

ANDREA ELECTRONICS CORP  
Form 10-Q  
November 14, 2012

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

FORM 10-Q

(Mark One)

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended September 30, 2012

OR

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-4324

ANDREA ELECTRONICS  
CORPORATION  
(Exact name of registrant as  
specified in its charter)

New York  
(State or other jurisdiction of  
incorporation or organization)

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

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

11716  
(Zip Code)

Registrant's telephone number (including area code):

631-719-1800

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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

Large Accelerated Filer o

Accelerated Filer o

Non-Accelerated Filer o

Smaller Reporting Company x

(Do not check if a smaller reporting company)

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: As of November 9, 2012, there were 63,721,035 common shares outstanding.

## PART I. FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

#### ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2012	December 31, 2011
	(unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash	\$ 2,006,374	\$ 2,193,377
Accounts receivable, net of allowance for doubtful accounts of \$18,316 and \$18,580, respectively	278,194	562,763
Inventories, net	742,343	702,177
Deferred income taxes, net		22,801
Prepaid expenses and other current assets	115,102	108,236
Total current assets	3,142,013	3,589,354
Property and equipment, net	274,090	307,440
Intangible assets, net	862,577	1,195,886
Deferred income taxes, net		131,820
Other assets, net	12,864	12,864
Total assets	\$ 4,291,544	\$ 5,237,364
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Trade accounts payable	\$ 415,848	\$ 267,353
Accrued Series C Preferred Stock Dividends	73,921	73,921
Other current liabilities	134,405	167,594
Total current liabilities	624,174	508,868
Series B Redeemable Convertible Preferred Stock, \$.01 par value; authorized: 1,000 shares; issued and outstanding: 0 shares		
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: 44.2 shares; liquidation value: \$442,314	1	1
Series D Convertible Preferred Stock, net, \$.01 par value; authorized: 2,500,000 shares; issued and outstanding: 907,144 shares; liquidation value: \$907,144	9,072	9,072

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Common stock, \$.01 par value; authorized: 200,000,000 shares; issued and outstanding: 63,721,035 shares

	637,210	637,210
Additional paid-in capital	77,515,499	77,462,595
Accumulated deficit	(74,494,412)	(73,380,382)
Total shareholders' equity	3,667,370	4,728,496
Total liabilities and shareholders' equity	\$ 4,291,544	\$ 5,237,364

See Notes to Condensed Consolidated Financial Statements.

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## ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
<b>Revenues</b>				
Net product revenues	\$ 817,416	\$1,072,411	\$2,042,628	\$2,248,081
License revenues	125,851	244,603	550,208	944,309
Revenues	943,267	1,317,014	2,592,836	3,192,390
Cost of revenues	456,871	554,473	1,170,739	1,186,281
Gross margin	486,396	762,541	1,422,097	2,006,109
Research and development expenses	189,822	182,178	574,871	577,306
General, administrative and selling expenses	642,319	647,036	1,813,011	1,795,710
Loss from operations	(345,745)	(66,673)	(965,785)	(366,907)
Interest income, net	2,053	2,053	6,392	5,742
Loss before provision for income taxes	(343,692)	(64,620)	(959,393)	(361,165)
Provision for income taxes	154,621	2,290	154,637	19,251
Net loss	\$ (498,313)	\$ (66,910)	\$ (1,114,030)	\$ (380,416)
Basic and diluted weighted average shares	63,721,035	63,721,035	63,721,035	63,721,035

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Basic and diluted net loss per share \$ (.01) \$(.00) \$(.02) \$(.01)

See Notes to Condensed Consolidated Financial Statements.

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**ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES**  
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2012  
(UNAUDITED)

	Series C Convertible Preferred Stock Outstanding	Series C Convertible Preferred Stock	Series D Convertible Preferred Stock Outstanding	Series D Convertible Preferred Stock	Common Stock Shares Outstanding	Common Stock	Additional Paid-In Capital
Balance, January 1, 2012	44,231,432	\$ 1	907,144	\$ 9,072	63,721,035	\$ 637,210	\$ 77,462,595
Stock-based Compensation Expense related to Stock Option Grants							52,904
Net loss							
Balance, September 30, 2012	44,231,432	\$ 1	907,144	\$ 9,072	63,721,035	\$ 637,210	\$ 77,515,499

See Notes to Condensed Consolidated Financial Statements.

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**ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES**  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

	For the Nine Months Ended	
	September 30, 2012	September 30, 2011
Cash flows from operating activities:		
Net loss	\$(1,114,030)	\$ (380,416)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	429,258	406,328
Stock based compensation	52,904	136,415
Provision for doubtful accounts		7,167
Deferred income taxes	154,621	19,079
Change in:		
Accounts receivable	284,569	(309,873)
Inventories	(40,166)	22,034
Prepaid expenses and other current assets	(6,866)	36,252
Trade accounts payable	148,495	168,455
Short-term deferred revenue		(109,632)

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Other current liabilities	(33,189)	(41,937)
Net cash used in operating activities	(124,404)	(46,128)
Cash flows from investing activities:		
Purchases of property and equipment	(35,293)	(124,424)
Purchases of patents and trademarks	(27,306)	(15,642)
Net cash used in investing activities	(62,599)	(140,066)
Cash flows from financing activities:		
Principal repayments of long term debt		(29,527)
Net cash used in financing activities		(29,527)
Net decrease in cash	(187,003)	(215,721)
Cash, beginning of year	2,193,377	2,220,994
Cash, end of period	\$ 2,006,374	\$ 2,005,273
Supplemental disclosures of cash flow information:		
Cash paid for:		
Income Taxes	\$ 4,041	\$ 4,637
Interest	\$	\$ 1,731

See Notes to Condensed Consolidated Financial Statements.

## ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

### Note 1. Basis of Presentation and Management's Liquidity Plans

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

These unaudited condensed consolidated interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In addition, the December 31, 2011 balance sheet data was derived from the audited consolidated financial statements, but does not include all disclosures required by GAAP. 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 any other interim period or for the fiscal year.

These unaudited condensed consolidated interim financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2011 included in the Company's Form 10-K for the fiscal year ended December 31, 2011, filed on March 23, 2012. The accounting policies used in preparing these unaudited condensed consolidated interim financial statements are consistent with those described in the December 31, 2011 audited consolidated financial statements.

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

**(Loss) Earnings Per Share** - Basic (loss) earnings per share is computed by dividing the net (loss) income by the weighted average number of common shares outstanding during the period. Diluted (loss) earnings adjusts basic (loss) earnings 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. 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:

	For the Three and Nine Months Ended September 30, 2012	September 30, 2011
Total potential common shares as of:		
Options to purchase common stock (Note 6)	17,375,821	17,760,321
Series C Convertible Preferred Stock and related accrued dividends (Note 3)	2,023,658	2,023,658
Series D Convertible Preferred Stock and related warrants (Note 4)	3,628,576	3,628,576
Total potential common shares	23,028,055	23,412,555

**Cash** - Cash includes cash and highly liquid investments with original maturities of three months or less. At times during the periods ended September 30, 2012 and December 31, 2011, the Company had cash deposits in excess of the maximum amounts insured by the Federal Deposit Insurance Corporation insurance limits. At September 30, 2012 and December 31, 2011, the Company's cash is held at three financial institutions.

**Concentration of Credit Risk** - The following customers accounted for 10% or more of Andrea's consolidated net revenues during at least one of the periods presented below:

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2012	September 30, 2011	September 30, 2012	September 30, 2011
Customer A	13%	16%	20%	24%
Customer B	32%	25%	15%	12%

Customer A accounted for approximately 44% of total accounts receivable at September 30, 2012. Customer A and Customer B accounted for approximately 61% and 8%, respectively, of total accounts receivable at December 31, 2011.

The following suppliers accounted for 10% or more of Andrea's purchases during the periods presented below:

**ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

(UNAUDITED)

	For the Three Months Ended September 30,	September 30,	For the Nine Months Ended September 30,	September 30,
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	2012	2011	2012	2011
Supplier A	94%	64%	67%	69%
Supplier B	*	*	15%	*
Supplier C	*	30%	*	16%

\* Amounts are less than 10%

At September 30, 2012 and December 31, 2011, Supplier A accounted for approximately 69% and 64% of accounts payable, respectively.

**Allowance for Doubtful Accounts** - The Company performs on-going credit evaluations of its customers and adjusts credit limits based upon payment history and the customer's current credit worthiness, as determined by the review of their current credit information. Collections and payments from customers are continuously monitored. The Company maintains an allowance for doubtful accounts, which is based upon historical experience as well as specific customer collection issues that have been identified. While such bad debt expenses have historically been within expectations and allowances established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has in the past. If the financial condition of customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

**Inventories** - Inventories are stated at the lower of cost (on a first-in, first-out) or market basis. The cost of inventory is based on the respective cost of materials. Andrea reviews its inventory reserve for obsolescence on a quarterly basis and establishes reserves on inventories based on the specific identification method as well as a general reserve. Andrea records changes in inventory reserves as part of cost of revenues.

	September 30, 2012	December 31, 2011
Raw materials	\$ 26,516	\$ 19,044
Finished goods	1,361,060	1,338,730
	1,387,576	1,357,774
Less: reserve for obsolescence	(645,233)	(655,597)
	\$ 742,343	\$ 702,177

**Intangible and Lived Assets** - Andrea accounts for its long-lived assets in accordance with Statement of Financial Accounting Standards Board (FASB) Accounting Standard Codification (ASC) 360 Plant, Property and Equipment, 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 is not recoverable using the sum of an undiscounted cash flow projection (gross margin dollars from product sales), the impaired asset is adjusted to its estimated fair value, based on an estimate of future discounted cash flows which becomes the new cost basis for the impaired asset. 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. No impairment charges were recognized during the three and nine month periods ended September 30, 2012 and 2011.

**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 ASC 985, Software and ASC 605 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 arrangements and the corresponding revenue is generally recognized as the services are performed.

**Income Taxes** - Andrea accounts for income taxes in accordance with ASC 740, Income Taxes (ASC 740). ASC 740 requires an asset and liability approach for financial accounting and reporting for income taxes and establishes for all entities a minimum threshold for financial statement recognition of the benefit of tax positions, and requires certain expanded disclosures. The provision for income taxes is based upon income or loss after adjustment for those permanent items that are not considered in the determination of taxable income. Deferred income taxes represent the tax effects of differences between the financial reporting and tax bases of the Company's assets and liabilities at the enacted tax rates in effect for the years in which the differences are expected to reverse. The Company evaluates the recoverability of deferred tax assets and

establishes a valuation allowance when it is more

**ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**  
**(UNAUDITED)**

likely than not that some portion or all of the deferred tax assets will not be realized. After considering changes in previously existing positive and negative evidence, the Company determined that a full valuation allowance against the deferred tax asset was required. As a result during the three months ended September 30, 2012, the Company recorded a provision for income tax of \$154,261. Andrea will reduce its valuation allowance in future periods when it becomes more likely than not that they have the ability to utilize the assets. Management makes judgments as to the interpretation of the tax laws that might be challenged upon an audit and cause changes to previous estimates of tax liability. In management's opinion, adequate provisions for income taxes have been made for all years. If actual taxable income by tax jurisdiction varies from estimates, additional allowances or reversals of reserves may be necessary. Income tax expense consists of the tax payable for the period and the change during the period in deferred tax assets and liabilities. The Company has identified its federal tax return and its state tax return in New York as major tax jurisdictions. Based on the Company's evaluation, it has been concluded that there are no significant uncertain tax positions requiring recognition in the Company's condensed consolidated interim financial statements. The Company's evaluation was performed for tax years ended 2008 through 2011. The Company believes that its income tax positions and deductions will be sustained on audit and does not anticipate any adjustments that will result in a material change to its financial position.

Stock-Based Compensation - At September 30, 2012, Andrea had two stock-based employee compensation plans, which are described more fully in Note 6. Andrea accounts for stock-based compensation in accordance with ASC 718, Compensation - Stock Compensation (ASC 718). ASC 718 establishes accounting for stock-based awards exchanged for employee services. Under the provisions of ASC 718, stock-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as expense over the employee's requisite service period (generally the vesting period of the equity grant). The fair value of the Company's common stock options are estimated using the Black Scholes option-pricing model with the following assumptions: expected volatility, dividend rate, risk free interest rate and the expected life. The Company expenses stock-based compensation by using the straight-line method. In accordance with ASC 718, excess tax benefits realized from the exercise of stock-based awards are classified in cash flows from financing activities. The future realization of the reserved deferred tax assets related to these tax benefits associated with the exercise of stock options will result in a credit to additional paid in capital if the related tax deduction reduces taxes payable. The Company has elected the with and without approach regarding ordering of windfall tax benefits to determine whether the windfall tax benefit did reduce taxes payable in the current year. Under this approach, the windfall tax benefit would be recognized in additional paid-in-capital only if an incremental tax benefit is realized after considering all other benefits presently available.

Use of Estimates - The preparation of condensed consolidated interim 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 disclosures of contingent assets and liabilities at the date of the condensed consolidated interim financial statements and the reported amounts of revenues and expenses during the reporting period.

Management bases its estimates on historical experience and on various assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. The most significant estimates, among other things, are used in accounting for allowances for bad debts, inventory valuation and obsolescence, product warranty, depreciation, deferred income taxes, expected realizable values for assets (primarily intangible assets), contingencies, revenue recognition as well as the recording and presentation of the Company's convertible preferred stock. Estimates and assumptions are periodically reviewed and the effects of any material revisions are reflected in the condensed consolidated interim financial statements in the period that they are determined to be necessary. Actual results could differ from those estimates and assumptions.

Reclassifications - Certain prior year amounts have been reclassified to conform to the current year presentation.

Subsequent Events - The Company evaluates events that occurred after the balance sheet date but before the condensed consolidated interim financial statements are issued. Based upon the evaluation the Company did not identify any recognized or non-recognized subsequent events that would have required adjustment or disclosure in the condensed consolidated interim financial statements.

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



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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"). Each of these shares of Series C Preferred Stock had a stated value of \$10,000 plus a \$1,671 increase in the stated value, which sum is convertible into Common Stock at a conversion price of \$0.2551. On February 17, 2004, Andrea announced that it had entered into an Exchange and Termination Agreement and an Acknowledgment and Waiver Agreement, which eliminated the dividend of 5% per annum on the stated value. The additional amount of \$1,671 represents the 5% per annum from October 10, 2000 through February 17, 2004. The shares of Series C Preferred Stock are subject to antidilution provisions, which are triggered in the event of certain stock splits, recapitalizations, or other dilutive transactions. In addition, issuances of common stock at a price below the conversion price then in effect (currently \$0.2551), or the issuance of warrants,

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### ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

#### NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

options, rights, or convertible securities which have an exercise price or conversion price less than that conversion price, other than for certain previously outstanding securities and certain "excluded securities" (as defined in the certificate of amendment), require the adjustment of the conversion price to that lower price at which shares of common stock have been issued or may be acquired. In the event that Andrea issues securities in the future which have a conversion price or exercise price which varies with the market price and the terms of such variable price are more favorable than the conversion price in the Series C Preferred Stock, the purchasers may elect to substitute the more favorable variable price when making conversions of the Series C Preferred Stock.

In accordance with Sub Topic 815-40, Andrea evaluated the Series C Preferred Stock and concluded that it is not indexed to the Company's stock because of the conversion price adjustment feature described above. Accordingly, under the provisions of ASC 815, "Derivatives and Hedging" (ASC 815), Andrea evaluated the Series C Preferred Stock embedded conversion feature. The Company has concluded that the embedded conversion feature would be classified in stockholders' equity if it were a freestanding instrument as the Series C Preferred Stock is more akin to equity and as such it should not be bifurcated from the Series C instrument and accounted for separately.

As of September 30, 2012, there were 44,231,432 shares of Series C Preferred Stock outstanding, which were convertible into 2,023,658 shares of Common Stock and remaining accrued dividends of \$73,921.

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

On February 17, 2004, Andrea entered into a Securities Purchase Agreement (including a Registration Rights Agreement) with certain holders of the Series C Preferred Stock 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. These warrants were exercisable at any time after August 17, 2004, at an exercise price of \$0.38 per share. On February 23, 2009, these warrants expired without being exercised.

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 were exercisable at any time after December 4, 2004 and before June 4, 2009 at an exercise price of \$0.17 per share. On June 4, 2009, these warrants expired without being exercised.

The shares of Series D Preferred Stock are also subject to antidilution provisions, which are triggered in the event of certain stock splits, recapitalizations, or other dilutive transactions. In addition, issuances of common stock at a price below the conversion price then in effect (currently \$0.25), or the issuance of warrants, options, rights, or convertible securities which have an exercise price or conversion price less than that conversion price, other than for certain previously outstanding securities and certain "excluded securities" (as defined in the certificate of amendment), require the adjustment of the conversion price to that lower price at which shares of common stock have been issued or may be acquired. In the event that Andrea issues securities in the future which have a conversion price or exercise price which varies with the market price and the terms of such variable price are more favorable than the conversion price in the Series D Preferred Stock, the purchasers may elect to substitute the more favorable variable price when making conversions of the Series D Preferred Stock. In addition, the Company is required to use its best efforts to secure the inclusion for quotation on the Over the Counter Bulletin Board for the common stock issuable under the Series D Preferred Stock and to arrange for at least two market makers to register with the Financial Industry Regulatory Authority. In the event that

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the holder of the Series D Preferred Stock and related warrants is unable to convert these securities into Andrea Common Stock, the Company shall pay to each such holder a Registration Delay Payment. This payment is to be paid in cash and is equal to the product of (i) the stated value of such Preferred Shares multiplied by (ii) the product of (1) .0005 multiplied by (2) the number of days that sales cannot be made pursuant to the Registration Statement (excluding any days during that may be considered grace periods as defined by the Registration Rights Agreement).

In accordance with Sub Topic 815-40, Andrea evaluated the Series D Preferred Stock and concluded that it is not considered to be indexed to the Company's stock because of the conversion price adjustment feature described above. Accordingly, under the provisions of ASC 815, Andrea evaluated the Series D Preferred Stock embedded conversion feature. The Company has concluded that the embedded conversion feature would be classified in stockholders' equity if it were a freestanding instrument as the Series D Preferred Stock is more akin to equity and as such it should not be bifurcated from the Series D instrument and accounted for separately.

As of September 30, 2012, there were 907,144 shares of Series D Preferred Stock outstanding which were convertible into 3,628,576 shares of Common Stock.

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### ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

#### NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(UNAUDITED)

#### **Note 5. Commitments And Contingencies**

##### Leases

Andrea leases its corporate headquarters located in Bohemia, New York. The lease from an unrelated party, which currently expires in April 2015, is for approximately 11,000 square feet and houses Andrea's warehousing, sales and executive offices. Rent expense under this operating lease was \$23,729 and \$70,265 for the three and nine-month periods ended September 30, 2012, respectively. Rent expense under this operating lease was \$23,038 and \$68,270 for the three and nine month periods ended September 30, 2011, respectively.

As of September 30, 2012, the minimum annual future lease payments, under this lease and all other noncancellable operating leases, are as follows:

2012 (October 1 – December 31)	\$ 27,666
2013	112,562
2014	112,575
2015	37,749
Total	\$290,552

##### Employment and Change in Control Agreements

In July 2012, the Company entered into an employment agreement with Mr. Andrea. The effective date of the employment agreement is August 1, 2012 and expires July 31, 2013 and is subject to renewal as approved by the Compensation Committee of the Board of Directors. Pursuant to his employment agreement, Mr. Andrea will receive an annual base salary of \$350,000 (which was identical to Mr. Andrea's salary for the period from August 1, 2011 to July 31, 2012) through July 31, 2013. The employment agreement provides for quarterly bonuses equal to 25% of the Company's pre-bonus net after tax quarterly earnings in excess of \$25,000 for a total quarterly bonus amount not to exceed \$12,500; and annual bonuses equal to 10% of the Company's annual pre-bonus net after tax earnings in excess of \$300,000. Adjustments to net after tax earnings shall be made to remove the impact of change in recognition of accumulated deferred tax asset value. All bonuses shall be payable as soon as the Company's cash flow permits. All bonus determinations or any additional bonus in excess of the above will be made in the sole discretion of the Compensation Committee. Mr. Andrea is also entitled to a change in control payment equal to two times his salary with continuation of health and medical benefits for two years in the event of a change in control. In the event of his termination without cause or resignation with the Company's consent, Mr. Andrea is also entitled to a severance payment equal to six months of his salary and a continuation for 12 months of health insurance coverage for Mr. Andrea, his spouse and his dependents. At September 30, 2012, the future minimum cash commitments under this agreement aggregate \$291,667.

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In November 1999, as amended August 2008, the Company entered into a change in control agreement with the Chief Financial Officer, Corisa L. Guiffre. This agreement provides for a change in control payment equal to three times her average annual compensation for the five preceding taxable years, with continuation of health and medical benefits for three years in the event of a change in control of the Company, as defined in the agreement, and subsequent termination of employment other than for cause.

### 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 the claims, Andrea believes any resolution of these matters will not have a material adverse effect on Andrea's consolidated financial position, results of operations or liquidity.

In addition, in December 2010, Audrey Edwards, Executrix of the Estate of Leon Leroy Edwards, filed a law suit in the Superior Court of Providence County, Rhode Island, against 3M Company and over 90 other defendants, including the Company, alleging that the Company processed, manufactured, designed, tested, packaged, distributed, marketed or sold asbestos containing products that contributed to the death of Leon Leroy Edwards. The Company received service of process in April 2011. The Company has retained legal counsel and has filed a response to the complaint. The Company believes the lawsuit is without merit. Accordingly, the Company does not believe the lawsuit will have a material adverse effect on the Company's financial position or results of operations.

### **Note 6. Stock Plans and Stock Based Compensation**

In 1998, the Board adopted the 1998 Stock Option Plan ( 1998 Plan ), which was subsequently approved by the shareholders. The 1998 Plan, as amended, authorizes the granting of awards, the exercise of which would allow up to an aggregate of 6,375,000 shares of Andrea's Common Stock to be acquired by the holders of those awards. The awards can take the form of stock options, stock

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### **ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES** **NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS** **(UNAUDITED)**

appreciation rights, restricted stock, deferred stock, stock reload options or other stock-based awards. Awards may be granted to key employees, officers, directors and consultants. No further awards will be granted under the 1998 Plan.

In October 2006, the Board adopted the Andrea Electronics Corporation 2006 Equity Compensation Plan ( 2006 Plan ), which was subsequently approved by the shareholders. The 2006 Plan, as amended, authorizes the granting of awards, the exercise of which would allow up to an aggregate of 18,000,000 shares of Andrea's Common Stock to be acquired by the holders of those awards. The awards can take the form of stock options, stock appreciation rights, restricted stock or other stock-based awards. Awards may be granted to key employees, officers, directors and consultants. At September 30, 2012, there were 4,276,436 shares available for further issuance under the 2006 Plan.

The stock option awards granted under these plans have been granted with an exercise price equal to the market price of the Company's stock at the date of grant; with vesting periods of up to four years and 10-year contractual terms.

The fair values of each stock option grant is estimated on the date of grant using the Black-Scholes option-pricing model that uses the weighted-average assumptions noted in the following table. Expected volatilities are based on implied volatilities from historical volatility of the Company's stock. The expected term of options granted represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

There were no options granted during the three and nine months ended September 30, 2012 and 2011.

Option activity during 2012 is summarized as follows:

Options Outstanding

Options Exercisable

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	Options Outstanding	Weighted Average Exercise Price	Weighted Average Fair Value	Weighted Average Remaining Contractual Life	Options Exercisable	Weighted Average Exercise Price	Weighted Average Fair Value	Weighted Average Remaining Contractual Life
At January 1, 2012	17,760,321	\$0.10	\$0.09	5.83 years	15,489,553	\$0.10	\$0.09	5.50 years
Forfeited	(6,000)	\$0.08	\$0.08					
Expired	(378,500)	\$0.68	\$0.64					
At September 30, 2012	17,375,821	\$0.08	\$0.08	5.20 years	16,656,237	\$0.08	\$0.08	5.09 years

During the three months ended September 30, 2012, 1,499,260 options vested with a weighted average exercise price and a weighted average fair value of \$0.09 per option. During the nine months ended September 30, 2012, 1,545,184 options vested with a weighted average exercise price and a weighted average fair value of \$0.09 per option. The intrinsic value for these options for the three and nine months ended September 30, 2012 was \$51,750.

Total compensation expense recognized related to stock option awards was \$12,272 and \$33,576 for the three months ended September 30, 2012 and 2011, respectively. In the accompanying condensed consolidated statements of operations for the three months ended September 30, 2012, \$9,643 of expense is included in general, administrative and selling expenses, \$1,666 is included in research and development expenses and \$963 is included in cost of revenues. In the accompanying consolidated statements of operations for the three months ended September 30, 2011, \$26,400 of expense is included in general, administrative and selling expenses, \$4,746 is included in research and development expenses and \$2,430 is included in cost of revenues. Total compensation expense recognized related to all stock option awards was \$52,904 and \$136,415 for the nine months ended September 30, 2012 and 2011, respectively. In the accompanying condensed consolidated statements of operations for the nine months ending September 30, 2012, \$42,751 of expense is included in general, administrative and selling expenses, \$6,880 is included in research and development expenses and \$3,273 is included in cost of revenues. In the accompanying condensed consolidated statements of operations for the nine months ending September 30, 2011, \$109,751 of expense is included in general, administrative and selling expenses, \$18,678 is included in research and development expenses and \$7,986 is included in cost of revenues.

As of September 30, 2012, there was \$19,879 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the 1998 and 2006 Plans. This unrecognized compensation cost is expected to be recognized over the next 2 years (\$5,717 in 2012 and \$14,162 in 2013).

## Note 7. Segment Information

Andrea follows the provisions of ASC 280 Segment Reporting (ASC 280). Reportable operating segments are determined based on Andrea's management approach. The management approach, as defined by ASC 280, is based on the way that the chief

## ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

### NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS (UNAUDITED)

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. Andrea Anti-Noise Products include noise cancellation and active noise cancellation computer headset products and related computer peripheral products.

The following represents selected condensed consolidated interim financial information for Andrea's segments for the three-month periods ended September 30, 2012 and 2011.

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2012 Three Month Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti- Noise Products	2012 Three Month Total
Net revenues from external customers	\$ 88,187	\$ 729,229	\$ 817,416
License revenues	125,851		125,851
Loss from operations	(222,383)	(123,362)	(345,745)
Depreciation and amortization	120,689	23,557	144,246
Purchases of property and equipment	4,121	1,463	5,584
Purchases of patents and trademarks	1,346	2,909	4,255
Assets	2,245,081	2,046,463	4,291,544
Total long lived assets	775,072	361,595	1,136,667

2011 Three Month Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti- Noise Products	2011 Three Month Total
Net revenues from external customers	\$228,186	\$ 844,225	\$1,072,411
License revenues	244,603		244,603
Loss from operations	45,793	(112,466)	(66,673)
Depreciation and amortization	119,925	19,868	139,793
Purchases of property and equipment	4,667	92,287	96,954
Purchases of patents and trademarks	2,692	1,539	4,231

December 31, 2011 Year End Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti- Noise Products	2011 Year End Total
Assets	\$3,114,849	\$2,122,515	\$5,237,364
Total long lived assets	1,150,426	352,900	1,503,326

The following represents selected condensed consolidated interim financial information for Andrea's segments for the nine-month periods ended September 30, 2012 and 2011:

2012 Nine Month Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti- Noise Products	2012 Nine Month Total
Net revenues from external customers	\$ 399,558	\$1,643,070	\$2,042,628
License revenues	550,208		550,208
Loss from operations	(397,000)	(568,785)	(965,785)
Depreciation and amortization	361,464	67,794	429,258
Purchases of property and equipment	6,574	28,719	35,293
Purchases of patents and trademarks	12,569	14,737	27,306
2011 Nine Month Segment Data			

**ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES**
**NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**
**(UNAUDITED)**

2012 Nine Month Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti- Noise Products	2011 Nine Month Total
Net revenues from external customers	\$ 374,414	\$ 1,873,667	\$ 2,248,081
License revenues	944,309		944,309
Income (loss) from operations	93,469	(460,376)	(366,907)
Depreciation and amortization	358,959	47,369	406,328
Purchases of property and equipment	19,761	104,663	124,424
Purchases of patents and trademarks	12,810	2,832	15,642

Management assesses 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 September 30, 2012 and 2011 net revenues by geographic area are as follows:

Geographic Data	September 30, 2012	September 30, 2011
Net revenues:		
United States	\$ 778,503	\$ 1,181,826
Foreign <sup>(1)</sup>	164,764	135,188
	\$ 943,267	\$ 1,317,014

- (1) Net revenues to any one foreign country did not exceed 10% of total net revenues for the three months ended September 30, 2012 and September 30, 2011.

For the nine-month periods ended September 30, 2012 and 2011, net revenues by geographic area are as follows:

Geographic Data	September 30, 2012	September 30, 2011
Net revenues:		
United States	\$ 2,166,970	\$ 2,711,775
Foreign <sup>(1)</sup>	425,866	480,615
	\$ 2,592,836	\$ 3,192,390

- (1) Net revenues to any one foreign country did not exceed 10% of total net revenues for the nine months ended September 30, 2012 and September 30, 2011.

As of September 30, 2012 and December 31, 2011, accounts receivable by geographic area is as follows:

Geographic Data	September 30, 2012	December 31, 2011
Accounts receivable:		
United States	\$ 252,694	\$ 499,679

Foreign <sup>(1)</sup>	25,500	63,084
	\$ 278,194	\$ 562,763

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

### 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 interim financial statements and the notes to our unaudited condensed consolidated interim 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 requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. On a continual basis, management reviews its estimates utilizing currently available information, changes in facts and circumstances, historical experience and reasonable assumptions. After such reviews, and if deemed appropriate, those estimates are adjusted accordingly. Actual results may vary from these estimates and assumptions under different and/or future circumstances. Our significant accounting policies are described in Note 2 of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2011. A discussion of our critical accounting policies and estimates are included in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2011. Management has discussed the development and selection of these policies with the Audit Committee of the Company's Board of Directors, and the Audit Committee of the Board of Directors has reviewed the Company's disclosures of these policies. There have been no material changes to the critical accounting policies or estimates reported in the Management's Discussion and Analysis section of the Annual Report on Form 10-K for the year ended December 31, 2011.

### Cautionary Statement Regarding Forward-Looking Statements

This report contains forward-looking statements that are based on assumptions and may describe future plans, strategies and expectations of the Company. These forward-looking statements are generally identified by use of the words believe, expect, intend, anticipate, estimate, project, or similar expressions. The Company's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in economic, competitive, governmental, technological and other factors that may affect our business and prospects. Additional factors are discussed below under Risk Factors and in Part I, *Item 1A Risk Factors* in the Company's Annual Report on Form 10-K for the year ended December 31, 2011. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not

be placed on such statements. Except as required by applicable law or regulation, the Company does not undertake, and specifically disclaims any obligation, to release publicly the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

## Risk Factors

**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; and
- 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 net revenues for the three months ended September 30, 2012 were \$943,267 compared to \$1,317,014 for the three months ended September 30, 2011. Net loss for the three months ended September 30, 2012 was \$498,313, or \$0.01 loss per share on a basic and diluted basis compared to net loss of \$66,910 or \$0.00 loss per share on a basic and diluted basis for the three months ended September 30, 2011. Our revenues for the nine months ended September 30, 2012 were \$2,592,836 compared to \$3,192,390 for the nine months ended September 30, 2011. Net loss for the nine months ended September 30, 2012 was \$1,114,030 or \$.02 loss per share on a basic and diluted basis, compared to net loss of \$380,416, or \$.01 loss per share on a basic and diluted basis for the nine months ended September 30, 2011. 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.

## **Shares Eligible For Future Sale May Have An Adverse Effect On Market Price and Andrea Shareholders 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, 63,721,035 were outstanding as of November 9, 2012. The number of shares outstanding does not include an aggregate of 27,264,491 shares of common stock that are issuable. This number of issuable common shares is equal to approximately 43% of the 63,721,035 outstanding shares. These issuable common shares are comprised of: a) 17,375,821 shares of our common stock reserved for issuance upon exercise of outstanding awards granted under our 1998 Stock Plan and 2006 Stock Plan; b) 4,276,436 shares reserved for future grants under our 2006 Stock Plan; c) 2,023,658 shares of common stock that are issuable upon conversion of the Series C Preferred Stock; and d) 3,628,576 shares of common stock issuable upon conversion of the Series D Preferred Stock.

In addition to the risk factors set forth above and the other information set forth in this report, you should carefully consider the factors discussed in Part I, *Item 1A Risk Factors* in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, which could materially affect our business, financial condition or future results. The risks described in this report and in our Annual Report on Form 10-K are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

## Results Of Operations



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*Three and Nine Months ended September 30, 2012 compared to Three and Nine Months ended September 30, 2011*

## Net Revenues

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2012	2011	% Change	2012	2011	% Change
<u>Andrea Anti-Noise Products net Product revenues</u>						
Sales of products to OEM customers for use with educational software	\$ 325,781	\$ 356,380	(9)	\$ 413,369	\$ 509,781	(19)
All other Andrea Anti-Noise net product revenues	403,448	487,845	(17)	1,229,701	1,363,886	(10)
Total Andrea Anti-Noise Products net Product revenues	\$ 729,229	\$ 844,225	(14)	\$ 1,643,070	\$ 1,873,667	(12)
<u>Andrea DSP Microphone and Audio Software Products revenues</u>						
Sales of automotive array microphone products	13,525	151,404	(91)	121,485	211,359	(43)
All other Andrea DSP Microphone and Audio product revenues	74,662	76,782	(3)	278,073	163,055	71
License revenues	125,851	244,603	(49)	550,208	944,309	(42)
Total Andrea DSP Microphone and Audio Software Products revenues	214,038	472,789	(55)	949,766	1,318,723	(28)
Total Revenues	\$ 943,267	\$ 1,317,014	(28)	\$ 2,592,836	\$ 3,192,390	(19)

- (a) The decrease of approximately \$31,000 and \$96,000 for the three and nine months periods, respectively, ended September 30, 2012, as compared to the same periods in 2011 reflect decreased product sales to our educational customers for use with their distance learning products.
- (b) The decreases of approximately \$84,000 and \$134,000 for the three and nine month periods, respectively, ended September 30, 2012, as compared to the same periods in 2011 in all other Andrea Anti-noise product revenues is related to decreased demand from our distance learning customers as well as distributor and reseller customers who sell both to distance learning customers and speech recognition end users.
- (c) The decreases of approximately \$138,000 and \$90,000 for the three and nine month periods, respectively, ended September 30, 2012, as compared to the same periods in 2011 in sales of automotive array microphone products are primarily the result of decreased product sales to integrators of public safety vehicle solutions.
- (d) The increase of approximately \$115,000 for the nine month period ended September 30, 2012, as compared to the same period in 2011 in all other Andrea DSP Microphone and Audio Software product revenues is related to increased demand from our OEM customer.
- (e) The decreases in license revenues of \$119,000 and \$394,000 are the result of decreased royalties reported for the three and nine months ending September 30, 2012, respectively, as compared to the same period last year. We believe this decrease is related to a decrease in sales of PC models which feature our technology.

## Cost of Revenues

Cost of revenues as a percentage of net revenues for the three months ended September 30, 2012 increased to 48% from 42% for the three months ended September 30, 2011. The cost of revenues as a percentage of net revenues for the three months ended September 30, 2012 for Andrea Anti-Noise Products is 56% compared to 62% for the three months ended September 30, 2011. The cost of revenues as a percentage of net revenues for the three months ended September 30, 2012 for Andrea DSP Microphone and Audio Software Products is 22% compared to 7% for the three months ended September 30, 2011. Cost of revenues as a percentage of net revenues for the nine months ended September 30, 2012 increased to 45% from 37% for the nine months ended September 30, 2011. The cost of revenues as a percentage of net revenues for the nine months ended September 30, 2012 for Andrea Anti-Noise Products is 58% compared to 59% for the nine months ended September 30, 2011. The cost of revenues as a percentage of net revenues for the nine months ended September 30, 2012 for Andrea DSP Microphone and Audio Software Products is 22% compared to 6% for the nine months ended September 30, 2011. The decreases in cost of sales as a percentage of sales

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Andrea Anti-Noise Products revenues for the three and nine month periods was attributable to the different product mix of revenues. The increases in cost of sales as a percentage of sales for Andrea DSP Microphone and Audio Software products segment for the three and nine month periods relates to decreased licensing revenues offset in part by increased OEM revenues.

#### Research and Development Expenses

Research and development expenses for the three months ended September 30, 2012 increased 4% to \$189,822 from \$182,178 for the three months ended September 30, 2011. For the three months ended September 30, 2012, the increase in research and development expenses reflects a 1% increase in our Andrea DSP Microphone and Audio Software Technology efforts to \$107,101, or 56% of total research and development expenses and a 9% increase in our Andrea Anti-Noise Headset Product efforts to \$82,721, or 44% of total research and development expenses. Research and development expenses for the nine months ended September 30, 2012 decreased less than 1% to \$574,871 from \$577,306 for the nine months ended September 30, 2011. For the nine months ended September 30, 2012, the decrease in research and development expenses reflects a 3% decrease in our Andrea DSP Microphone and Audio Software Technology efforts to \$323,471, or 56% of total research and development expenses, and a 4% increase in our Andrea Anti-Noise Headset Product efforts to \$251,400, or 44% of total research and development expenses. These increases primarily relate to ongoing development of new products.

#### General, Administrative and Selling Expenses

General, administrative and selling expenses decreased less than 1% to \$642,319 for the three months ended September 30, 2012 from \$647,036 for the three months ended September 30, 2011. For the three months ended September 30, 2012, the expenses reflect a 1% decrease in our Andrea DSP Microphone and Audio Software Technology efforts to \$282,274, or 44% of total general, administrative and selling expenses and a decrease of less than 1% in our Andrea Anti-Noise Headset Product efforts to \$360,045, or 56% of total general, administrative and selling expenses. General, administrative and selling expenses increased 1% to, \$1,813,011 for the nine months ended September 30, 2012 from \$1,795,711 for the nine months ended September 30, 2011. For the nine months ended September 30, 2012, the expenses reflect an increase of less than 1% in our Andrea DSP Microphone and Audio Software Technology efforts to \$813,217, or 45% of total general, administrative and selling expenses and a 2% increase in our Andrea Anti-Noise Headset Product efforts to \$999,794, or 55% of total general, administrative and selling expenses. The quarter over quarter decrease relates to a decrease of stock based compensation expense partially offset by increased promotional and marketing expenses related to our newly engaged distribution channels. The nine month increases relate to promotional and marketing expenses related to our newly engaged distribution channels partially offset in part by decreases in stock based compensation expenses.

#### Interest Income, net

Interest income, net for the three months ended September 30, 2012 and 2011 was \$2,053. Interest income, net for the nine months ended September 30, 2012 was \$6,392 compared to \$5,742 for the nine months ended September 30, 2011.

#### Provision for Income Taxes

The provision for income taxes for the three months ended September 30, 2012 was \$154,621 compared to a provision for income taxes of \$2,290 for the three months ended September 30, 2011. The provision for income taxes for the nine months ended September 30, 2012 was \$154,637 compared to a provision for income taxes of \$19,251 for the three months ended September 30, 2011. After considering changes in previously existing positive and negative evidence, the Company determined that a full valuation allowance against the deferred tax asset was required. As a result during the three months ended September 30, 2012, the Company recorded a provision for income tax of \$154,261.

#### Net Loss

Net loss for the three months ended September 30, 2012 was \$498,313 compared to net loss of \$66,910 for the three months ended September 30, 2011. Net loss for the nine months ended September 30, 2012 was \$1,114,030 compared to net loss of \$380,416 for the nine months ended September 30, 2011. The net loss for the three and nine months ended September 30, 2012 and 2011 principally reflects the factors described above.

#### Off-Balance Sheet Arrangements

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The Company has no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on its financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

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### Liquidity And Capital Resources

At September 30, 2012, we had cash of \$2,006,374 compared with \$2,193,377 at December 31, 2011. The cash balance at September 30, 2012 is primarily a result of our cash that we historically generated from operations.

Our working capital balance at September 30, 2012 was \$2,517,839 compared to a working capital of \$3,080,486 at December 31, 2011. The decrease in working capital reflects a decrease in total current assets of \$447,341 and an increase in total current liabilities of \$115,306. The decrease in total current assets reflects a decrease in cash of \$187,003, a decrease in accounts receivable of \$284,569, an increase in inventories of \$40,166, a decrease in deferred income taxes of \$22,801, and an increase in prepaid expenses of \$6,866. The increase in total current liabilities reflects an increase in trade accounts payable of \$148,495, and a decrease of \$33,189 in other current liabilities.

The decrease in cash of \$187,003 reflects \$124,404 of net cash used in operating activities and \$62,599 of net cash used in investing activities.

The cash used in operating activities of \$124,404, excluding non-cash charges for the nine months ended September 30, 2012, is attributable to a \$284,569 decrease in accounts receivable, a \$40,166 increase in inventories, a \$6,866 increase in prepaid expenses and other current assets, a \$148,495 increase in trade accounts payable and a \$33,189 decrease in other current liabilities. The changes in accounts receivable, inventories, prepaid expenses and other current assets and trade 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 of \$62,599 reflects purchases of property and equipment of \$35,293 and an increase in patents and trademarks of \$27,306. The significant increase in property and equipment reflects capital expenditures associated with information technology purchases and to a lesser extent, molds associated with our Andrea Anti-Noise Headset Products. The increase in patents and trademarks reflects capital expenditures associated with our intellectual property.

We plan to improve our cash flows in 2013 and the remainder of 2012 by aggressively pursuing additional licensing opportunities related to our Andrea DSP Audio Software and increasing the sales of our Andrea Anti-Noise Headset Products through the introduction of new products as well as the increased efforts we are putting into our sales and marketing efforts. However, there can be no assurance that we will be able to successfully execute the aforementioned plans. As of November 9, 2012, Andrea has approximately \$1,800,000 of cash deposits. We believe that we have sufficient liquidity available to continue in operation through at least September 2013. To the extent that we do not generate sufficient cash flows from our operations in the next twelve months, additional financing might be required. We will look to improve cash flows by reducing overall expenses, if our revenues continue to 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. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

### ITEM 4. 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 Andrea's management, including its principal executive and principal financial officers, as appropriate to

allow timely decisions regarding required disclosure.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that all control issues and instances 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.

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

## **PART II OTHER INFORMATION**

### **ITEM 1. 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 the claims, Andrea believes any resolution of these matters will not have a material adverse effect on Andrea's consolidated financial position, results of operations or liquidity.

In addition, in December 2010, Audrey Edwards, Executrix of the Estate of Leon Leroy Edwards, filed a law suit in the Superior Court of Providence County, Rhode Island, against 3M Company and over 90 other defendants, including the Company, alleging that the Company processed, manufactured, designed, tested, packaged, distributed, marketed or sold asbestos containing products that contributed to the death of Leon Leroy Edwards. The Company received service of process in April 2011. The Company has retained legal counsel and has filed a response to the complaint. The Company believes the lawsuit is without merit. Accordingly, the Company does not believe the lawsuit will have a material adverse effect on the Company's financial position or results of operations.

### **ITEM 1A. RISK FACTORS**

Not applicable.

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

None.

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

None.

### **ITEM 4. MINE SAFETY DISCLOSURES**

None.

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

None.

### **ITEM 6. EXHIBITS**

#### **a) Exhibits**

Exhibit 31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer

Exhibit 31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer

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### Exhibit 32 Section 1350 Certifications

Exhibit 101.0\* The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, formatted in XBRL: (i) the Condensed Consolidated Balance Sheets; (ii) Condensed Consolidated Statements of Operations; (iii) the Condensed Consolidated Statements of Shareholders' Equity; (iv) the Condensed Consolidated Statements of Cash Flows and (v) the Notes to the Condensed Consolidated Financial Statements.

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\* Furnished, not filed

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### SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly 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: November 14, 2012

<u>/s/ DOUGLAS J. ANDREA</u> <b>Douglas J. Andrea</b>	Chairman of the Board, President, Chief Executive Officer and Corporate Secretary	November 14, 2012
<u>/s/ CORISA L. GUIFFRE</u> <b>Corisa L. Guiffre</b>	Vice President, Chief Financial Officer and Assistant Corporate Secretary	November 14, 2012

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