

ANDREA ELECTRONICS CORP
Form 10QSB
November 14, 2006

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 September 30, 2006

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 small business issuer as specified in its charter)

New York
(State or other jurisdiction of

incorporation or organization)

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

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

11-0482020
(I.R.S. employer

identification no.)

11716
(Zip Code)

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Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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

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 3, 2006, there are 58,512,333 common shares outstanding.

Transitional Small Business Disclosure format (check one) Yes No

PART I. FINANCIAL INFORMATION**ITEM 1. FINANCIAL STATEMENTS****ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES**

CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2006 (unaudited)	December 31, 2005 (audited)
<u>ASSETS</u>		
Current Assets		
Cash and cash equivalents	\$ 167,213	\$ 418,597
Accounts receivable, net of allowance for doubtful accounts of \$17,068 and \$18,856, respectively	1,292,916	605,963
Inventories, net	940,920	679,002
Prepaid expenses and other current assets	87,403	218,621
Total current assets	2,488,452	1,922,183
Property and equipment, net	30,868	34,238
Intangible assets, net	3,547,203	3,886,493
Other assets, net	12,864	12,864
Total assets	\$ 6,079,387	\$ 5,855,778
<u>LIABILITIES AND SHAREHOLDERS' EQUITY</u>		
Current Liabilities:		
Trade accounts payable	\$ 592,231	\$ 460,144
Short-term portion of capital lease	7,622	12,191
Other current liabilities	544,721	457,212
Total current liabilities	1,144,574	929,547
Capital lease, net of short-term portion	763	5,338
Total liabilities	1,145,337	934,885
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: 100.7 and 105.7 shares, respectively; liquidation value: \$1,007,015 and \$1,057,015, respectively	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: 58,512,333 and 58,283,575, respectively	585,123	582,836
Additional paid-in capital	76,274,886	76,246,870
Accumulated deficit	(71,939,246)	(71,922,100)
Total shareholders' equity	4,934,050	4,920,893
Total liabilities and shareholders' equity	\$ 6,079,387	\$ 5,855,778

See Notes to Condensed Consolidated Financial Statements.

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	For the Three Months Ended		For the Nine Months Ended	
	September 30,	September 30,	September 30,	September 30,
	2006	2005	2006	2005
Revenues				
Net Product revenues	\$ 1,486,680	\$ 816,492	\$ 3,653,022	\$ 2,400,251
License revenues	205,771	26,715	477,330	62,601
Amortization of license revenues		56,301		713,284
Revenues	1,692,451	899,508	4,130,352	3,176,136
Cost of revenues	961,591	383,122	2,237,344	1,258,078
Gross margin	730,860	516,386	1,893,008	1,918,058
Research and development expenses	145,783	133,151	414,176	504,354
General, administrative and selling expenses	516,625	465,776	1,453,597	1,775,347
Income (loss) from operations	68,452	(82,541)	25,235	(361,643)
Other expense				
Interest (expense) income, net	(1,129)	(618)	(1,439)	1,431
Loss on disposal of property and equipment, net				(52,839)
Other expense	(1,129)	(618)	(1,439)	(51,408)
Income (loss) before provision for income taxes	67,323	(83,159)	23,796	(413,051)
Provision for Income Taxes	(20,446)		(40,942)	
Net income (loss)	\$ 46,877	\$ (83,159)	\$ (17,146)	\$ (413,051)
Basic weighted average shares	58,512,333	57,883,575	58,391,669	57,883,575
Diluted weighted average shares	59,385,460	57,883,575	58,391,669	57,883,575
Basic and diluted net income (loss) per share	\$.00	\$ (.00)	\$ (.00)	\$ (.01)

See Notes to Condensed Consolidated Financial Statements.

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006

(UNAUDITED)

					Common		Additional		Total
	Series C Convertible Preferred Stock Outstanding	Series C Convertible Preferred Stock	Series D Convertible Preferred Stock Outstanding	Series D Convertible Preferred Stock	Stock Shares Outstanding	Common Stock	Paid-In Capital	Accumulated Deficit	
Balance, January 1, 2006	105.701477	\$ 1	1,328,572	\$ 13,286	58,283,575	\$ 582,836	\$ 76,246,870	\$ (71,922,100)	\$ 4,920,893
Conversions of Series C Convertible Preferred Stock	(5.000000)				228,758	2,287	6,069		8,356
Stock Option Grants							6,944		6,944
Amortization of Deferred Stock compensation							15,003		15,003
Net loss								(17,146)	(17,146)
Balance, September 30, 2006	100.701477	\$ 1	1,328,572	\$ 13,286	58,512,333	\$ 585,123	\$ 76,274,886	\$ (71,939,246)	\$ 4,934,050

See Notes to Condensed Consolidated Financial Statements.

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	For the Nine Months Ended	
	September 30, 2006	September 30, 2005
Cash flows from operating activities:		
Net loss	\$ (17,146)	\$ (413,051)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	366,028	390,839
Non-cash stock-based compensation expense	15,003	13,000
Non-cash employee stock option compensation expense	6,944	
Provision for bad debt	(1,788)	(4,407)
Inventory reserve	(43,354)	(217,386)
Loss on disposal of property and equipment, net		52,839
Change in:		
Accounts receivable	(685,165)	326,269
Inventories	(218,564)	331,580
Prepaid expenses and other current assets	131,218	93,605
Other assets, net		26,056
Trade accounts payable	132,087	168,145
Deferred revenue		(713,284)
Other current and long term liabilities	95,865	(459,142)
Net cash used in operating activities	(218,872)	(404,937)
Cash flows from investing activities:		
Proceeds from sale of property and equipment		9,000
Purchases of property and equipment	(9,370)	(1,744)
Patents and trademarks	(13,998)	(7,781)
Net cash used in investing activities	(23,368)	(525)
Cash flows from financing activities:		
Payment of capital lease	(9,144)	(4,569)
Net cash used in by financing activities	(9,144)	(4,569)
Net decrease in cash and cash equivalents	(251,384)	(410,031)
Cash and cash equivalents, beginning of period	418,597	826,910
Cash and cash equivalents, end of period	\$ 167,213	\$ 416,879
Supplemental disclosures of cash flow information:		
Non-cash investing and financing activities:		
Equipment acquired in exchange for a capital lease	\$	\$ 18,277
Conversion of Series C Convertible Preferred Stock into common stock	\$ 8,356	\$

See Notes to Condensed Consolidated Financial Statements.

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 September 30, 2006, Andrea had working capital of \$1,343,878 and cash and cash equivalents of \$167,213. Andrea s income from operations was \$68,452 and \$25,235 for the quarter and first nine months ended September 30, 2006, respectively. Andrea plans to continue to improve its cash flows during 2006 by placing heightened emphasis on its sales and marketing efforts.

As of November 3, 2006, Andrea has approximately \$150,000 (unaudited) of cash. Management believes that Andrea has sufficient liquidity available to operate through at least September 2007.

While Andrea continues to explore opportunities to increase sales in new business areas, the Company is also examining 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 7). 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 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

Management 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 doubtful accounts, inventory obsolescence, product warranties, depreciation, deferred income taxes, expected realizable values for assets (primarily intangible assets), contingencies, revenue recognition, future cash flows 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 arrangements and the corresponding revenue is generally recognized as the services are performed.

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

	September 30, 2006	September 30, 2005
Total potential common shares:		
Options to purchase common stock	2,090,000	5,082,500
Series C Convertible Preferred Stock and related accrued dividends (Note 4)	4,607,252	4,836,010
Series D Convertible Preferred Stock and related Warrants (Note 5)	10,472,632	10,472,632
Total potential common shares as of September 30, 2006	17,169,884	20,391,142

The following table sets forth the components used in the computation of basic and diluted earnings per share for the quarter ended September 30, 2006:

Numerator:	
Net income	\$ 46,877
Denominator:	
Weighted average shares	58,512,333
Effect of dilutive securities:	
Employee stock options	873,127
Denominator for diluted earnings per share-adjusted weighted average shares after assumed conversions	59,385,460

The above computation was not necessary for the three months ended September 30, 2005 or the nine months ended September 30, 2006 and 2005 as the periods had a net loss.

Stock-Based Compensation - At September 30, 2006, Andrea had three stock-based employee compensation plans, which are described more fully in Note 3. Effective, January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123R Share-Based Payment. SFAS No. 123R establishes accounting for stock-based awards exchanged for employee services. Under the provisions of SFAS 123R, share-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 Company amortizes sock-based compensation by using the straight-line method. The Company elected to adopt the modified prospective transition method as provided by SFAS 123R. In accordance with the requirements of the modified prospective transition method, consolidated financial statements for prior year periods have not been restated to reflect the fair value method of expensing share-based compensation. Additionally, effective with the adoption of SFAS 123R excess tax benefits realized from the exercise of stock-based awards are classified in cash flows from financing activities.

Prior to January 1, 2006, the Company applied Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related interpretations in accounting for its stock-based compensation plans applying the disclosure-only provisions of SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. In accordance with APB 25, no stock-based compensation expense was recognized 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. 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 \$2,203 and \$6,944 of compensation expense for the quarter and first nine months ended September 30, 2006, which is included in general, administrative and selling expenses in the accompanying condensed consolidated statement of operations.

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The proforma effect of expensing stock options on the Company's results of operations using a Black-Scholes option-pricing model for the periods prior to the adoption of the SFAS 123R is presented in the following pro forma table:

	For the three Months Ended September 30, 2005	For the Nine Months Ended September 30, 2005
Net loss to common shareholders as reported	\$ (83,159)	\$ (413,051)
Deduct: Total stock-based employee compensation expense determined under fair value-based method, net of income tax	91,849	110,547
Pro forma net loss attributable to common shareholders	\$ (175,008)	\$ (523,598)
Basic and diluted net loss per share as reported	\$ (.00)	\$ (.01)
Basic and diluted pro forma net loss per share	\$ (.00)	\$ (.01)

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 September 30, 2006 and December 31 2005.

Concentration of Credit Risk - Andrea is a manufacturer of audio communications equipment for several industries. Revenues related to the recognition of deferred revenue as well as other service related revenues to one customer were approximately 5% and 17% of the total net revenues for the three months ended September 30, 2006 and 2005, respectively and accounted for 4% of total accounts receivable at September 30, 2006. Revenues related to the recognition of deferred revenue as well as other service related revenues to one customer were approximately 7% and 29% of the total net revenues for the nine months ended September 30, 2006 and 2005, respectively. Sales of noise canceling and active noise canceling products were significant to one customer and its affiliates, accounting for approximately 8% and 9% of the total sales for the three months ended September 30 2006 and 2005, respectively, and accounted for 6% of total accounts receivable at September 30, 2006. Sales of noise canceling and active noise canceling products were significant to one customer and its affiliates, accounting for approximately 11% and 9% of the total sales for the nine months ended September 30 2006 and 2005, respectively. Sales of superbeam array microphone products were significant to one customer and its affiliates, accounting for approximately 44% and 0% of the total sales for the three months ended September 30 2006 and 2005, respectively, and accounted for 55% of total accounts receivable at September 30, 2006. Sales of superbeam array microphone products were significant to one customer and its affiliates, accounting for approximately 25% and 0% of the total sales for the nine months ended September 30, 2006 and 2005, respectively. Licensing revenues and other sales of noise canceling and active noise canceling products were significant to one customer and its affiliates, accounting for approximately 10% and 0% of the total sales for the three months ended September 30 2006 and 2005, respectively, and accounted for 8% of total accounts receivable at September 30, 2006. Licensing revenues and other sales of noise canceling and active noise canceling products were significant to one customer and its affiliates, accounting for approximately 11% and 1% of the total sales for the nine months ended September 30, 2006 and 2005, respectively.

Andrea purchased a substantial portion of its finished goods from one supplier. Purchases from this supplier amounted to 79% and 35% of total purchases for the three months ended September 30, 2006 and 2005, respectively. During the nine months ended September 30, 2006 and 2005, purchases from this supplier amounted to 77% and 64%, respectively, of total purchases. At September 30, 2006, the amount due to this supplier included in accounts payable was \$382,805.

Allowance for Doubtful Accounts - The allowance for doubtful accounts reflects management's best estimate of probable losses inherent in the accounts 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.

	September 30, 2006 (unaudited)	December 31, 2005 (audited)
Raw materials	\$ 127,842	\$ 112,929

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Work-in-process		
Finished goods	1,443,541	1,239,890
	1,571,383	1,352,819
Less: reserve for obsolescence	(630,463)	(673,817)
	\$ 940,920	\$ 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 September 30, 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 September 30, 2006 and 2005, amortization expense was \$117,923 and \$117,610, respectively. For the nine-month periods ended September 30, 2006 and 2005, amortization expense was \$353,289 and \$352,567, respectively.

Reclassifications Certain accounts in the prior period's financial statements have been reclassified for comparative purposes to conform to the presentation in the current period's financial statements. These reclassifications have no effect on the Company's previously reported consolidated financial position or results of operations.

Recently Issued Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued SFAS Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109 Accounting for Income Taxes*. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for financial statements issued for fiscal years beginning after December 15, 2006. The Company is currently evaluating the requirements of FIN 48 and does not expect that the adoption of FIN 48 will have a significant impact on the Company's consolidated financial position and results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 provides guidance for using fair value to measure assets and liabilities. In addition, this statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. Where applicable, this statement simplifies and codifies related guidance within generally accepted accounting principles. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company's adoption of SFAS No. 157 is not expected to have a material effect on its consolidated financial position and results of operations.

In September 2006, the staff of the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108 (SAB 108), which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. SAB 108 becomes effective in fiscal 2007. Adoption of SAB 108 is not expected to have a material impact on the Company's consolidated financial position and results of operations.

Note 3. Stock Plans and Stock Based Compensation

In 1991, the Board of Directors of Andrea (the Board) adopted the 1991 Performance Equity Plan (1991 Plan), which was approved by the shareholders. The 1991 Plan, as amended, authorizes the granting of awards, the exercise of which would allow up to an aggregate of 4,000,000 shares of Andrea's Common Stock to be acquired by the holders of those awards. Stock options granted to employees and directors under the 1991 Plan were granted for terms of up to 10 years at an exercise price equal to the market value at the date of grant. No further awards will be granted under the 1991 Plan.

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 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. At June 30, 2006, there were 1,401,653 shares available for further issuance under the 1998 Plan.

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In October 2006, the Board adopted the Andrea Electronics Corporation 2006 Equity Compensation Plan (2006 Plan), subject to approval by the shareholders at the Company s stockholders meeting scheduled for November 16, 2006. The 2006 Plan authorizes the granting of awards, the exercise of which would allow up to an aggregate of 10,000,000 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. As of November 3, 2006, there have been no grants under this plan.

There were 0 and 75,000 stock options granted during the three and nine-month periods ended September 30, 2006, respectively. There were 2,335,000 granted during the three and nine-month periods ended September 30, 2005. Compensation expense recognized related to option awards was \$2,203 and \$6,944 for the quarter and first nine months ended September 30, 2006, respectively, which is included in general, administrative and selling expenses in the accompanying condensed consolidated statement of operations.

The fair values of the stock options granted were estimated on the date of grant using the Black-Scholes option-pricing model that uses the following weighted-average assumptions for the three-month period ended September 30, 2005. There were no stock options granted during the three month period ended September 30, 2006.

	September 30, 2005
Expected life in years	5
Risk-free interest rates	4.16%
Volatility	222%
Dividend yield	0%

The fair values of the stock options granted were estimated on the date of grant using the Black-Scholes option-pricing model that uses the following weighted-average assumptions for the nine-month periods ended September 30, 2006 and 2005:

	September 30, 2006	September 30, 2005
Expected life in years	7	5
Risk-free interest rates	4.57%	4.16%
Volatility	220%	222%
Dividend yield	0%	0%

The following table is the summary of the Company's option activity during the first three quarters ended September 30, 2006:

	Options Outstanding			Options Exercisable	
	Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Options Exercisable	Weighted Average Exercise Price
At January 1, 2006	4,512,500	\$ 1.71	7.74 years	4,182,500	\$ 1.84
Granted	60,000	0.04			
Cancelled	(145,000)	0.78			
At March 31, 2006	4,427,500	1.72	7.30 years	4,287,500	\$ 1.77
Granted	15,000	0.08			
At June 30, 2006	4,442,500	1.71	7.06 years	4,367,500	\$ 1.74
Cancelled	(7,500)	5.00			
At September 30, 2006	4,435,000	1.70	6.91 years	4,390,000	\$ 1.73

The weighted average fair value of options at the date of grant using the Black-Scholes fair value based method for the nine-month period ended September 30, 2006 is estimated at \$0.05. There were no options granted during the quarter ended September 30, 2006. There was no total intrinsic value for these options for the nine months ended September 30, 2006.

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The following table summarizes information about stock options outstanding at September 30, 2006:

Range of Exercise Prices	Options Outstanding	Weighted-	Weighted-	Options Exercisable	Weighted-
	Number	Average	Average	Number	Average
	Outstanding	Contractual Life	Price	Exercisable	Price
\$ 0.04 to \$ 0.06	2,345,000	8.88	\$ 0.05	2,315,000	\$ 0.05
0.07 to 0.11	265,000	7.95	0.10	250,000	0.10
0.12 to 0.17	425,000	7.71	0.13	425,000	0.13
0.28 to 0.43	35,000	6.62	0.34	35,000	0.34
0.44 to 0.65	70,000	6.20	0.57	70,000	0.57
0.66 to 1.00	342,500	5.34	0.69	342,500	0.69
1.52 to 2.28	75,000	4.53	1.75	75,000	1.75
2.29 to 3.43	10,000	4.18	3.30	10,000	3.30
5.17 to 7.75	632,500	2.55	6.03	632,500	6.03
7.76 to 11.65	40,000	2.85	8.25	40,000	8.25
11.66 to 17.49	195,000	1.61	14.28	195,000	14.28
\$ 0.04 to \$ 17.49	4,435,000	6.91	\$ 1.70	4,390,000	\$ 1.73

The following table is the summary of the Company's nonvested shares as of September 30, 2006 and changes during the first three quarters ended September 30, 2006:

	Options Outstanding	Weighted Average Exercise Price
Nonvested at January 1, 2006	330,000	\$ 0.04
Granted	60,000	0.04
Vested	(330,000)	0.04
Nonvested at March 31, 2006	60,000	0.04
Granted	15,000	0.08
Nonvested at June 30, 2006	75,000	0.05
Vested	(30,000)	0.04
Nonvested at September 30, 2006	45,000	0.05

As of September 30, 2006, there was \$656 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the 1998 Plan. That cost is expected to be recognized over the next nine months. The total fair value of shares vested during the nine months ended September 30, 2006 was \$1,200.

During 2005 and 2004, pursuant to Andrea's compensation policy for outside directors, Andrea granted 400,000 shares of Common Stock with a fair market value of \$0.05 and 176,472 shares of Common Stock with a fair market value of \$0.17, respectively. Compensation expense related to these awards was \$5,001 and \$0 for the three months ended September 30, 2006 and 2005, respectively. Compensation expense related to these awards was \$15,003 and \$13,000 for the nine months ended September 30, 2006 and 2005, respectively. Compensation expense related to these awards is included in general, administrative and selling expenses in the accompanying condensed consolidated statement of operations.

Note 4. 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 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 was 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 prior to 2004.

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). 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 a result of the Acknowledgment and Waiver Agreement, the Series C Preferred Stock outstanding is classified as part of shareholders' equity in the accompanying condensed consolidated balance sheets.

On May 24, 2006, 5 shares of Series C Preferred Stock, together with related accrued dividends, were converted into 228,758 shares of Common Stock at a conversion price of \$0.2551. As of September 30, 2006, there were 100.701477 shares of Series C Preferred Stock outstanding and accrued dividends of \$168,296, which were convertible into 4,607,252 shares of Common Stock.

Note 5. Series D 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 September 30, 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 6. Licensing Agreements

In December 2001 and March 2002, Andrea entered into two agreements with Analog Devices, Inc. (Analog). 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 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 September 30, 2006 and September 30, 2005, \$0 and \$56,301, respectively of license revenues was recognized in the accompanying condensed consolidated statements of operations. During the nine months ended September 30, 2006 and 2005, \$0 and \$713,284, respectively of license revenues was recognized in the accompanying 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 Digital Super Directional Array (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 discussions at normal conversation levels, even in a noisy environment. During the three months ended September 30, 2006 and 2005 \$4,840 and \$960, respectively, of license revenues were recognized in the accompanying condensed consolidated statements of operations. During the nine months ended September 30, 2006 and 2005 \$28,360 and \$5,800, respectively, of license revenues were recognized in the accompanying 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 pays Andrea a royalty for each VoiceCenter license shipped with the Soundblaster Live. During the three months ended September 30, 2006 and 2005, Andrea recorded \$172,126 and \$437, respectively of licensing revenue related to this agreement was recognized in the accompanying condensed consolidated statements of operations. During the nine months

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ended September 30, 2006 and 2005,

Andrea recorded \$376,749 and \$436, respectively of licensing revenue related to this agreement was recognized in the accompanying condensed consolidated statements of operations.

In November 2004, Andrea entered into a license agreement with Analog to integrate its EchoStop technology with certain Analog products for one of Analog's customers (EchoStop Licensed Products). As consideration of this license, Analog will pay Andrea a royalty for each EchoStop Licensed Product shipped. During the first year of the agreement, Analog will pay Andrea a minimum of \$100,000 in royalty payments, payable in payments of \$25,000 per quarter. During the three months ended June 30, 2006 Andrea received the final \$25,000 of the minimum royalty payment due under this agreement. Andrea will continue to receive royalty payments based on the number of EchoStop Licensed Products shipped until either party terminates the agreement per the terms of the agreement. During the three months ended September 30, 2006 and September 30, 2005, Andrea has recognized \$0 and \$25,000, respectively of revenues under this agreement. During the nine months ended September 30, 2006 and September 30, 2005, Andrea has recognized \$25,000 and \$50,000, respectively of revenues under this agreement.

In January 2006, Andrea entered into a license agreement with Analog to integrate our DSDA and EchoStop technologies with certain of Analog products for specific Analog PC Original Equipment Manufacturer (OEM) customers (DSDA/EchoStop Licensed Product). In consideration of this license, Analog will pay Andrea a royalty for each DSDA/EchoStop Licensed Product shipped. During the three months ended September 30, 2006 and September 30, 2005, Andrea has recognized \$12,500 and \$0, respectively of revenues under this agreement. During the nine months ended September 30, 2006 and September 30, 2005, Andrea has recognized \$25,000 and \$0, respectively of revenues 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 7. 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 for the three and nine-month periods ended September 30, 2005, respectively.

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 \$19,873 and \$59,039 for the three and nine-month periods ended September 30, 2006, respectively. Rent expense under this operating lease for the three and nine-month periods ended September 30, 2005 was \$19,294 and \$38,588, respectively. As of September 30, 2006, the future minimum lease payments under this lease and all non-cancelable operating leases are as follows:

Period ending December 31,	Amount
2006 (October to December 31)	\$ 28,293
2007	99,807
2008	90,374
2009	89,557
2010	29,171
Total	\$ 337,202

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 expired June 2006. Pursuant to his employment agreement, Mr. Andrea received 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 was also entitled to a change in control payment equal to one time 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. In accordance with Amendment 1 of Mr. Andrea's employment agreement, Mr. Andrea will not receive a \$50,000 bonus for the periods ending December 31, 2005 and 2004, and instead will be entitled to \$100,000 bonus when the Company has positive cash flows. At September 30, 2006, the future minimum cash commitments under this agreement aggregate \$116,167 (including the unpaid portion of Mr. Andrea's prorated 2006, 2005 and 2004 bonuses), of which \$116,167 and \$100,000 is included in other liabilities at

September 30, 2006 and December 31, 2005, respectively.

In November 2006, the Company entered into an employment agreement with the Chairman of the Board, Douglas J. Andrea. The employment agreement expires July 31, 2008 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 \$300,000 per annum. In addition, upon execution of the employment agreement, Mr. Andrea is entitled to a salary adjustment from August 1, 2006 through the date of the employment agreement. 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. 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. On November 2, 2006, in accordance with his employment agreement, Mr. Andrea was granted 1,000,000 stock options. This grant provides for a three year vesting period, an exercise price of \$0.12 per share, which was fair market value at the date of grant, and a term of 10 years. In addition, subject to stockholder approval of the Company's proposed 2006 Equity Compensation Plan at the Company's stockholder meeting scheduled for November 16, 2006, an additional 1,000,000 stock options will be granted to Mr. Andrea as soon as practicable after stockholder approval of the plan. These stock options will vest ratably over a 3-year period. 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 and subsequent termination of employment other than for cause. At September 30, 2006, the future minimum cash commitments under this agreement aggregate \$562,500, of which \$12,500 is included in other liabilities at September 30, 2006.

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 8. 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 condensed consolidated financial information for Andrea's segments for the three-month periods ended September 30, 2006 and 2005:

Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti- Noise Products	Total 2006
Net revenues from external customers	\$ 915,875	\$ 570,805	\$ 1,486,680
License Revenues	205,771		205,771
Income from operations	45,117	23,335	68,452
Depreciation and amortization	116,161	4,805	120,966
Assets	4,361,135	1,718,252	6,079,387
Total long lived assets	3,405,072	172,999	3,578,071

	Andrea DSP Microphone and Audio Software Products	Andrea Anti- Noise Products	Total 2005
Net revenues from external customers	\$ 256,060	\$ 560,432	\$ 816,492
License Revenues	26,715		26,715
Amortization of License Revenues	56,301		56,301

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(Loss) income from operations	(130,411)	47,870	(82,541)
Depreciation and amortization	118,955		