

ANDREA ELECTRONICS CORP  
Form 10QSB  
May 14, 2007

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

**FORM 10-QSB**

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the quarterly period ended March 31, 2007

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (NO FEE REQUIRED)  
for the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-4324

**ANDREA ELECTRONICS  
CORPORATION**

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

New York

(State or other jurisdiction of incorporation or organization)

11-0482020

(I.R.S. employer identification no.)

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

11716

(Zip Code)

Issuer's telephone number, including area code:

631-719-1800

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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  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 May 10, 2007, there are 59,679,373 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**

	March 31, 2007 (unaudited)	December 31, 2006 (audited)
<u>ASSETS</u>		
Current assets:		
Cash and cash equivalents	\$ 700,183	\$ 303,678
Accounts receivable, net of allowance for doubtful accounts of \$16,626 and \$16,704, respectively	679,043	839,599
Inventories, net	848,171	1,088,778
Prepaid expenses and other current assets	177,234	367,421
Total current assets	2,404,631	2,599,476
Property and equipment, net	35,392	39,243
Intangible assets, net	3,319,478	3,437,432
Other assets, net	12,864	12,864
Total assets	\$ 5,772,365	\$ 6,089,015
<u>LIABILITIES AND SHAREHOLDERS' EQUITY</u>		
Current liabilities:		
Trade accounts payable	\$ 205,677	\$ 619,159
Short-term portion of capital lease	2,290	5,068
Other current liabilities	447,588	413,166
Total liabilities	655,555	1,037,393
Series B Redeemable Convertible Preferred Stock, \$.01 par value; authorized: 1,000 shares; none issued and outstanding	-	-
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 shares; liquidation value: \$1,007,015	1	1
Series D Convertible Preferred Stock, net, \$.01 par value; authorized: 2,500,000 shares; issued and outstanding: 1,217,858 and 1,242,858 shares, respectively; liquidation value: \$1,217,858 and \$1,242,858, respectively	12,179	12,429
Common stock, \$.01 par value; authorized: 200,000,000 shares; issued and outstanding: 59,121,857 and 59,021,857 shares, respectively	591,219	590,219
Additional paid-in capital	76,416,356	76,352,407

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Accumulated deficit	(71,902,945)	(71,903,434)
Total shareholders' equity	5,116,810	5,051,622
Total liabilities and shareholders' equity	\$ 5,772,365	\$ 6,089,015

See Notes to Condensed Consolidated Financial Statements (unaudited).

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

	For the Three Months Ended	
	March 31, 2007	March 31, 2006
Revenues		
Net product revenues	\$ 1,304,822	\$ 926,667
License revenues	267,730	126,658
Revenues	1,572,552	1,053,325
Cost of revenues	789,169	497,357
Gross margin	783,383	555,968
Research and development expenses	172,759	133,535
General, administrative and selling expenses	588,761	476,077
Income (loss) from operations	21,863	(53,644)
Other expense, net	(1,172)	(142)
Income (loss) before provision for income taxes	20,691	(53,786)
Provision for income taxes	20,202	-
Net income (loss)	\$ 489	\$ (53,786)
Basic weighted average shares	59,039,635	58,283,575
Diluted weighted average shares	69,958,736	58,283,575
Basic and diluted net income (loss) per share	\$ 0.00	\$ (0.00)

See Notes to Condensed Consolidated Financial Statements (unaudited)..

**ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES**

CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
FOR THE THREE MONTHS ENDED MARCH 31, 2007  
(UNAUDITED)

	Series C Convertible Preferred Stock Outstanding	Series C Convertible Preferred Stock Outstanding	Series D Convertible Preferred Stock Outstanding	Series D Convertible Preferred Stock Outstanding	Common Shares Outstanding	Common Stock Outstanding	Additional Paid-In Capital	Accumulated Deficit	Total Shareholders' Equity
Balance, January 1, 2007	100,701,477	\$ 1	1,242,858	\$ 12,429	59,021,857	\$ 590,219	\$ 76,352,407	\$ (71,903,434)	\$ 5,051,622
Conversions of Series D Convertible Preferred Stock	-	-	(25,000)	(250)	100,000	1,000	(750)	-	-
Stock Grant to Outside Directors and related amortization	-	-	-	-	-	-	5,000	-	5,000
Amortization of Stock Option Grants	-	-	-	-	-	-	59,699	-	59,699
Net Income	-	-	-	-	-	-	-	489	489
Balance, March 31, 2007	100,701,477	\$ 1	1,217,858	\$ 12,179	59,121,857	\$ 591,219	\$ 76,416,356	\$ (71,902,945)	\$ 5,116,810

See Notes to Condensed Consolidated Financial Statements (unaudited)..

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

	For the Three Months Ended	
	March 31, 2007	March 31, 2006
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ 489	\$ (53,786)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	121,805	123,899
Stock compensation expense	64,699	8,726
Provision for bad debt	(78)	(462)
Inventory reserve	3,199	(208)
<b>Change in:</b>		
Accounts receivable	160,634	(28,638)
Inventories	237,408	(59,949)
Prepaid expenses and other current assets	190,187	(198,630)
Trade accounts payable	(413,482)	178,721
Other current liabilities	34,422	(14,302)
Net cash provided by (used in) operating activities	399,283	(44,629)
<b>Cash flows from investing activities:</b>		
Purchases of patents and trademarks	-	(225)
Net cash used in investing activities	-	(225)
<b>Cash flows from financing activities:</b>		
Payments under capital lease	(2,778)	(3,048)
Net cash used in financing activities	(2,778)	(3,048)
Net increase (decrease) in cash and cash equivalents	396,505	(47,902)
Cash and cash equivalents, beginning of period	303,678	418,597
Cash and cash equivalents, end of period	\$ 700,183	\$ 370,695
<b>Cash paid for:</b>		
Interest	\$ 1,189	\$ 373
Income Taxes	\$ 43,509	\$ 4,061

See Notes to Condensed Consolidated Financial Statements (unaudited)..

**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 interim financial statements include the accounts of Andrea Electronics Corporation and its subsidiaries ("Andrea" or the "Company"). All intercompany balances and transactions have been eliminated in consolidation.

These unaudited, condensed consolidated interim financial statements have been prepared in accordance with accounting principles generally 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 ("GAAP") for complete financial statements. In addition, the December 31, 2006 balance sheet data was derived from the audited consolidated financial statements, but does not include all disclosures required by GAAP. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for any other interim period or for the fiscal year.

These unaudited interim condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2006 included in the Company's Form 10-KSB for the fiscal year ended December 31, 2006, filed on March 23, 2007. The accounting policies used in preparing these unaudited condensed consolidated interim financial statements are consistent with those described in the December 31, 2006 audited consolidated financial statements except for the adoption of Financial Accounting Standards Board ("FASB") Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109"("FIN 48"), which is discussed in Note 9.

Management's Liquidity Plans - As of March 31, 2007, Andrea had working capital of \$1,749,076 and cash on hand of \$700,183. Andrea's income from operations was \$21,863 for the quarter ended March 31, 2007. Andrea plans to continue to improve its cash flows during 2007 by placing heightened emphasis on its sales and marketing efforts.

As of May 10, 2007, Andrea has approximately \$540,000 (unaudited) of cash. Management believes that Andrea has sufficient liquidity available to operate through at least March 2008. While Andrea continues to explore opportunities to increase sales in new business areas, the Company is also examining additional opportunities for cost reduction, production efficiencies and further diversification of its business. In 2005, Andrea made significant changes in its facilities to improve overall cash expenditures. In 2006, Andrea increased sales whereas they reached profitability and become cash flow positive. Although these steps are encouraging, if Andrea fails to develop additional revenues from sales of its products or to generate adequate funding from operations, or if Andrea fails to obtain additional financing through a capital transaction or other type of financing, Andrea will be required to continue to significantly reduce its operating expenses and/or operations or Andrea may have to relinquish its products, technologies or markets which could have a materially adverse effect on revenue and operations. Andrea has no commitment for additional financing and may experience difficulty in obtaining additional financing on favorable terms, if at all.

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

Earnings (loss) Per Share - Basic earnings (loss) per share is computed by dividing the net income (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:

For the Three Months Ended

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	March 31, 2007	March 31, 2006
Total potential common shares as of:		
Options to purchase common stock (Note 7)	4,980,001	4,427,500
Series C Convertible Preferred Stock and related accrued dividends (Note 3)	-	4,836,010
Series D Convertible Preferred Stock and related warrants (Note 4)	5,158,344	10,472,632
Total potential common shares	10,138,345	19,736,142

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

The following table sets forth the components used in the computation of basic and diluted earnings per share:

	For the Three Months Ended	
	March 31, 2007	March 31, 2006
Numerator:		
Net income (loss)	\$ 489	\$ (53,786)
Denominator:		
Weighted average shares	59,039,635	58,283,575
Effect of dilutive securities:		
Series C Convertible Preferred Stock	4,607,252	- (1)
Series D Convertible Preferred Stock	4,871,432	- (1)
Employee stock options	1,440,417	- (1)
Denominator for diluted earnings per share-adjusted weighted average shares after assumed conversions	69,958,736	58,283,575

1. There were no dilutive securities for the quarter ended March 31, 2006 as the period had a net loss and the effect of any dilutive security would be anti-dilutive

**Cash and Cash Equivalents** - Cash and cash equivalents include cash and highly liquid investments with original maturities of three months or less. Andrea has cash deposits in excess of the maximum amounts insured by FDIC at March 31, 2007 and December 31, 2006. The Company mitigates its risk by investing in or through major financial institutions.

**Concentration of Credit Risk** - Andrea is a manufacturer of audio communications equipment for several industries. Revenues of noise canceling and active noise canceling products were significant to one customer and its affiliates, accounting for approximately 8% and 21% of the total net revenues for the three months ended March 31, 2007 and 2006, respectively, and accounted for 0% and 3% of total accounts receivable at March 31, 2007 and December 31, 2006, respectively. Revenues of superbeam array microphone products were significant to one customer and its affiliates, accounting for approximately 13% and 0% of the total net revenues for the three months ended March 31, 2007 and 2006, respectively, and accounted for 30% and 24% of total accounts receivable at March 31, 2007 and December 31, 2006, respectively. Licensing revenues and other revenues of noise canceling and active noise canceling products were significant to one customer and its affiliates, accounting for approximately 23% and 9% of the total net revenues for the year ended March 31, 2007 and 2006, respectively, and accounted for 27% and 41% of total accounts receivable at March 31, 2007 and December 31, 2006, respectively.

During the three months ended March 31, 2007 and 2006, Andrea purchased a substantial portion of its finished goods from two suppliers. Purchases from these two suppliers amounted to 86% and 7% for the three months ended March 31, 2007 and 63% and 10% for the three months ended March 31, 2006, of total purchases. At March 31, 2007, the amounts due to these suppliers in accounts payable were \$34,415 and \$0, respectively. At December 31, 2006, the amounts due to these suppliers in accounts payable were \$377,019 and \$0 respectively.

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

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Inventories - Inventories are stated at the lower of cost (on a first-in, first-out) or market basis. The cost elements of inventories include materials, labor and overhead. Andrea reviews its inventory reserve for obsolescence on a quarterly basis and establishes reserves on inventories when the cost of the inventory is not expected to be recovered. Andrea's policy is to reserve for inventory that shows slow movement over the preceding six consecutive quarters. Andrea records changes in inventory reserves as part of cost of revenues.

	March 31, 2007	December 31, 2006
Raw materials	\$ 37,137	\$ 40,237
Finished goods	1,406,213	1,640,521
	1,443,350	1,680,758
Less: reserve for obsolescence	(595,179)	(591,980)
	\$ 848,171	\$ 1,088,778

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

At March 31, 2007, management compared the sum of Andrea's undiscounted cash flow projections (gross margin dollars from product sales) of the Andrea DSP Microphone and Audio Software core technology to the carrying value of that technology. The results of this test indicated that there was no impairment. However, this process utilized probability weighted undiscounted cash flow projections which include a significant amount of management's judgment and estimates as to future revenue. If these probability weighted projections do not come to fruition, the Company could be required to record an impairment charge in the near term and such impairment could be material.

Andrea amortizes its core technology, patents and trademarks on a straight-line basis over the estimated useful lives of its intangible assets that range from 15 to 17 years. For the three-month periods ended March 31, 2007 and 2006, amortization expense was \$117,954 and \$117,622, respectively.

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 in Financial Statement." License revenue is recognized based on the terms and conditions of individual contracts (see Note 5). In addition, fee based services, which are short-term in nature, are generally performed on a time-and-material basis under separate service arrangements and the corresponding revenue is generally recognized as the services are performed.

Income Taxes - The provision for income taxes for the quarter ended March 31, 2007 is a result of certain licensing revenues that are subject to withholding of income tax as mandated by the foreign jurisdiction in which the revenues are earned. There is no provision for income taxes for the quarter ending March 31, 2006, as Andrea did not have revenue subject to these withholding taxes in this period. For all other income taxes, Andrea accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." SFAS No. 109 requires an asset and liability approach for financial accounting and reporting for income taxes. The provision for income taxes is based upon income or loss after adjustment for those permanent items that are not considered in the determination of taxable income. Deferred income taxes represent the tax effects of differences between the financial reporting and tax bases of the Company's assets and liabilities at the enacted tax rates in effect for the years in which the differences are expected to reverse. The Company evaluates the recoverability of deferred tax assets and establishes a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. If it becomes more likely than not that a tax asset will be used, the related valuation allowance on such assets would be reversed. Management makes judgments as to the interpretation of the tax laws that might be challenged upon an audit and cause changes to previous estimates of tax liability. In management's opinion, adequate provisions for income taxes have been made for all years. If actual taxable income by tax jurisdiction varies from estimates, additional allowances or reversals of reserves may be necessary. Income tax expense consists of the tax payable for the period and the change during the period in deferred tax assets and liabilities. Effective January 1, 2007, the Company adopted the provisions of FIN 48. FIN 48 establishes for all entities a minimum threshold for financial statement recognition of the benefit of tax positions, and requires certain expanded disclosures. FIN 48 is effective for fiscal years beginning after December 31, 2006, and is to be applied to all open tax years as of the date of effectiveness. The adoption of FASB Interpretation No. 48 did not have a material effect on the Company's condensed consolidated financial position or

results of operations or cash flows (Note 9).

Stock-Based Compensation - At March 31, 2007, Andrea had three stock-based employee compensation plans, which are described more fully in Note 7. Effective, January 1, 2006, the Company adopted the provisions of SFAS No. 123R, "Share-Based Payment." SFAS No. 123R establishes accounting for stock-based awards exchanged for employee services. Under the provisions of SFAS No. 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 stock-based compensation by using the straight-line method. The Company elected to adopt the modified prospective transition method as provided by SFAS No. 123R. In accordance with the requirements of the modified prospective transition method, condensed 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 No. 123R excess tax benefits realized from the exercise of stock-based awards are classified in cash flows from financing activities. The result of adoption of this pronouncement was \$59,699 of compensation expense for the three month period ended March 31, 2007, \$49,148 which is included in general, administrative and selling expenses, \$10,077 is included in research and development expenses and \$474 is included in cost of revenues in the accompanying condensed consolidated statement of operations. The result of adoption of this pronouncement was \$3,725 of compensation expense for the three month period ended March 31, 2006, which is included in general, administrative and selling expenses in the accompanying condensed consolidated statement of operations.



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

Recently Issued Accounting Pronouncements

Effective January 1, 2007, the Company adopted Emerging Issues Task Force (“EITF”) Issue No. 06-2, “Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, Accounting for Compensated Absences” (“EITF Issue No. 06-2”). EITF Issue No. 06-2 requires that compensation expense associated with a sabbatical leave, or other similar benefit arrangements, be accrued over the requisite service period during which an employee earns the benefit. The adoption of EITF Issue No. 06-2 did not have a material impact on our condensed consolidated financial position, results of operations or cash flows.

In September 2006, the FASB issued Statement No. 157, “Fair Value Measurements” (“Statement No. 157”) which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. Statement No. 157 applies to other accounting pronouncements that require or permit fair value measurements and accordingly, does not require any new fair value measurements. Statement No. 157 is effective for fiscal years beginning after November 15, 2007, and should be applied prospectively, except for the provisions for certain financial instruments that should be applied retrospectively as of the beginning of the year of adoption. The transition adjustment of the difference between the carrying amounts and the fair values of those financial instruments should be recognized as a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. The Company is currently evaluating the impact of adopting the provisions of Statement No. 157.

In November 2006, the EITF reached a final consensus in EITF Issue 06-6 “Debtor’s Accounting for a Modification (or Exchange) of Convertible Debt Instruments” (“EITF 06-6”). EITF 06-6 addresses the modification of a convertible debt instrument that changes the fair value of an embedded conversion option and the subsequent recognition of interest expense for the associated debt instrument when the modification does not result in a debt extinguishment pursuant to EITF 96-19, “Debtor’s Accounting for a Modification or Exchange of Debt Instruments,”. The consensus should be applied to modifications or exchanges of debt instruments occurring in interim or annual periods beginning after November 29, 2006. The adoption of EITF 06-6 did not have a material impact on the Company’s condensed consolidated financial position, results of operations or cash flows.

In November 2006, the FASB ratified EITF Issue No. 06-7, Issuer’s Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (“EITF 06-7”). At the time of issuance, an embedded conversion option in a convertible debt instrument may be required to be bifurcated from the debt instrument and accounted for separately by the issuer as a derivative under FAS 133, based on the application of EITF 00-19. Subsequent to the issuance of the convertible debt, facts may change and cause the embedded conversion option to no longer meet the conditions for separate accounting as a derivative instrument, such as when the bifurcated instrument meets the conditions of Issue 00-19 to be classified in stockholders’ equity. Under EITF 06-7, when an embedded conversion option previously accounted for as a derivative under FAS 133 no longer meets the bifurcation criteria under that standard, an issuer shall disclose a description of the principal changes causing the embedded conversion option to no longer require bifurcation under FAS 133 and the amount of the liability for the conversion option reclassified to stockholders’ equity. EITF 06-7 should be applied to all previously bifurcated conversion options in convertible debt instruments that no longer meet the bifurcation criteria in FAS 133 in interim or annual periods beginning after December 15, 2006, regardless of whether the debt instrument was entered into prior or subsequent to the effective date of EITF 06-7. Earlier application of EITF 06-7 is permitted in periods for which financial statements have not yet been issued. The Company does not expect that the adoption of EITF 06-7 to have a material impact on the Company’s condensed consolidated financial position, results of operations or cash flows.

In December 2006, the FASB issued FASB Staff Position (“FSP”) EITF 00-19-2 “Accounting for Registration Payment Arrangements” (“FSP EITF 00-19-2”) which specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement should be separately recognized and

measured in accordance with SFAS No. 5, "Accounting for Contingencies." Adoption of FSP EITF 00-19-02 is required for fiscal years beginning after December 15, 2006. The adoption of FSP EITF 00-19-02 did not have a material impact on the Company's condensed consolidated financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159 "The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115" ("SFAS No. 159"), which permits entities to choose to measure many financial instruments and certain other items at fair value. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. Adoption is required for fiscal years beginning after November 15, 2007. Early adoption is permitted as of the beginning of a fiscal year that begins on or before November 15, 2007, provided the entity also elects to apply the provisions of SFAS No. 159. The Company is currently evaluating the expected effect of SFAS 159 on its condensed consolidated financial statements and is currently not yet in a position to determine such effects.

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

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

Management bases its estimates on historical experience and on various assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. The most significant estimates, among other things, are used in accounting for allowances for bad debts, inventory valuation and obsolescence, product warranty, depreciation, deferred income taxes, expected realizable values for assets (primarily intangible assets), contingencies, revenue recognition as well as the recording and presentation of our 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.

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

On October 10, 2000, Andrea issued and sold in a private placement \$7,500,000 of Series C Redeemable Convertible Preferred Stock (the "Series C Preferred Stock"). Each of these shares of Series C Preferred Stock had a stated value of \$10,000 plus \$671.23 increase in the stated value, which sum is convertible into Common Stock at a conversion price of \$0.2551. The Series C Preferred Stock currently has no dividends. Prior to the amendment there was a dividend of 5% per annum on the stated value. The additional amount of \$671.23 represents the 5% per annum from October 10, 2000 through the amendment.

As of March 31, 2007, there were 100.701477 shares of Series C Preferred Stock outstanding, which were convertible into 4,607,252 shares of Common Stock and remaining accrued dividends of \$168,296, which is included in other current liabilities in the accompany unaudited condensed consolidated balance sheet.

On April 11, 2007, 10 shares of Series C Preferred Stock, together with related accrued dividends, were converted into 457,516 shares of Common Stock at a conversion price of \$0.2551. As of May 10, 2007, there were 90.701477 shares of Series C Preferred Stock outstanding, which were convertible into 4,149,736 shares of Common Stock.

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

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

Knightsbridge Capital served as a financial advisor to Andrea in connection with the aforementioned transactions and the initial issuance of the Series D Preferred Stock and related warrants. In connection with these transactions, Andrea

agreed to pay Knightsbridge Capital \$300,000 in cash and to issue warrants exercisable for an aggregate of 377,094 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.

From the time of issuance through June 4, 2009, the Company is required to maintain effective registration statements. Prior to 2007, there were 281,250 exercises of Series D Preferred Stock Warrants. On March 16, 2007, 25,000 shares of Series D Preferred Stock were converted into 100,000 shares of Common Stock at a conversion price of \$0.25. As of March 31, 2007, there are 1,217,858 shares of Series D Preferred Stock and 5,158,344 related warrants outstanding, which are convertible and exercisable into 10,029,776 shares of Common Stock. There were no Series D Preferred Stock Warrant exercises during the quarter ended March 31, 2007.

On April 11, 2007, 25,000 shares of Series D Preferred Stock were converted into 100,000 shares of Common Stock at a conversion price of \$0.25. As of May 10, 2007, there are 1,192,858 shares of Series D Preferred Stock and 5,158,344 related warrants outstanding, which are convertible and exercisable into 9,929,776 shares of Common Stock.

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## Note 5. Licensing Agreements

### *Analog*

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 March 31, 2007 and March 31, 2006, Andrea has recognized \$41,513 and \$25,000, respectively of licensing revenues related to this agreement.

In January 2006, Andrea entered into a license agreement with Analog to integrate its 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 March 31, 2007 and March 31, 2006, Andrea has recognized \$26,941 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.

### *Marconi*

In December 2002, Andrea entered into a license agreement with Marconi Communications to provide and integrate a number of its 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. In 2006, Ericsson Inc. purchased certain assets and liabilities of Marconi Communication Inc. In conjunction with this purchase, Andrea, Marconi Communications Inc. and Ericsson Inc. executed a Novation Agreement in which the 2002 license agreement is now between Ericsson and Andrea. During the three months ended March 31, 2007 and 2006 Andrea recorded \$6,080 and \$9,240 of license revenue related to this agreement, respectively.

### *Creative*

In October 2004 Andrea entered into a Production and Distribution Agreement with Creative Technology Ltd. ("Creative"). This agreement was modified in January 2005 to incorporate additional license rights. This agreement grants Creative a non-exclusive license to VoiceCenter, PureAudio and DSDA as well as the right to purchase and resell certain of its 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. The features of PureAudio and DSDA will be distributed in certain of Creative's other products to enable optimized far-field voice input. In consideration of this agreement, Creative pays Andrea a royalty for each VoiceCenter license shipped with the Soundblaster Live and each webcam shipped with Andrea's licensed technologies. During the three months ended March 31, 2007 and 2006, Andrea recorded \$179,308 and \$90,101 of licensing revenue related to this agreement, respectively.

### *Samsung*

In October 2005, Andrea entered into a license agreement with Samsung Electronics Co., LTD ("Samsung") to integrate our DSDA and EchoStop technologies with certain notebook/laptop PC products incorporating directional



microphone and speaker phone functions for use in conjunction with PC software voice driven applications. During the three months ended March 31, 2007 and 2006, Andrea recorded \$13,430 and \$0 of licensing revenue related to this agreement, respectively.

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**Note 6. Commitments And Contingencies**Leases

In March 2005, Andrea entered into a lease for its 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 \$19,294, respectively for the three-month periods ended March 31, 2007 and March 31, 2006.

As of March 31, 2007, the future minimum annual lease payments under this lease and all non-cancelable operating leases are as follows:

2007 (April to December 31)	\$	71,515
2008		90,374
2009		89,557
2010		29,171
Total	\$	280,617

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 this employment agreement, Mr. Andrea received an annual base salary of \$225,000 per annum, a minimum annual prorated bonus of \$50,000. 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 did not receive a \$50,000 bonus for the periods ended December 31, 2005 and 2004, and instead is entitled to \$100,000 bonus when the Company has positive cash flows. At December 31, 2006 and March 31, 2007, the future minimum cash commitments under this agreement aggregate \$115,000 and 100,000, respectively, (including the unpaid portion of Mr. Andrea's 2005 and 2004 bonuses), and is included in other liabilities in the Company's accompanying condensed balance sheet.

In November 2006, the Company entered into a new employment agreement with Mr. 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. On November 16, 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. 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. At March 31, 2007, the future minimum cash commitments under this agreement aggregate \$400,000. At December 31, 2006, the future minimum cash commitments under this agreement aggregate \$481,349, of which \$6,349 is included in other liabilities at December 31, 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 7. 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 December 31, 2006, there were 9,984 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”), which was subsequently approved by the shareholders. 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. At March 31, 2007, there were 8,070,000 shares available for further issuance under the 2006 Plan.

In 2006, pursuant to Andrea’s compensation policy for outside directors, Andrea granted 166,668 shares of Common Stock with a fair market value of \$0.12. Compensation expense related to these awards was \$5,000 and \$5,001 for the three-month period ended March 31, 2007 and 2006, respectively.

On August 4, 2005, in accordance with his employment agreement, Mr. Andrea was granted 250,000 stock options. This grant provides for a six month vesting period, an exercise price of \$0.04 per share, which was fair market value at the date of grant, and a term of 10 years. The compensation expense related to the award was \$0 and 1,333 for the three-month period ended March 31, 2007 and 2006, respectively.

On November 1, 2005, the Board granted 40,000 stock options to each chairperson on the Nominating and Audit Committees. The grants provide for a six-month vesting period, an exercise price of \$0.05 per share, which was fair market value at the date of grant, and a term of 10 years. The compensation expense related to these awards was \$0 and 2,000 for the three-month period ended March 31, 2007 and 2006, respectively.

In November 2006, in accordance with his employment agreement, Mr. Andrea was granted 2,000,000 stock options. These grants provide for three year vesting, an exercise price of \$0.12 per share, which was fair market value at the date of grant, and a term of 10 years. The compensation expense related to these awards was \$36,648 and \$0 for the three-month period ended March 31, 2007 and 2006, respectively.

During 2006, the Board granted 400,000 stock options to the Vice President and Chief Financial Officer and 755,000 stock options to employees of the Company. Each option grant provides for vesting periods of up to three years, a weighted average exercise price of \$0.12 per share, the exercise price of each option grant was equal to the fair market value at the date of grant, and a term of 10 years. The compensation expense related to these awards was \$20,302 and \$392 for the three-month period ended March 31, 2007 and 2006, respectively.

On November 16, 2006, the Board granted 16,667 stock options to each chairperson on the Nominating and Compensation Committees and 41,667 stock options to the chairperson on the Audit Committee. The grants provide for an eighteen-month 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. The compensation expense related to these awards was \$2,749 and \$0 for the three-month period ended March 31, 2007 and 2006, respectively.

Total compensation expense recognized related to stock option awards was \$59,699 and \$3,725 for the three-month period ended March 31, 2007 and 2006, respectively. For the three month period ended March 31, 2007, \$49,148 is included in general, administrative and selling expenses, \$10,077 is included in research and development expenses and \$474 is included in cost of revenues in the accompanying condensed consolidated statement of operations. For the three-month period ended March 31, 2006, the expense 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 months ended March 31, 2006:

March 31, 2006

Expected life in years	7
Risk-free interest rates	4.46%
Volatility	220%
Dividend yield	0%

There were no options granted during the three-month period ending March 31, 2007.

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Option activity during 2007 and 2006 is summarized as follows:

	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	3,230,001	0.12			
Cancelled	(152,500)	0.98			
At December 31, 2006	7,590,001	1.05	8.01 years	4,397,500	\$ 1.72
At March 31, 2007	7,590,001	1.05	7.81 years	4,427,500	\$ 1.71

The following table is the summary of the Company's nonvested shares as of March 31, 2007 and 2006:

	Options Outstanding and Nonvested	Weighted Average Exercise Price	Weighted Average Fair Value
Nonvested at January 1, 2006	330,000	0.04	0.04
Granted	3,230,001	0.12	0.12
Vested	(367,500)	0.04	0.04
Nonvested at December 31, 2006	3,192,501	0.12	0.12
Vested	(30,000)	0.04	0.04
Nonvested at March 31, 2007	3,162,501	0.12	0.12

The following table summarizes information about stock options outstanding at March 31, 2007:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
\$0.04 to \$0.06	2,345,000	8.29	\$ 0.05	2,345,000	\$ 0.05
0.07 to 0.11	265,000	6.93	0.09	257,500	0.10
0.12 to 0.17	3,580,001	9.34	0.12	425,000	0.13
0.28 to 0.43	35,000	6.12	0.34	35,000	0.34
0.44 to 0.65	70,000	5.70	0.57	70,000	0.57
0.66 to 1.00	342,500	4.84	0.69	342,500	0.69
1.52 to 2.28	75,000	4.03	1.75	75,000	1.75
2.29 to 3.43	10,000	3.68	3.30	10,000	3.30

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5.17 to 7.75	632,500	2.05	6.03	632,500	6.03
7.76 to 11.65	40,000	2.36	8.25	40,000	8.25
11.66 to 17.49	195,000	1.11	14.28	195,000	14.28
\$0.04 to \$17.49	7,590,001	7.81	\$ 1.05	4,427,500	\$ 1.71

As of March 31, 2007, there was \$244,794 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the 1998 and 2006 Plans. This unrecognized compensation cost is expected to be recognized over the next 3 years (\$133,382 during the remaining period in 2007, \$83,602 in 2008 and \$27,810 in 2009).

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**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 unaudited condensed consolidated financial information for Andrea's segments for the three-month periods ended March 31, 2007 and 2006:

2007 Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti- Noise Products	Total 2007
Net revenues from external customers	\$ 467,484	\$ 837,338	\$ 1,304,822
License Revenues	267,730	-	267,730
(Loss) income from operations	(2,257)	24,119	21,863
Depreciation and amortization	117,159	4,646	121,805
Assets	4,196,850	1,575,515	5,772,365
Total long lived assets	3,181,254	173,616	3,354,870

2006 Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti- Noise Products	Total 2006
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