Andrea were unable to effect such redemption, the Company would be subject to additional penalties. Due to these redemption features, the Series C Preferred Stock was presented outside of shareholders' equity (deficit) in the condensed consolidated balance sheets at December 31, 2003.

On February 17, 2004, Andrea announced that it had entered into an Exchange and Termination Agreement and an Acknowledgment and Waiver Agreement and that certain third party investors (the "Series C Investors") had purchased 582,887,593 shares of the Series C Preferred Stock from the original holder of such Series C Preferred Stock (the "Existing C Holder"). Pursuant to the Exchange and Termination Agreement, the Existing C Holder would exchange 46.3 shares of the Series C Preferred Stock, together with related accrued

dividends of \$77,378, in exchange for 1.8 million shares of Common Stock and cease to own any of the Series C Preferred Stock. In the Acknowledgment and Waiver Agreement between Andrea and the Series C Investors, the terms of the Series C Preferred Stock would effectively be revised, which among other things would: (i) eliminate the holders' security interest in Andrea's assets; (ii) eliminate any right of holders of the Series C Preferred Stock to require a redemption of the Series C Preferred Stock, with two limited exceptions which are within Andrea's control; (iii) eliminate the future increases, based on a rate of 5% per year of the Stated Value of the unconverted balance of the Series C Preferred Stock, of the shares of Common Stock issuable upon conversion of Series C Preferred Stock; and (iv) eliminate an existing election by a holder of Series C Preferred Stock to utilize a lower market price as the conversion price and reset the conversion price of the Series C Preferred Stock to \$0.2551 per share of Common Stock from the existing \$0.30 per share.

As of March 31, 2006, there were 105,701,477 shares of Series C Preferred Stock outstanding, which were convertible into 4,836,010 shares of Common Stock and accrued dividends of \$176,652, which is included in other current liabilities in the accompanying unaudited condensed consolidated balance sheet.

**Note 4. Series D Redeemable Convertible Preferred Stock**

On February 17, 2004, Andrea entered into a Securities Purchase Agreement with the Series C Investors and other investors (collectively, the Buyers) pursuant to which the Buyers agreed to invest a total of \$2,500,000. In connection with this agreement, on February 23, 2004, the Buyers purchased, for a purchase price of \$1,250,000, an aggregate of 1,250,000 shares of a new class of preferred stock, the Series D Preferred Stock, convertible into 5,000,000 shares of Common Stock (an effective conversion price of \$0.25 per share) and Common Stock warrants exercisable for an aggregate of 2,500,000 shares of Common Stock. The warrants are exercisable at any time after August 17, 2004 and before February 23, 2009 at an exercise price of \$0.38 per share.

In addition, on June 4, 2004, the Buyers purchased for an additional \$1,250,000, an additional 1,250,000 shares of Series D Preferred Stock convertible into 5,000,000 shares of Common Stock (an effective conversion price of \$0.25 per share) and Common Stock warrants exercisable for an aggregate of 2,500,000 shares of Common Stock. The warrants are exercisable at any time after December 4, 2004 and before June 4, 2009 at an exercise price of \$0.17 per share.

As of March 31, 2006, there were 1,328,572 shares of Series D Preferred Stock and 5,158,344 related warrants outstanding, which are convertible and exercisable into 10,472,632 shares of Common Stock.

**Note 5. Licensing Agreements**

In December 2001 and March 2002, Andrea entered into two agreements with Analog Devices. These license agreements relate to Andrea's high performance noise canceling technologies that enable clear voice communications and high-performance audio in small home-office and regular office environments. Under these agreements, Analog Devices paid Andrea a total of \$5 million in license fees during 2002. All license revenues were being recognized on a straight-line basis over three-years, \$3.0 million of which started to be recognized during the first quarter of 2002, and \$2.0 million which started in the third quarter of 2002. During the three months ended March 31, 2006 and 2005 \$0 and \$408,443, respectively, of amortization of license revenues was recognized in the accompanying unaudited condensed consolidated statements of operations.

In December 2002, we entered into a license agreement with Marconi Communications to provide and integrate a number of our proprietary audio software technologies into the Marconi ViPr Virtual Presence System (ViPr). The ViPr conference system is a new network appliance developed by Marconi that enables secure, high resolution, real-time, multimedia communications between people in geographically dispersed locations. The addition of our hands-free audio system includes an advanced stereo version of Andrea's patented EchoStop, as well as its patented DSDA and PureAudio noise canceling algorithms, among others. The implementation of Andrea's microphone array, which is embedded in the monitor of the ViPr system allows users to carry on discussion at normal conversation levels, even in a noisy environment. During the three months ended March 31, 2006 and 2005 \$9,240 and \$2,160, respectively, of license revenues were recognized in the accompanying unaudited condensed consolidated statements of operations.

In October 2004 we entered into a Production and Distribution Agreement with Creative Technology Ltd. (Creative). This agreement grants Creative a non-exclusive license to VoiceCenter as well as the right to purchase and resell certain of our other products. VoiceCenter will be distributed with Creative's Sound Blaster Live! ADVANCED MB, a simple online upgrade allowing PC users with motherboard audio produced by Dell to upgrade to Sound Blaster audio quality. The Sound Blaster Live! ADVANCED MB audio solution is available for PCs equipped with this configuration. In consideration of this agreement, Creative will pay Andrea a royalty for each VoiceCenter license shipped with the Soundblaster Live. During the three months ended March 31, 2006 and 2005, Andrea recorded \$90,101 and \$0 of licensing revenue related to this agreement, respectively.

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In November 2004, Andrea entered into a license agreement with Analog Devices to integrate its EchoStop technology with Analog's audio codec products for one of Analog Devices' customers ( EchoStop Licensed Products ). As consideration of this license, Analog will pay Andrea a royalty for each EchoStop Licensed Product shipped. If at the end of the first year of the agreement royalty payments are less than \$100,000, Analog will pay Andrea the difference between \$100,000 and the royalties paid to Andrea based on the number of EchoStop Licensed Products shipped during the first year of the agreement. During the three months ended March 31, 2006 and March 31, 2005, Andrea has recognized \$25,000 and \$0, respectively of revenues under this agreement.

In January 2006, Andrea entered into a license agreement with Analog Devices to integrate our DSDA and EchoStop technologies with certain of Analog's audio codec products for specific Analog's PC OEM customers ( DSDA/EchoStop Licensed Product ). In

consideration of this license, Analog will pay Andrea a royalty for each DSDA/EchoStop Licensed Product shipped. Commencing with the first product shipped under this agreement, Analog will pay Andrea a \$100,000 minimum royalty amount, payable in quarterly amounts of \$25,000. As of March 31, 2006, no revenue has been recognized under this agreement. When the royalties paid to Andrea from DSDA/EchoStop Licensed Products amount to \$500,000, no further payments will be required under this agreement.

**Note 6. Commitments And Contingencies**

Leases

In March 2005, Andrea entered into an assignment of lease and assumption agreement with respect to its existing corporate headquarters in Melville, New York. Under this agreement, Andrea vacated the premises on March 26, 2005 and the assignee took over the current lease, as amended. Andrea recorded a non-cash reversal of \$330,807 related to deferred rent charges, proceeds from the sale of property and equipment of \$9,000, a non-cash charge of \$33,281 related to the write off of certain property and equipment including leasehold improvements related to this operating lease and a cash charge of \$219,224 for lease termination costs. The net effect of these items of approximately \$112,000 was included in operating expenses for the year ended December 31, 2005. Rent expense under this operating lease was \$0 and \$153,420, respectively for the three-month periods ended March 31, 2006 and March 31, 2005.

Additionally, in March 2005, Andrea entered into a new lease for its new corporate headquarters located in Bohemia, New York, where Andrea leases space for warehousing, sales and executive offices from an unrelated party. The lease is for approximately 11,000 square feet and expires in October 2008. Rent expense under this operating lease was \$19,294 and \$0, respectively for the three-month periods ended March 31, 2006 and March 31, 2005.

As of March 31, 2006, the future minimum annual lease payments under this lease and all non-cancelable operating leases are as follows:

|                             |                |
|-----------------------------|----------------|
| 2006 (April to December 31) | \$ 84,878      |
| 2007                        | 99,807         |
| 2008                        | 90,374         |
| 2009                        | 89,557         |
| 2010                        | 29,171         |
| <br>Total                   | <br>\$ 393,787 |

Employment Agreements

In June 2004, the Company entered into a one-year employment contract with the Chairman of the Board, Douglas J. Andrea, which automatically renewed for one additional one-year term and expires June 2006. Pursuant to his employment agreement, Mr. Andrea receives an annual base salary of \$200,000 per annum through August 3, 2005 and \$225,000 per annum thereafter, a minimum annual prorated bonus of \$50,000 and an annual stock grant of 250,000 options. Mr. Andrea is also entitled to a change in control payment equal to one times his base salary with continuation of health and medical benefits for one year in the event of a change in control and subsequent termination of employment other than for cause. Mr. Andrea agreed to postpone payment of his \$50,000 bonus for the periods ended December 31, 2005 and 2004, respectively. At March 31, 2006, the future minimum cash commitments under this agreement aggregate \$171,875 (including Mr. Andrea's 2005 and 2004 bonus), of which \$112,500 and \$100,000 is included in other liabilities at March 31, 2006 and December 31, 2005, respectively.

Legal Proceedings

Andrea is involved in routine litigation incidental to the normal course of business. While it is not feasible to predict or determine the final outcome of claims, Andrea believes the resolution of these matters will not have a material adverse effect on Andrea's financial position, results of operations or liquidity.



**Note 7. Segment Information**

Andrea follows the provisions of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. Reportable operating segments are determined based on Andrea's management approach. The management approach, as defined by SFAS No. 131, is based on the way that the chief operating decision-maker organizes the segments within an enterprise for making operating decisions and assessing performance. While Andrea's results of operations are primarily reviewed on a consolidated basis, the chief operating decision-maker also manages the enterprise in two segments: (i) Andrea DSP Microphone and Audio Software Products and (ii) Andrea Anti-Noise Products. Andrea DSP Microphone and Audio Software Products primarily include products based on the use of some, or all, of the following technologies: Andrea Digital Super Directional Array microphone technology (DSDA), Andrea Direction Finding and Tracking Array microphone technology (DFTA), Andrea PureAudio noise filtering technology, and Andrea EchoStop, an advanced acoustic echo cancellation technology. Our Andrea Anti-Noise Products include noise cancellation and active noise cancellation computer headset products and related computer peripheral products. The following represents selected unaudited condensed consolidated financial information for Andrea's segments for the three-month periods ended March 31, 2006 and 2005:

| Segment Data                         | Andrea DSP<br>Microphone and<br>Audio Software<br>Products | Andrea Anti-<br>Noise Products | Total 2006 |
|--------------------------------------|--|--------------------------------|------------|
| Net revenues from external customers | \$ 190,549   | \$ 736,118                     | \$ 926,667 |
| License Revenues                     | 126,658  |                                | 126,658    |
| (Loss)/Income from operations        | (149,442)  | 95,798                         | (53,644)   |
| Depreciation and amortization        | 117,574  | 6,325                          | 123,899    |
| Assets                               | 4,623,460  | 1,348,629                      | 5,972,089  |
| Total long lived assets              | 3,629,786  | 167,271                        | 3,797,057  |

| Segment Data                                 | Andrea DSP<br>Microphone<br>and<br>Audio Software<br>Products | Andrea Anti-<br>Noise<br>Products | Total 2005 |
|--|---|-----------------------------------|------------|
| Net product revenues from external customers | \$ 180,251  | \$ 650,416                        | \$ 830,667 |
| License Revenues                             | 2,499   |                                   | 2,499      |
| Amortization of license revenues             | 408,443   |                                   | 408,443    |
| Loss from operations                         | (105,567)   | (80,904)                          | (186,471)  |
| Depreciation and amortization                | 122,403   | 13,405                            | 135,808    |
| Assets                                       | 5,205,298   | 1,345,746                         | 6,551,044  |
| Total long lived assets                      | 4,088,729   | 174,613                           | 4,263,342  |

Management of Andrea assesses assets and non-operating income statement data on a consolidated basis only. International revenues are based on the country in which the end-user is located. For the three-month periods ended March 31, 2006 and 2005, and as of each respective period-end, net revenues and accounts receivable by geographic area are as follows:

| Geographic Data        | March 31,<br>2006 | March 31,<br>2005 |
|------------------------|-------------------|-------------------|
| Net revenues:          |                   |                   |
| United States          | \$ 830,998        | \$ 1,189,461      |
| Foreign <sup>(1)</sup> | 222,327           | 52,148            |
|                        | \$ 1,053,325      | \$ 1,241,609      |
| Accounts receivable:   |                   |                   |
| United States          | \$ 491,978        | \$ 409,228        |
| Foreign                | 143,085           | 18,698            |
|                        | \$ 635,063        | \$ 427,926        |

(1) Net revenue to any one foreign country did not exceed 10% of total revenues for the period ended March 31, 2006 and 2005.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION**

**Overview**

Our mission is to provide the emerging voice interface markets with state-of-the-art communications products that facilitate natural language, human/machine interfaces.

Examples of the applications and interfaces for which Andrea DSP Microphone and Audio Software Products and Andrea Anti-Noise Products provide benefit include: Internet and other computer-based speech; telephony communications; multi-point conferencing; speech recognition; multimedia; multi-player Internet and CD ROM interactive games; and other applications and interfaces that incorporate natural language processing. We believe that end users of these applications and interfaces will require high quality microphone and earphone products that enhance voice transmission, particularly in noisy environments, for use with personal computers, mobile personal computing devices, cellular and other wireless communication devices and automotive communication systems. Our Andrea DSP Microphone and Audio Software Products use far-field digital signal processing technology to provide high quality transmission of voice where the user is at a distance from the microphone. High quality audio communication technologies will be required for emerging far-field voice applications, ranging from continuous speech dictation, to Internet telephony and multiparty video teleconferencing and collaboration, to natural language-driven interfaces for automobiles, home and office automation and other machines and devices into which voice-controlled microprocessors are expected to be introduced during the next several years.

We outsource to Asia high volume assembly for most of our products from purchased components. We assemble some low volume Andrea DSP Microphone and Audio Software Products from purchased components. As sales of any particular Andrea DSP Microphone and Audio Software Product increases, assembly operations are transferred to a subcontractor in Asia.

### **Our Critical Accounting Policies**

Our unaudited condensed consolidated financial statements and the notes to our unaudited condensed consolidated financial statements contain information that is pertinent to management's discussion and analysis. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities. In addition to the recording and presentation of our convertible preferred stock, we believe that the following are some of the more critical judgment areas in the application of our accounting policies that affect our financial condition and results of operations. We have discussed the application of these critical accounting policies with our Audit Committee.

**Revenue Recognition** Non software-related revenue, which is generally comprised of microphones and microphone connectivity product revenues, is recognized when title and risk of loss pass to the customer, which is generally upon shipment. With respect to licensing revenues, Andrea recognizes revenue in accordance with Statement of Position ( SOP ) 97-2, Software Revenue Recognition, as amended, and Staff Accounting Bulletin Topic 13 Revenue Recognition. License revenue is recognized based on the terms and conditions of individual contracts (see Note 5 of our unaudited condensed consolidated financial statements, for example). In addition, fee based services, which are short-term in nature, are generally performed on a time-and-material basis under separate service arrangements and the corresponding revenue is generally recognized as the services are performed.

**Accounts Receivable** We are required to estimate the collectibility of our trade receivables. Judgment is required in assessing the realization of these receivables, including the current creditworthiness of each customer and related aging of the past due balances. We evaluate specific accounts when we become aware of a situation where a customer may not be able to meet its financial obligations due to a deterioration of its financial viability, credit ratings or bankruptcy. The reserve requirements are based on the best facts available to us and reevaluated and adjusted as additional information is received. Our reserves also are determined by using percentages applied to certain aged receivable categories. At March 31, 2006 and December 31, 2005, our allowance for doubtful accounts was \$18,394 and \$18,856, respectively.

**Inventories** We are required to state our inventories at the lower of cost or market. In assessing the ultimate realization of inventories, we are required to make considerable judgments as to future demand requirements and compare that with our current inventory levels. Our reserve requirements generally increase as our projected demand requirements decrease due to market conditions, technological and product life cycle changes as well as longer than previously expected usage periods. Inventories of \$739,159 and \$679,002 at March 31, 2006 and December 31, 2005 are net of reserves of \$673,609 and \$673,817, respectively. It is possible that additional charges to inventory may be recorded in the future if there are further declines in market conditions, or if additional restructuring actions are taken.

**Statement of Financial Accounting Standards ( SFAS ) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets** - Andrea accounts for its long-lived assets in accordance with SFAS No. 144 for purposes of determining and measuring impairment of its long-lived assets (primarily intangible assets) other than goodwill. Andrea's policy is to review the value assigned to its long lived assets to determine if they have been permanently impaired by adverse conditions which may affect Andrea whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If Andrea identifies a permanent impairment such that the carrying amount of Andrea's long lived assets are not recoverable using the sum of an undiscounted cash flow projection (gross margin dollars from product sales), the impaired asset is adjusted to the estimated fair value which becomes the new cost basis for the impaired asset. This new cost basis will be net of any recorded impairment. Considerable management judgment is necessary to estimate undiscounted future operating cash flows and fair values and, accordingly, actual results could vary significantly from such estimates.

At March 31, 2006, because the revenues from the Andrea DSP Microphone and Audio Software Products business segment were lower than expected and this business segment was still operating at a loss, management compared the sum of Andrea's undiscounted cash flow projections (gross margin dollars from product sales) of the Andrea DSP Microphone and Audio Software core technology to the carrying value of that technology. The results of this test indicated that there was not an impairment. However, this process utilized probability weighted undiscounted cash flow projections which include a significant amount of management's judgment and estimates as to future revenue. If these probability weighted projections do not come to fruition, the Company could be required to record an impairment charge in the near term and such impairment could be material.

Amortization expense was \$117,622 and \$117,455 for the periods ended March 31, 2006 and 2005, respectively. Amortization of core technology is expected to be \$441,421 per year for the next nine years. Trademarks and patents are amortized on a straight-line basis over 17 years. The net value of Andrea's core technology and patents and trademarks at March 31, 2006 is \$3,421,013 and \$348,083 respectively. The net value of Andrea's core technology and patents and trademarks at December 31, 2005 was \$3,531,369 and \$355,124, respectively.

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**Deferred Tax Assets** We currently have significant deferred tax assets. SFAS No. 109, Accounting for Income Taxes, requires a valuation allowance to be established when it is more likely than not that all or a portion of deferred tax assets will not be realized. Furthermore, SFAS No. 109 provides that it is difficult to conclude that a valuation allowance is not needed when there is negative evidence such as cumulative losses in recent years. Therefore, cumulative losses weigh heavily in the overall assessment. Accordingly, we

expect to provide a full valuation allowance on future tax benefits until we can sustain a level of profitability that demonstrates our ability to utilize the assets, or other significant positive evidence arises that suggests our ability to utilize such assets. The future realization of a portion of our reserved deferred tax assets related to tax benefits associated with the exercise of stock options, if and when realized, will not result in a tax benefit in the consolidated statement of operations, but rather will result in an increase in additional paid-in capital. We will continue to re-assess our reserves on deferred income tax assets in future periods on a quarterly basis.

We are subject to proceedings, lawsuits and other claims, including proceedings under laws and government regulations related to securities, environmental, labor, product and other matters. We are required to assess the likelihood of any adverse judgments or outcomes to these matters, as well as potential ranges of probable losses. A determination of the amount of reserves required, if any, for these contingencies is based on an analysis of each individual issue with the assistance of legal counsel. The amount of any reserves may change in the future due to new developments in each matter.

The impact of changes in the estimates and judgments pertaining to revenue recognition, receivables and inventories is directly reflected in our segments' loss from operations. Although any charges related to our deferred tax assets are not reflected in our segment results, the long-term forecasts supporting the realization of those assets and changes in them are significantly affected by the actual and expected results of each segment.

### **Cautionary Statement Regarding Forward-Looking Statements**

Certain information contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations for the three months ended March 31, 2006 (the "2006 First Quarter") compared to the three months ended March 31, 2005 (the "2005 First Quarter") are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words anticipates, believes, estimates, expects, intends, plans, seeks, variations of such words and similar expressions are intended to identify forward-looking statements. We have based these forward-looking statements on our current expectations, estimates and projections about our business and industry, our beliefs and certain assumptions made by our management. Investors are cautioned that matters subject to forward-looking statements involve risks and uncertainties including economic, competitive, governmental, technological and other factors that may affect our business and prospects. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. In order to obtain the benefits of these "safe harbor" provisions for any such forward-looking statements, we wish to caution investors and prospective investors about the following significant factors, which, among others, have in some cases affected our actual results and are in the future likely to affect our actual results and could cause them to differ materially from those expressed in any such forward-looking statements. These factors include the following:

**Our operating results are subject to significant fluctuation, period-to-period comparisons of our operating results may not necessarily be meaningful and you should not rely on them as indications of our future performance.**

Our results of operations have historically been and are subject to continued substantial annual and quarterly fluctuations. The causes of these fluctuations include, among other things:

the volume of sales of our products under our collaborative marketing arrangements;

the cost of development of our products;

the mix of products we sell;

the mix of distribution channels we use;

the timing of our new product releases and those of our competitors;

fluctuations in the computer and communications hardware and software marketplace;

general economic conditions.

We cannot assure that the level of revenues and gross profit, if any, that we achieve in any particular fiscal period will not be significantly lower than in other fiscal periods. Our revenues for the 2006 First Quarter were approximately \$1.1 million versus \$1.2 million for the 2005 First Quarter. Net loss for the 2006 First Quarter was \$53,786, or \$0.00 net loss applicable to common shareholders per share on a basic and diluted basis, versus net loss of \$237,057, or \$0.00 net loss applicable to common shareholders per share on a basic and diluted basis for the 2005 First Quarter. During 2004, we continued to experience cash flow constraints and, in response, on February 17, 2004, we entered into a Securities Purchase Agreement with third party investors ( Buyers ) pursuant to which the Buyers agreed to invest a total of \$2.5 million in the Company. Pursuant to the terms of the Securities Purchase Agreement, Andrea received \$1.25 million on February 23, 2004 and another \$1.25 million on June 4, 2004. While we continue to explore opportunities to grow sales in other business areas, we are also examining additional opportunities for cost reduction, production efficiencies and further diversification of our business. In the first quarter of 2005 we made tremendous strides in cutting our expenses. By assigning our lease in Melville, New York, entering into our new lease in Bohemia, New York, closing our facility in Israel, moving our facility in Utah and other related operational expense reductions, effective April 2005, we reduced our annual cash expenses by approximately \$1.1 million. Although we are

improving cash flows by reducing overall expenses, if our revenues decline we may not generate positive cash flows and our net income or loss may be affected. Furthermore, our acquisition in 1998 of Lamar Signal Processing, Ltd. ( Lamar ) resulted in a substantial amount of goodwill (written off in entirety) and other intangible assets. The amortization of these intangible assets has had, and will continue to have, a negative, non-cash impact on our results of operations. As a result of all of the above factors, we might continue to accumulate losses and the market price of our common stock could decline and/or continue to fluctuate.

**If we fail to obtain additional capital or maintain access to funds sufficient to meet our operating needs, we may be required to significantly reduce, sell, or refocus our operations and our business, results of operations and financial condition could be materially and adversely effected.**

In order to be a viable entity we need to achieve profitable operations. To accomplish profitable operations we need to maintain/increase current revenues and continue to look for ways to control expenses. We might also need to sell additional assets or raise capital as a means of funding continued operations. In recent years, we have sustained significant operating losses. Since 1997, we have been unable to generate sufficient cash flow from operations to meet our operating needs and, correspondingly, from time to time during the past several years, we have raised additional capital from external sources. We may have to continue to raise additional capital from external sources. These sources may include private or public financings through the issuance of debt, convertible debt or equity, or collaborative arrangements. Such additional capital and funding may not be available on favorable terms, if at all. Additionally, we may only be able to obtain additional capital or funds through arrangements that require us to relinquish rights to our products, technologies or potential markets, in whole or in part, or result in our sale. On February 20, 2004, we entered into a Securities Purchase Agreement pursuant to which the Buyers agreed to invest a total of \$2.5 million in the Company, of which we received \$1.25 million on February 23, 2004 and \$1.25 million on June 4, 2004. In addition to these funds, we have significantly cut our expenses. By assigning our lease in Melville, New York, and entering into our new lease in Bohemia, New York, closing our facility in Israel, moving our facility in Utah and other related operational expense reductions, effective April 2005, we have reduced our annual cash expenses by approximately \$1.1 million. As a result, we believe that we now have sufficient liquidity to continue our operations at least through March 2007, provided our revenues do not decline and our operating expenses do not increase. Although we have revised our business strategies to reduce our expenses and capital expenditures, we cannot assure you that we will be successful in generating positive cash flows or obtaining access to additional sources of funding in amounts necessary to continue our operations. Failure to maintain sufficient access to funding may also result in our inability to continue operations.

**Shares Eligible For Future Sale May Have An Adverse Effect On Market Price; Andrea Stockholders May Experience Substantial Dilution.**

Sales of a substantial number of shares of our common stock in the public market could have the effect of depressing the prevailing market price of our common stock. Of the 200,000,000 shares of common stock presently authorized, 58,283,575 were outstanding as of May 10, 2006. The number of shares outstanding does not include an aggregate of 21,152,795 shares of common stock that are issuable. This number of issuable common shares is equal to 36% of the 58,283,575 outstanding shares. These issuable common shares are comprised of: a) 4,442,500 shares of our common stock reserved for issuance upon exercise of outstanding awards granted under our 1991 Performance Equity Plan and 1998 Stock Plan; b) 1,401,653 shares reserved for future grants under our 1998 Stock Plan; c) 4,836,010 shares of common stock that are issuable upon conversion of the Series C Preferred Stock; d) 5,314,288 shares of common stock issuable upon conversion of the Series D Preferred Stock; and e) 5,158,344 of common stock issuable upon exercise of warrants relating to the Series D Preferred stock.

**Conversions of our Series C Preferred Stock, Series D Preferred Stock and related Warrants may result in substantial dilution to other holders of our common stock.**

As of May 10, 2006, we had 105,701,477 shares of Series C Preferred Stock, 1,328,572 shares of Series D Preferred Stock and 5,158,344 Common Stock warrants outstanding. The issuance of shares of common stock upon conversion of the Series C Preferred Stock is limited to that amount which, after given effect to the conversion, would cause the holder not to beneficially own in excess of 4.99% or, together with other shares beneficially own during the 60 day period prior to such conversion, not to beneficially own in excess of 9.99% of the outstanding shares of common stock. The issuance of common stock upon conversion of the Series D Preferred Stock and the related warrants also are limited to that amount which, after given effect to the conversion, would cause the holder not to beneficially own an excess of 4.99% of then outstanding shares of our common stock, except that each holder has a right to terminate such limitation upon 61 days notice to us. Beneficial ownership for purposes of calculation of such percentage limitations does not include shares whose acquisition is subject to similar limitations. If all shares of the Series C and Series D Preferred Stock and warrants, which are outstanding to be issued, are assumed to be converted into or exercised for shares of common stock, the number of new shares of common stock required to be issued as a result would aggregate 15,308,642 shares, which would represent 26% of the then outstanding shares of common stock.

**Short sales of our common stock may be attracted by or accompany conversions of Series C Preferred Stock and Series D Preferred Stock, which sales may cause downward pressure upon the price of our common stock.**

Short sales of our common stock may be attracted by or accompany the sale of converted common stock, which in the aggregate could cause downward pressure upon the price of the common stock, regardless of our operating results, thereby attracting additional short sales of the common stock.

**If we fail to commercialize and fully market our Andrea DSP Microphone and Audio Software products, or continue to develop, and not fully market, Andrea Anti-Noise Headset products, our revenues may not increase at a high enough rate to improve our results of operations or may not increase at all.**

Our business, results of operations and financial condition depend on the successful commercialization of our Andrea DSP Microphone and Audio Software products and technologies. We introduced our first Andrea DSP Microphone products in 1998 and we continued to introduce complementary products and technologies over the last several years. We are primarily targeting these products at the desktop computer market, the audio and video conferencing markets and the market for in-vehicle computing, among others. The success of these products is subject to the risks frequently encountered by companies in an early stage of product commercialization, particularly companies in the computing and communications industries.

**If we are unable to obtain market acceptance of Andrea DSP Microphone and Audio Software products and technologies or if market acceptance of these products and technologies occurs at a slow rate, then our business, results of operations and financial condition will be materially and adversely affected.**

We, and our competitors, are focused on developing and commercializing products and technologies that enhance the use of voice, particularly in noisy environments, for a broad range of computer and communications applications. These products and technologies have been rapidly evolving and the number of our competitors has grown, but the markets for these products and technologies are subject to a high level of uncertainty and have been developing slowly. We, alone or together with our industry, may be unsuccessful in obtaining market acceptance of these products and technologies.

**If we fail to develop and successfully introduce new products and technologies in response to competition and evolving technology, we may not be able to attract new customers or retain current customers.**

The markets in which we sell our Andrea DSP Microphone and Audio Software and Andrea Anti-Noise Headset products are highly competitive. We may not compete successfully with any of our competitors. Most of our current and potential competitors have significantly greater financial, technology development, marketing, technical support and other resources than we do. Consequently, these competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, or devote greater resources to the development, marketing, and sale of their products than we can. One or more of these competitors may independently develop technologies that are substantially equivalent or superior to our technology. The introduction of products incorporating new technologies could render our products obsolete and unmarketable and could exert price pressures on existing products.

We are currently engaged in the development of digital signal processing products and technologies for the voice, speech and natural language interface markets. We may not succeed in developing these new digital signal processing products and technologies, and any of these new digital signal processing products or technologies may not gain market acceptance.

Further, the markets for our products and technologies are characterized by evolving industry and government standards and specifications that may require us to devote substantial time and expense to adapt our products and technologies. For example, certain of our Andrea DSP Microphone and Audio Software and Andrea Anti-Noise Headset products are subject to the Federal Communications Commission requirements. We may not successfully anticipate and adapt our products and technologies in a cost effective and timely manner to changes in technology and industry standards or to introductions of new products and technologies by others that render our then existing products and technologies obsolete.

**If our marketing collaborators do not effectively market their products with which our products are included or incorporated, our sales growth will be adversely affected.**

We have entered into collaborative and distribution arrangements with software publishers and computer hardware manufacturers relating to the marketing and sale of Andrea DSP Microphone and Audio Software products through inclusion or incorporation with the products of our collaborators. Our success will therefore be dependent to a substantial degree on the efforts of these collaborators to market their products with which our products are included or incorporated. Our collaborators may not successfully market these products. In addition, our collaborators generally are not contractually obligated to any minimum level of sales of our products or technologies, and we have no control over their



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marketing efforts. Furthermore, our collaborators may develop their own microphone, earphone or headset products that may replace our products or technologies or to which they may give higher priority.

**Shortages of, or interruptions in, the supply of more specialized components for our products could have a material adverse effect on our sales of these products.**

The majority of our assembly operations are fulfilled by subcontractors (primarily in the Far East) using purchased components. Some specialized components for the Andrea DSP Microphone and Audio Software products and Andrea Anti-Noise products, such as microphones and digital signal processing boards, are available from a limited number of suppliers (in some cases foreign) and subject to

long lead times. We may not be able to continue to obtain sufficient supplies of these more specialized components, particularly if the sales of our products increase substantially or market demand for these components otherwise increases. If our subcontractors fail to meet our production and shipment schedules, our business, results of operations and financial condition would be materially and adversely affected.

**Our ability to compete may be limited by our failure to adequately protect our intellectual property or by patents granted to third parties.**

We rely on a combination of patents, patent applications, trade secrets, copyrights, trademarks, nondisclosure agreements with our employees, independent contractors, licensees and potential licensees, limited access to and dissemination of our proprietary information, and other measures to protect our intellectual property and proprietary rights. However, the steps that we have taken to protect our intellectual property may not prevent its misappropriation or circumvention. In addition, numerous patents have been granted to other parties in the fields of noise cancellation, noise reduction, computer voice recognition, digital signal processing and related subject matter. We expect that products in these fields will increasingly be subject to claims under these patents as the numbers of products and competitors in these fields grow and the functionality of products overlap. Claims of this type could have an adverse effect on our ability to manufacture and market our products or to develop new products and technologies, because the parties holding these patents may refuse to grant licenses or only grant licenses with onerous royalty requirements. Moreover, the laws of other countries do not protect our proprietary rights to our technologies to the same extent as the laws of the United States.

**An unfavorable ruling in any current litigation proceeding or future proceeding may adversely affect our business, results of operations and financial condition.**

From time to time we are subject to litigation incidental to our business. For example, we are subject to the risk of adverse claims, interference proceedings before the U.S. Patent and Trademark Office, oppositions to patent applications outside the United States, and litigation alleging infringement of the proprietary rights of others. Litigation to establish the validity of patents, to assert infringement claims against others, and to defend against patent infringement claims can be expensive and time-consuming, even if the outcome is in our favor.

**Changes in economic and political conditions outside the United States could adversely affect our business, results of operations and financial condition.**

We generate revenues to regions outside the United States, particularly in Europe and areas in the Americas and Asia. For the quarter ended March 31, 2006 and 2005, net revenues to customers outside the United States accounted for approximately 21% and 4%, respectively, of our net revenues. International revenues and operations are subject to a number of risks, including:

trade restrictions in the form of license requirements;

restrictions on exports and imports and other government controls;

changes in tariffs and taxes;

difficulties in staffing and managing international operations;

problems in establishing and managing distributor relationships;

general economic conditions; and

political and economic instability or conflict.

To date, we have invoiced our international revenues in U.S. dollars, and have not engaged in any foreign exchange or hedging transactions. We may not be able to continue to invoice all of our revenues in U.S. dollars in order to avoid engaging in foreign exchange or hedging transactions.

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If we are required to invoice any material amount of international revenues in non-U.S. currencies, fluctuations in the value of non-U.S. currencies relative to the U.S. dollar may adversely affect our business, results of operations and financial condition or require us to incur hedging costs to counter such fluctuations.

**If we are unable to attract and retain the necessary managerial, technical and other personnel necessary for our business, then our business, results of operations and financial condition will be harmed.**

Our performance is substantially dependent on the performance of our executive officers and key employees. The loss of the services of any of these executive officers or key employees could have a material adverse effect on our business, results of operations and financial condition. Our future success depends on our continuing ability to attract and retain highly qualified managers and technical personnel. Competition for qualified personnel is intense and we may not be able to attract, assimilate or retain qualified personnel in the future.

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## Results Of Operations

*Quarter ended March 31, 2006 compared to Quarter ended March 31, 2005.*

### Net Revenues

Net Revenues for the 2006 First Quarter were \$1,053,325, a decrease of 15% from net revenues of \$1,241,609 for the 2005 First Quarter. This decrease in net revenues reflects a 46% decrease in net revenues of Andrea DSP Microphone and Audio Software Products to \$317,207, or 30% of total net revenues and a 13% increase in net revenues of Andrea Anti-Noise Products to \$736,118, or 70% of total net revenues. The decrease in net revenues of Andrea DSP Microphone and Audio Software Products is primarily due to revenue recognized related to our agreements with Analog Devices. Included in the 2005 First Quarter net revenues was \$408,443 in amortization of license revenues recognized related to our agreements with Analog Devices. The unamortized portion of the same license agreements is recorded as deferred revenue as of March 31, 2005. All license revenues were being recognized on a straight-line basis over three-years, \$3 million of which started to be recognized during the first quarter of 2002, and \$2 million of which started in the third quarter of 2002. The increase in revenues of Andrea Anti-Noise Headset Products is primarily due to increased shipments to one of our OEM customers.

### Cost of Revenues

Cost of revenues as a percentage of revenues for the 2006 First Quarter increased to 47% from 37% for the 2005 First Quarter. This increase primarily reflects the impact of the changes in the composition of our revenues as described under Net Revenues above. This increase is specifically the result of the licensing revenue recognized related to our agreements with Analog Devices during the 2005 First Quarter.

### Research and Development

Research and development expenses for the 2006 First Quarter decreased 35% to \$133,535 from \$204,324 for the 2005 First Quarter. This decrease is primarily due to the closure of our Israel facility, decrease in operating costs as a result of our new lease and, to a lesser extent, other cost reduction efforts related to employee compensation and related benefit costs, legal and patent expenses as well as the company's strategic focus being re-directed towards sales and marketing efforts. Notwithstanding this decline, the substantial level of research and development is a reflection of our efforts to develop and commercialize DSP Microphone and Audio Software technologies, coupled with, to a lesser extent, Andrea Anti-Noise headset products. For the 2006 First Quarter, the Andrea DSP Microphone and Audio Software Technology efforts were \$103,537, or 78% of total research and development expenses and Andrea Anti-Noise Headset Product efforts were \$29,998, or 22% of total research and development expenses. With respect to DSP Microphone and Audio Software technologies, research efforts are primarily focused on the pursuit of commercializing a natural language-driven human/machine interface by developing optimal far-field microphone solutions for various voice-driven interfaces, incorporating Andrea's digital super directional array microphone technology, and certain other related technologies such as noise suppression and stereo acoustic echo cancellation. We believe that continued research and development spending should provide Andrea with a competitive advantage, however, as part of our overall effort to conserve cash, we intend to continue to reduce, where possible, the relatively high levels of such expenses during fiscal 2006.

### General, Administrative and Selling Expenses

General, administrative and selling expenses decreased approximately 37% to \$476,077 for the 2006 First Quarter from \$760,770 for the 2005 First Quarter. This decrease is primarily related to the decrease in operating costs as a result of our new lease and, to a lesser extent, other cost reduction efforts related to employee compensation and related benefit costs, legal and patent expenses, promotional costs, and depreciation expenses.

### Other expense

Other expense for the 2006 First Quarter was \$142 compared to other expense of \$50,586 for the 2005 First Quarter. This decrease in other expense is the result of the loss in disposal of property and equipment in the 2005 First Quarter.

### Provision for Income Taxes

We provide a full valuation allowance on future tax benefits until we can sustain a level of profitability that demonstrates our ability to utilize the assets, or other significant positive evidence arises that suggests our ability to utilize such assets. The future realization of a portion of our reserved deferred tax assets related to tax benefits associated with the exercise of stock options, if and when realized, will not result in a tax benefit in the unaudited condensed consolidated statement of operations, but rather will result in an increase in additional paid in capital. We will continue to re-assess our reserves on deferred income tax assets in future periods on a quarterly basis.



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Net Loss

Net loss for 2006 First Quarter was \$53,786 compared to a net loss of \$237,057 for the 2005 First Quarter. The net loss for the 2006 First Quarter principally reflects the factors described above.

**Liquidity And Capital Resources**

Andrea's principal sources of funds have historically been, and are expected to continue to be, gross cash flows from operations and proceeds from the sale of convertible notes, preferred stock or other securities to certain financial institutions, investors and potential industry partners. At March 31, 2006, we had cash and cash equivalents of \$370,695 compared with \$418,597 at December 31, 2005. The balance of cash and cash equivalents at March 31, 2006 is primarily a result of our cash provided from operations during the quarters ended September 30, 2005 and December 31, 2005 as well as the cash remaining from our issuance and sale of \$2,500,000 of our Series D Preferred Stock and Warrants in 2004, partially offset by gross cash outflows from operations from the time of the issuance through the quarter ended June 30, 2005 and gross cash outflows from operations during the First Quarter of 2006.

Working capital balance at March 31, 2006 was \$1,068,202 compared to a working capital balance of \$992,636 at December 31, 2005. The increase in working capital reflects an increase in total current assets of \$239,985 coupled with a decrease in total current liabilities of \$164,419. The increase in total current assets reflects a decrease in cash and cash equivalents of \$47,902, an increase in accounts receivable of \$29,100, an increase in inventory of \$60,157, and an increase in prepaid expenses and other current assets of \$198,630. The increase in total current liabilities reflects an increase in trade accounts payable of \$178,721, and a decrease of \$14,302 in other current liabilities. The decrease in cash and cash equivalents of \$47,902 reflects \$44,629 of net cash used in operating activities, \$225 of net cash used in investing activities and \$3,048 of net cash used in financing activities.

The cash used in operating activities of \$44,629, excluding non-cash charges, is attributable to the \$53,644 net loss from operations for the quarter ended March 31, 2006, a \$28,638 increase in accounts receivable, a \$59,949 increase in inventory, a \$198,630 increase in prepaid expenses and other current assets, a \$178,721 increase in accounts payable, and a \$14,302 decrease in other current and long-term liabilities. The changes in receivables, inventory, prepaid expenses and accounts payable primarily reflect differences in the timing related to both the payments for and the acquisition of inventory as well as for other services in connection with ongoing efforts related to Andrea's various product lines.

The cash used in investing activities reflects patents and trademarks expenditures of \$225 associated with intellectual property related to our Andre Anti-Noise Products.

The net cash used in financing activities of \$3,048 reflects payment of our capital leases associated with communication related equipment.

We plan to continue to improve our cash flows during 2006 by identifying additional cost savings opportunities. Additionally we will be aggressively pursuing 1) existing sales opportunities in our Andrea Anti-Noise Headset Products market, 2) existing and prospective opportunities to sell our Superbeam Array Microphone generated through our co-marketing efforts with Analog Devices in the personal computing market, 3) opportunities in the video and audio conferencing market and 4) the automotive (in-vehicle computing) market. However, there can be no assurance that we will be able to successfully execute the aforementioned plans. As of May 10, 2006, Andrea has approximately \$180,000 (unaudited) of cash and cash equivalents. During 2005, we utilized approximately \$400,000 in cash. This cash balance included net lease termination cash expenditures of approximately \$210,000, rent expense under our previous operating lease of approximately \$150,000 partially offset by the settlement reached with the current owner of the Company's former building in Long Island City to release of approximately \$110,000 of funds held in escrow. As a result, we believe that we have sufficient liquidity available to continue in operation through at least March 2007. To the extent that we do not generate sufficient cash flows from our operations in 2006, additional financing might be required. Although we are improving cash flows by reducing overall expenses, if our revenues decline, these reductions may impede our ability to be cash flow positive and our net income or loss may be disproportionately affected. We have no commitment for additional financing and may experience difficulty in obtaining additional financing on favorable terms, if at all. Any financing we obtain may contain covenants that restrict our freedom to operate our business or may have rights, preferences or privileges senior to our common stock and may dilute our current shareholders' ownership interest in Andrea. We cannot assure that demand will continue for any of our products, including future products related to our Andrea DSP Microphone and Audio Software technologies, or, that if such demand does exist, that we will be able to obtain the necessary working capital to increase production and provide marketing resources to meet such demand on favorable terms, or at all.

**ITEM 3. CONTROLS AND PROCEDURES**

Andrea's management, including its principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's disclosure controls and procedures, as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the Exchange Act). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of

the end of the period covered by this report, Andrea's disclosure controls and procedures were effective for

the purpose of ensuring that the information required to be disclosed in the reports that it files or submits under the Exchange Act with the Securities and Exchange Commission (the "SEC") (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Andrea's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

There have been no changes in the Company's internal controls over financial reporting that have materially affected, or is reasonable likely to materially affect the Company's internal controls over financial reporting during the period covered by this Quarterly Report.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that all control issues and instance of fraud, if any, within a company have been detected. Andrea's disclosure controls and procedures are designed to provide reasonable assurance of achieving its objectives.

## **PART II OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

Andrea is involved in routine litigation incidental through the normal course of business. While it is not feasible to predict or determine the final outcome of the claims, Andrea believes the resolution of these matters will not have a material adverse effect on Andrea's financial position, results of operations or liquidity.

See Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations Cautionary Statement Regarding Forward-Looking Statements. An unfavorable ruling in any current litigation proceeding or future proceeding may adversely affect our business, results of operations and financial condition and Note 7 to the unaudited condensed consolidated financial statements in this quarterly report for a discussion of the legal proceedings of Andrea.

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

None.

### **ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITIES HOLDERS**

None.

### **ITEM 5. OTHER INFORMATION**

None.

### **ITEM 6. EXHIBITS**

#### **a) Exhibits**

Exhibit 31 Rule 13a-14(a)/15d-14(a) Certifications



Exhibit 32 Section 1350 Certifications

**SIGNATURES**

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

ANDREA ELECTRONICS CORPORATION

By: /s/ DOUGLAS J. ANDREA  
Name: **Douglas J. Andrea**  
Title: **Chairman of the Board, President, Chief Executive Officer and Corporate Secretary**

Date: May 12, 2006

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|---|---|--------------|
| /s/ DOUGLAS J. ANDREA<br><b>Douglas J. Andrea</b> | Chairman of the Board, President, Chief Executive Officer and Corporate Secretary | May 12, 2006 |
| /s/ CORISA L. GUIFFRE<br><b>Corisa L. Guiffre</b> | Vice President, Chief Financial Officer and Assistant Corporate Secretary         | May 12, 2006 |