

ANDREA ELECTRONICS CORP
Form 10-K
March 30, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF
1934

For the Fiscal Year Ended December 31, 2014

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	11-0482020
(State or other jurisdiction of incorporation or organization)	(I.R.S. employer identification no.)

65 Orville Drive, Bohemia, New York	11716
(Address of principal executive offices)	(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Exchange Act:

Common Stock, par value \$.01 per share

Title of class

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes o No ☒ x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No ☒ x

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒ x

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)

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Large Accelerated Filer ☐ Accelerated Filer ☐

Non-Accelerated Filer ☐ Smaller Reporting Company ☒
(Do not check if a smaller reporting company)

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates was \$3,946,998 based upon the closing price of \$0.08 per share as quoted on the OTC Bulletin Board on June 30, 2014.

The number of shares outstanding of the registrant's Common Stock as of March 20, 2015, was 63,721,035.

DOCUMENTS INCORPORATED BY REFERENCE

None

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PART I

ITEM 1. BUSINESS

Overview

Andrea Electronics Corporation (“Andrea,” “us,” “we,” “our”) designs, develops and manufactures state-of-the-art microphone technologies and products for enhancing speech-based applications software and communications that require high quality, clear voice signals. Our technologies eliminate unwanted background noise to enable the optimum performance of various speech-based and audio applications. We are incorporated under the laws of the State of New York and have been engaged in the electronic communications industry since 1934.

Andrea’s products and technologies optimize the performance of speech-based applications and audio applications primarily in the following markets:

- computer speech recognition applications;
- computer voice over the internet protocol (VoIP) applications; and
- OEM microphone components and assemblies.

Andrea Digital Signal Processing (“DSP”) Microphone and Audio Software Business – Our patented and patent-pending digital noise canceling technologies enable a speaker to be at a distance from the microphone (we refer to this capability as “far-field” microphone use), and free the speaker from having to use a close talking microphone. Our Digital Super Directional Array (“DSDA”) and PureAudio microphone products convert sound received by an array of microphones into digital signals that are then processed to cancel background noise from the signal to be transmitted. These two adaptive technologies represent the core technologies within our portfolio of far-field technologies. In addition to DSDA and PureAudio, Andrea has developed and commercialized several other digital, far-field noise canceling technologies, including, among others, Andrea EchoStop, a high-quality acoustic echo canceller which enables speaker phone functionality with technology for canceling speaker feedback.

All of our digital, far-field microphone technologies are software-based and operate using either a dedicated DSP or a general purpose processor (for example, the Intel Pentium). The software, which may encompass one or all of our far-field noise canceling technologies, can be applied to improve the performance of a single microphone or multiple microphones. In addition, our digital, far-field, noise canceling technologies can be tailored and implemented into various form factors, including for example, into the monitor of a PC, a personal digital assistant or a rear view mirror, and can be used individually or combined depending on particular customer requirements.

We are currently targeting our far-field technologies at: 1) the desktop and laptop computing market; 2) the video and audio conferencing market; and 3) the market for personal hands free communication designed for use in automobiles, trucks and buses to control PCs and cellular communication and OEM voice input applications. Our far-field, digital noise canceling technologies and related products, together with implementations of other high-end audio technologies (for example, our software noise cancellation technology) comprise our Andrea DSP Microphone and Audio Software line of business. Net revenues from such technologies and products during the years ended December 31, 2014 and 2013 was approximately 44% and 47%, respectively, of our total net revenues. We dedicate a significant amount of our marketing and research and development resources to this business segment, as we believe that communication products will increasingly require high performance, untethered (hands-free and headset-free) microphone technology.

Andrea Anti-Noise Products Business – Our headset microphone products help to ensure clear speech in personal computer and VoIP headset applications. Our Active Noise Cancellation microphone technology uses electronic circuits that distinguish a speaker's voice from background noise in the speaker's environment and then cancels the noise from the signal to be transmitted by the microphone. Together with our standard Noise Canceling headset products, these products comprise our Andrea Anti-Noise Product operating segment. During the years ended December 31, 2014 and 2013, net revenues from our Andrea Anti-Noise Product operating segment was approximately 56% and 53%, respectively, of our total net revenues. On March 27, 2015, we entered into a contract to sell our Andrea Anti-Noise Products Division. For the year ended December 31, 2014, this business segment generated approximately \$1.5 million in revenue and a total operating loss of approximately \$365,000. Proceeds from the sale will primarily be used to fund our other operating segments. The discussion of our Anti-Noise Products Business in this Form 10-K relates to our operations for the year ended December 31, 2014.

Patent Monetization, Intellectual Property and Licensing – Our products and technologies are developed in part using our proprietary intellectual property, and we believe that the strength of our intellectual property rights will be important to the success of our business. We utilize patent and trade secret protection, confidentiality agreements with customers and partners, disclosure and invention assignment agreements with employees and consultants and other contractual provisions to protect our intellectual property and other proprietary information. We plan to license specific, custom designs to our customers, charging royalties at a fixed amount

per product or a percentage of sales. More generally, we intend to vigorously defend and monetize our intellectual property through licensing arrangements and, where necessary, enforcement actions against those entities using our patented solutions in their products. Royalties resulting from these patent monetization efforts can be structured in a variety of ways, including but not limited to one-time paid up licenses or on-going royalty arrangements. We expect to generate a portion of our revenues with these types of licensing arrangements. As part of our plan to aggressively pursue patent monetization, we have entered into a Revenue Sharing and Note Purchase Agreement (the “Revenue Sharing Agreement”) with AND34 Funding LLC (“AND34”). Under the Revenue Sharing Agreement, the Company granted AND34 a perpetual predetermined share in the rights of the Company’s specified future revenues from currently owned patents by the Company in exchange for \$3,500,000. On December 24, 2014, the Company entered into an Amended and Restated Revenue Sharing and Note Purchase Agreement (the “Amended and Restated Revenue Sharing Agreement”) with AND34, which was retroactively effective as of February 14, 2014. Under the Amended and Restated Revenue Sharing Agreement, the Company agreed to issue and sell to AND34 an additional \$6,500,000 in notes for an aggregate of \$10,500,000 in notes. The proceeds of the notes will be used to pay preclose expenses and our patent monetization expenses.

For more financial information regarding our operating segments, see Note 13 of the accompanying consolidated financial statements.

Industry Background

Our primary mission is to provide the emerging “voice interface” markets with state-of-the-art microphone and communication products. The idea underlying these markets is that natural language spoken by the human voice will become an important means by which to communicate and control many types of computing devices and other appliances and equipment that contain microprocessors. We are designing and marketing our products and technologies to be used for these “natural language, human/machine” interfaces with:

- desktop, laptop and hand-held computers, mobile personal computing devices and cellular phones;
- video and audio conferencing systems; and
- automotive communication systems.

We believe that end users of these applications and interfaces will require high quality microphone and speakerphone products that enhance voice transmission, particularly in noisy office and mobile environments. We also believe that these applications will increasingly require microphones that are located at a distance from the person speaking, or far-field microphone technology. Applications in this area include:

- continuous speech dictation to personal computers;

- multiparty video teleconferencing and software that allow participants to see and jointly communicate; and
- cellular hands free interfaces for automobiles, home and office automation.

We believe that an increasing number of these devices will be introduced into the marketplace during the next several years.

Our Strategy

Our strategy is to:

- maintain and extend our market position with our Andrea DSP Microphone and Audio Software technologies and products;
- develop relationships with companies that have significant distribution capabilities for our Andrea DSP Microphone and Audio Software technologies and products;
- broaden our Andrea DSP Microphone and Audio Software product lines through a healthy level of internal research and development;
- design our products to satisfy specific end-user requirements identified by our collaborative partners;
- outsource manufacturing of our products in order to reduce fixed overhead and achieve economies of scale; and
- vigorously defend and monetize our intellectual property through licensing arrangements and, where necessary, enforcement actions against those entities using our patented solutions in their products.

An important element of our strategy for expanding the channels of distribution and broadening the base of users for our products is our collaborative arrangements with manufacturers of computing and communications equipment and software publishers that are actively engaged in the various markets in which our products have application. In addition, we have been increasing our own direct marketing efforts to original equipment manufacturers for incorporation into, or for use with their products.

The success of our strategy will depend on our ability to, among other things:

- increase net revenues of Andrea DSP Microphone and Audio Software products;
- continue to contain costs;
- introduce additional Andrea DSP Microphone and Audio Software products;
- maintain the competitiveness of our technologies through focused and targeted research and development;
- achieve widespread adoption of our products and technologies through ongoing marketing efforts; and
- defend and monetize our intellectual property.

Our Technologies

We design our Andrea DSP Microphone and Audio Software and Andrea Anti-Noise products to transmit voice signals with the high level of quality, intelligibility and reliability required by the broad range of voice-based applications in computing and telecommunications. We achieve this through the use of several audio technologies that employ software processes that are proprietary to us. Software processes of this type are commonly referred to as algorithms.

Andrea DSP Microphone and Audio Software Technology

This set of technologies is generally based on the use of an array of microphones from which the analog signals are converted to digital form and then processed using digital electronic circuitry to eliminate unwanted noise in the speaker's environment. Our Andrea DSP Microphone and Audio Software Products provide clear acoustic and audio input performance where the desired audio signal is at a distance from the microphone. An example of this is a person using a notebook computer with embedded web cam and array microphone who wants to video conference using VoIP with a friend in another country. We have also engineered our Andrea DSP Microphone and Audio Software Products to be compatible with Universal Serial Bus, or USB, computer architecture. USB is an industry standard for connecting peripherals, such as microphones, earphones, headsets, keyboards, mice, joysticks, scanners and printers, to personal computers. We believe that our Andrea DSP Microphone and Audio Software technology achieve far-field microphone performance previously unattainable through microphones based on mechanical acoustic designs and microphones based on analog signal processing.

Our Andrea DSP Microphone and Audio Software Products include the use of the following technologies, among other technologies and techniques:

Digital Super Directional Array (“*DSDA*”®). Andrea's patented DSDA adaptive beam forming system powers Andrea's SuperBeam microphone which enables more intelligible audio by forming a beam toward the speaker and

eliminating background noises that are outside of the beam. DSDA microphone technology enables high quality far-field communications by centering microphone sensitivity on a user's voice and canceling noise outside of that signal. DSDA continuously samples the ever changing acoustic properties within an environment and adaptively identifies interfering noises that are extraneous to the voice signal, resulting in increased intelligibility of communications.

PureAudio®. Andrea's patented PureAudio and award winning noise reduction speech enhancement algorithm significantly improves intelligibility of voice audio and accuracy in speech driven applications, particularly in high noise environments. PureAudio is especially effective for use with speech recognition and mobile devices. PureAudio is a noise canceling algorithm that enhances applications that are controlled by speech by sampling the ambient noise in an environment and attenuating the noise from sources near or around the desired speech signals, thus delivering a clear audio signal. Designed specifically to improve the signal-to-noise ratio, PureAudio is effective in canceling stationary noises such as computer and ventilation fans, tires and engines.

EchoStop®. Andrea's patented EchoStop provides a full duplex acoustic echo cancellation algorithm enabling both loudspeakers to broadcast and microphone to transmit simultaneously turning your PC into a high quality speakerphone. EchoStop is an advanced acoustic echo canceller (stereo version available) developed for use with conferencing systems such as group audio and videoconferencing systems and cellular car phone kits. EchoStop allows true two-way communication (often referred to as full duplex) over a conferencing system, even when the system is used in large spatial environments that may be vulnerable to extensive reverberation. EchoStop incorporates noise reduction algorithms to reduce the background noise of both the microphone input and the loudspeaker output, thus preventing the accumulation of interfering noise over conferencing systems that facilitate communication among multiple sites.

SuperBeam®. SuperBeam is a highly accurate digital algorithm that forms an acoustic beam that extends from the microphone to the speech source in an environment. We believe SuperBeam provides a fixed noise reduction microphone solution for the typical acoustic environment found in room environments in which speech is used, such as in offices and homes. The microphone beam is generated by processing multiple microphone samples through pre-established digital filters and adding the outputs. The result is an optimum speech enhancement and noise reduction solution to a predefined setting. Because the beam is able to adapt to changes in the acoustic environment, this technology is called adaptive beamforming.

Andrea Anti-Noise Technologies

Noise Cancellation (“NC”) Microphone Technology. This technology is based on the use of pressure gradient microphones to reduce the transmission of noise from the speaker’s location. Instead of using electronic circuitry to reduce noise, pressure gradient microphones rely on their mechanical and acoustic design to do so. Our NC microphones are well-suited for applications in which there is less background noise in the speaker’s environment.

Active Noise Cancellation (“ANC”) Microphone Technology. This technology is based on analog signal processing circuits that electronically cancel the transmission of noise from the speaker’s location. ANC is particularly well-suited for those environments in which the speaker is surrounded by high levels of ambient background noise.

Our ANC and NC microphones are most effectively used in “near-field” applications where the microphone is next to the speaker’s mouth such as a boom microphone headset.

Our Products and their Markets and Applications

Our Andrea DSP Microphone and Audio Software Products and Andrea Anti-Noise Products have been designed for applications that are controlled by or depend on speech across a broad range of hardware and software platforms. These products incorporate our DSP NC and ANC microphone technologies, and are designed to cancel background noise in a range of noisy environments, such as homes, offices, factories and automobiles. We also manufacture a line of accessories for these products. For the consumer and commercial markets, we have designed our Andrea DSP Microphone and Audio Software Products and Andrea Anti-Noise Products for the following applications:

- Speech recognition for word processing, database, and similar applications;
- Distance Learning (education through the use of Internet-based lessons and training information);
- Audio/videoconferencing;
- Internet telephony and Voice Chat;
- Cellular and other wireless telecommunications; and
- Telematics, or in-vehicle computing (the use of computer-controlled systems in automobiles and trucks).

We market and sell our products directly to end users through our website, computer product distributors, through value-added resellers, to original equipment manufacturers and to software publishers. For more information about

these collaborative arrangements, please refer to the information under the caption “Our Collaborative Arrangements.”

Andrea DSP Microphone and Audio Software Products

We develop our Andrea DSP Microphone and Audio Software Products primarily through customer-specific integration efforts, and we either license our related algorithms, sell a product incorporating our related algorithms, or both. For example, we have developed technologies that can be, or are, embedded into a PC, PC monitors, high-end videoconferencing units, IP telephony applications, automotive interiors and hand-held devices, among others. In addition, we have developed stand-alone products for specific customers who then sell such products to end users. As a result, such products are not available from us directly. However, as part of our strategy to increase sales to prospective customers desiring high-quality microphone performance for certain customer-specific environments, we have developed the following products that may be purchased directly from Andrea:

Andrea SuperBeam Array Microphone. Andrea’s patented DSDA adaptive beam forming system powers Andrea’s SuperBeam Array Microphone which enables more intelligible audio by forming a beam toward the speaker and eliminating background noises that are outside of the beam. DSDA is particularly effective for small office/home office use, providing an untethered noise cancelling microphone experience.

Andrea USB-SA External Digital Sound Card. Andrea’s PureAudio USB-SA with patented noise reduction technology eliminates noise problems by utilizing high quality digital circuitry and state of the art noise reduction algorithm software. This format bypasses the desktop or laptop computer’s sound system, providing increased intelligibility and performance of stereo microphone input and stereo speaker output for all of a user’s digital audio applications including VoIP and speech recognition programs.

Andrea AudioCommander™. Andrea’s PC Audio Control Panel, AudioCommander, includes a speaker volume adjustment with received PureAudio noise reduction control and a 10-band graphic equalizer with 18 built-in presets to customize sound for a user’s listening preference. It also includes a microphone volume adjustment with noise reduction, beam forming, and acoustic echo cancellation controls. The software also includes an audio wizard that sets microphone levels to optimize PC audio for speech-enabled applications including speech recognition, Internet telephony and command and speech control functions.

Andrea AutoArray™ Microphone (“AutoArray”). The AutoArray is a digital, high performance microphone system designed for computing applications in vehicles such as automobiles and trucks. It is the first super-directional audio input device designed specifically for in-vehicle computing. The AutoArray incorporates several technologies, including DSDA and PureAudio.

Andrea Pureaudio Live Recorder. PureAudio™ Live Recorder is a full function digital voice and audio recording application for use with Apple™ iOS devices. The PureAudio™ Live Recorder is enhanced with Andrea’s patented digital noise reduction microphone technology. PureAudio™ digitally reduces background noise, while enhancing the recorded sound quality and intelligibility when making recordings in real-world noisy mobile environments.

Andrea Pureaudio Pro Recorder. In addition to the features offered in PureAudio Live Recorder, PureAudio Pro Recorder offers unlimited bookmarks for easy navigation of large recordings, 10-band graphic equalizer to customize your listening experience, aggressive PureAudio for recording in noisy environments, stereo recording for capturing surround sound recordings and beam forming noise cancellation to reduce sounds coming from the sides. PureAudio Pro Recorder is an easy to use, intuitive stereo recorder for capturing music, recitals, church services or precious family events and offers back ground noise reduction for crystal clear recordings of voice notes, lectures and interviews. With its almost unlimited recording time, you never have to worry about cutting off the end of a lecture or recital.

Andrea Anti-Noise Products

Our Andrea Anti-Noise Products include a line of headsets, handsets and related accessories that incorporate our NC and ANC technologies. Our headsets are mostly differentiated by the various designs of their headband, microphone boom and earphone components and are available in both single earphone monaural and dual earphone stereo models.

NC Products. Our NC products are sold through our internal contact center, as well as to original equipment manufacturers for incorporation into, or for use with their products. Our headsets are designed so you can get the most out of your PC audio experience. In addition, with our USB headset products, Andrea has combined the benefits of PureAudio USB digital audio which includes Andrea’s AudioCommander and PureAudio Technology with our noise cancelling PC headsets delivering a high fidelity audio experience with the highest voice recognition industry rating.

Wireless NC Products. Andrea Electronics is now offering our noise cancellation boom microphone technology in our BT-201 Bluetooth headset and our WNC-1500 RF headset. This wireless headset solution enhances sound quality in noisy environments and provides the user with a PureAudio experience, as well as delivering superior speech dialing performance. As an added value, these products can be combined with a USB audio adapter that can be used to seamlessly communicate to a PC.

ANC Products. ANC Products are our premium close talking microphone platform for enhancing speech recognition applications. All of our ANC products are sold through our internal contact center. ANC headset products incorporate a dual microphone system design that optimizes the acoustic performance of the sound.

Our Collaborative Arrangements

An important element of our strategy is to promote widespread adoption of our products and technologies by collaborating with large enterprises and market and technology leaders in security systems and services, industrial system integrators, voice activated services, communications, computer manufacturing, and software publishing. In addition to the arrangements we are involved in, we are currently discussing additional arrangements with other companies, but we cannot assure that any of these discussions will result in any definitive agreements.

Patents, Trademarks, and Other Intellectual Property Rights

Our products and technologies are developed in part using our proprietary intellectual property, and we believe that the strength of our intellectual property rights will be important to the success of our business. We utilize patent and trade secret protection, confidentiality agreements with customers and partners, disclosure and invention assignment agreements with employees and consultants and other contractual provisions to protect our intellectual property and other proprietary information. We plan to license specific, custom designs to our customers, charging royalties at a fixed amount per product or a percentage of sales. More generally, we intend to vigorously defend and monetize our intellectual property through licensing arrangements and, where necessary, enforcement actions against those entities using our patented solutions in their products. Royalties resulting from these patent monetization efforts can be structured in a variety of ways, including but not limited to one-time paid up licenses or on-going royalty arrangements. We expect to generate a portion of our revenues with these types of licensing arrangements.

Andrea maintains a number of patents in the United States covering claims to certain of its products and technology, which expire at various dates ranging from 2015 to 2030. We also have other patent applications currently pending; however, we cannot assure that patents will be issued with respect to these currently pending or future applications which we may file, nor can we assure that the

strength or scope of our existing patents, or any new patents, will be of sufficient scope or strength or provide meaningful protection or commercial advantage to us.

Research and Development

We consider our technology to be of substantial importance to our competitiveness. To maintain this competitiveness, we have organized our research and development efforts using a “market and applications” approach for meeting the requirements of new and existing customers. Consistent with this approach, our engineering staff interacts closely with our sales and marketing personnel and directly with customers. The engineering staff is responsible for the research and development of new products and the improvement and support of existing products. For the years ended December 31, 2014 and 2013, total research and development expenses were \$728,240 and \$701,161, respectively. During 2015, we expect research and development expenses to remain at the same level when compared to 2014. No assurance can be given that our research and development efforts will succeed. See “Part II – Item 7 – Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

Sales and Marketing

We employ a sales staff as well as outside sales representatives and sales organizations to market our Andrea DSP Microphone and Audio Software Products. Andrea DSP Microphone and Audio Software Products are marketed to computer Original Equipment Manufacturers (“OEMs”), distributors of personal computers and communications equipment, software publishers, and industrial system integrators. Under our existing collaborative agreements, our collaborators have various marketing and sales rights to our Andrea DSP Microphone and Audio Software. We are seeking to enter into additional collaborative arrangements for the marketing and sale of our Andrea DSP Microphone and Audio Software Products but we cannot assure that we will be successful in these efforts. Market acceptance of the Andrea DSP Microphone and Audio Software Products and achievement of patent monetization is critical to our success.

Production Operations

In 2014 and 2013, all of our assembly operations were performed with subcontractors in Asia or in the United States. Most of the components for the Andrea DSP Microphone and Audio Software Products and Andrea Anti-Noise Products are available from several sources and are not characteristically in short supply. However, certain specialized components, such as microphones and DSP boards, are available from a limited number of suppliers and subject to long lead times. To date, we have been able to obtain sufficient supplies of these more specialized components, but we cannot assure that we will continue to be able to do so. Shortages of, or interruptions in, the supply of these more specialized components could have a material adverse effect on our sales of Andrea DSP Microphone Products.

Competition

The markets for our Andrea DSP Microphone and Audio Software Products and Andrea Anti-Noise Products are highly competitive. Competition in these markets is based on varying combinations of product features, quality and reliability of performance, price, sales, marketing and technical support, ease of use, compatibility with evolving industry standards and other systems and equipment, name recognition, and development of new products and enhancements. Most of our current and potential competitors in these markets have significantly greater financial, marketing, technical, and other resources than us. Consequently, these competitors may be able to respond more quickly to new or emerging technologies and changes in customer requirements, or to devote greater resources to the development, marketing, and sale of their products than we can.

We believe that our ability to compete successfully will depend upon our ability to develop and maintain advanced technology, develop proprietary products, attract and retain qualified personnel, obtain patent or other proprietary protection for our products and technologies and manufacture, assemble and market products, either alone or through third parties, in a profitable manner.

Employees

At December 31, 2014, we had 15 employees, of whom three were engaged in production and related operations, six were engaged in research and development, and six were engaged in management, administration, sales and customer support duties. None of our employees are unionized or covered by a collective bargaining agreement. We believe that we generally enjoy good relations with our employees. In addition to our regular employees, we utilize seven independent consultants (four are sales representatives, one is engaged for administration purposes and two are engaged in research and development activities).

ITEM 1A. RISK FACTORS

Andrea is a party to the Amended and Restated Revenue Sharing Agreement under which a perpetual predetermined share of its future Monetization Revenues will be allocated to AND34 and under which a default could cause a material adverse effect on its financial position.

Under the Amended and Restated Revenue Sharing Agreement that we entered into with AND34, Monetization Revenues will first be applied 100% to the payment of accrued and unpaid interest on, and then to repay outstanding principal of notes. After the notes are paid off in full, Monetization Revenues received will be allocated to AND34 and the Company in accordance with certain predetermined percentages ranging from 100% until AND34 has received \$3,500,000 to ultimately 20%. The Amended and Restated Revenue Sharing Agreement contains many stipulations between the parties regarding the handling of various matters related to the monetization of our patents. Following an Event of Default, under the Amended and Restated Revenue Sharing Agreement, AND34 may proceed to protect and enforce their rights by suit or other appropriate proceeding, either for specific performance or in aid of the exercise of any power granted under the Amended and Restated Revenue Sharing Agreement or ancillary documents including the notes.

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 years ended December 31, 2014 and

2013 were approximately \$2.8 million and \$3.3 million, respectively. Net loss for the year ended December 31, 2014 was approximately \$2.9 million, or \$0.05 per share on a basic and diluted basis, versus a net loss of approximately \$1.1 million, or \$0.02 per share on a basic and diluted basis for the year ended December 31, 2013. On March 27, 2015, we entered into a contract to sell our Andrea Anti-Noise Products Division. For the year ended December 31, 2014, the Anti-Noise Products business segment generated approximately \$1.5 million in revenue and a total operating loss of approximately \$365,000. We continue to explore opportunities to grow sales in other business areas and vigorously defend and monetize our intellectual property.

Shares Eligible For Future Sale May Have An Adverse Effect On Market Price; 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 March 20, 2015. The number of shares outstanding does not include an aggregate of 26,464,491 shares of common stock that are issuable. This number of issuable common shares is equal to approximately 42% of the 63,721,035 outstanding shares. These issuable common shares are comprised of: a) 18,534,821 shares of our common stock reserved for issuance upon exercise of outstanding awards granted under our 1998 Stock Plan and 2006 Stock Plan; b) 2,277,436 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.

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

As of March 20, 2015, we had 44,231,432 shares of Series C Preferred Stock and 907,144 shares of Series D Preferred Stock outstanding. The issuance of shares of common stock upon conversion of the Series C Preferred Stock is limited to that amount which, after giving effect to the conversion, would cause the holder not to beneficially own in excess of 4.99% or, together with other shares beneficially owned during the 60 day period prior to such conversion, not to beneficially own in excess of 9.99% of the

outstanding shares of common stock. The issuance of common stock upon conversion of the Series D Preferred Stock also is limited to that amount which, after giving effect to the conversion, would cause the holder not to beneficially own in excess of 4.99% of the outstanding shares of our common stock, except that each holder has a right to terminate such limitation upon 61 days notice to us. Beneficial ownership for purposes of calculation of such percentage limitations does not include shares whose acquisition is subject to similar limitations. If all shares of the Series C and Series D Preferred Stock, which are outstanding to be issued, are assumed to be converted into or exercised for shares of common stock, the number of new shares of common stock required to be issued as a result would aggregate 5,652,234 shares, which is equal to approximately 9% of the 63,721,035 outstanding shares.

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

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

If we fail to commercialize and fully market our Andrea DSP Microphone and Audio Software products our net revenues may not increase at a high enough rate to improve our results of operations or may not increase at all.

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

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

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

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

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

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

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

If our marketing collaborators do not effectively market their products that include or incorporate our products, our sales growth will be adversely affected.

We have entered into collaborative and distribution arrangements with software publishers and computer hardware manufacturers relating to the marketing and sale of Andrea DSP Microphone and Audio Software products through inclusion or incorporation with

the products of our collaborators. Our success is dependent to a substantial degree on the efforts of these collaborators to market their products that include or incorporate our products. Our collaborators may not successfully market these products. In addition, our collaborators generally are not contractually obligated to any minimum level of sales of our products or technologies, and we have no control over their marketing efforts. Furthermore, our collaborators may develop their own microphone, earphone or headset products that may replace our products or technologies or to which they may give higher priority.

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

The majority of our assembly operations are fulfilled by subcontractors (primarily in the Far East) using purchased components. Some specialized components for the Andrea DSP Microphone products, such as microphones and digital signal processing boards, are available from a limited number of suppliers (and in some cases foreign) and subject to long lead times. We may not be able to continue to obtain sufficient supplies of these more specialized components, particularly if the sales of our products increase substantially or market demand for these components otherwise increases. If our subcontractors fail to meet our production and shipment schedules, our business, results of operations and financial condition would be materially and adversely affected.

The Company depends on component and product manufacturing and logistical services provided by third parties, many of whom are located outside of the United States.

Substantially all of the Company's components and products are manufactured in whole or in part by a few third-party manufacturers. Many of these manufacturers are located outside of the United States. The Company has also outsourced much of its transportation and logistics management. While these arrangements may lower operating costs, they also reduce the Company's direct control over production and distribution. It is uncertain what effect such diminished control will have on the quality or quantity of products or the Company's flexibility to respond to changing conditions. If manufacturing or logistics in these locations is disrupted for any reason, including but not limited to, natural disasters, information technology system failures, military actions or economic, business, labor, environmental, public health, or political issues, the Company's consolidated financial condition and operating results could be materially adversely affected.

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

We rely on a combination of patents, patent applications, trade secrets, copyrights, trademarks, and nondisclosure agreements with our employees, independent contractors, licensees and potential licensees, limited access to and dissemination of our proprietary information, and other measures to protect our intellectual property and proprietary rights. However, the steps that we have taken to protect our intellectual property may not prevent its misappropriation or circumvention. In addition, numerous patents have been granted to other parties in the fields of noise cancellation,

noise reduction, computer voice recognition, digital signal processing and related subject matter. We expect that products in these fields will increasingly be subject to claims under these patents as the numbers of products and competitors in these fields grow and the functionality of products overlap. Claims of this type could have an adverse effect on our ability to manufacture and market our products or to develop new products and technologies, because the parties holding these patents may refuse to grant licenses or only grant licenses with onerous royalty requirements. Moreover, the laws of other countries do not protect our proprietary rights to our technologies to the same extent as the laws of the United States.

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

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

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

We generate revenues from regions outside the United States. For the years ended December 31, 2014 and 2013, net revenues from sales to customers outside the United States accounted for approximately 47% and 49%, respectively, of our net revenues. International sales and operations are subject to a number of risks, including:

- trade restrictions in the form of license requirements;
- restrictions on exports and imports and other government controls;

- changes in tariffs and taxes;
- difficulties in staffing and managing international operations;
- problems in establishing and managing distributor relationships;
- general economic conditions; and