ANDREA ELECTRONICS CORP
Form 10-Q
May 06, 2010

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2010

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<br>(State or other jurisdiction of incorporation or organization) | 11-0482020<br>(I.R.S. employer identification no.) |
| 65 Orville Drive, Bohemia, New York<br>(Address of principal executive offices) | 11716<br>(Zip Code) |

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

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

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 ¨ No ¨

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

| | |
|---|---|
| Large Accelerated Filer ¨ | Accelerated Filer ¨ |
| Non-Accelerated Filer ¨<br>(Do not check if a smaller reporting company) | Smaller Reporting Company x |

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

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: As of May 4, 2010, there were 63,538,029 common shares outstanding.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

| | March 31, 2010 (unaudited) | December 31, 2009 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash | $1,892,896 | $1,805,091 |
| Accounts receivable, net of allowance for doubtful accounts of $8,416 and $6,262, respectively | 513,475 | 514,327 |
| Inventories, net | 678,278 | 842,428 |
| Short term customer deposits | 79,632 | 93,168 |
| Deferred income taxes, net | 134,901 | 143,130 |
| Prepaid expenses and other current assets | 147,589 | 93,552 |
| Total current assets | 3,446,771 | 3,491,696 |
| | | |
| Property and equipment, net | 225,468 | 215,974 |
| Intangible assets, net | 1,987,356 | 2,106,507 |
| Other assets, net | 12,864 | 12,864 |
| Total assets | $5,672,459 | $5,827,041 |
| | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| | | |
| Current liabilities: | | |
| Trade accounts payable | $190,289 | $392,128 |
| Current portion of long-term debt | 21,562 | 21,214 |
| Accrued Series C Preferred Stock Dividends | 80,606 | 80,606 |
| Short-term deferred revenue | 109,632 | 123,168 |
| Other current liabilities | 192,889 | 156,503 |
| Total current liabilities | 594,978 | 773,619 |
| | | |
| Long term debt, net of current portion | 94,153 | 99,786 |
| | | |
| Series B Redeemable Convertible Preferred Stock, $.01 par value; authorized: 1,000 shares; issued and outstanding: 0 shares | - | - |
| | | |
| Commitments and contingencies | | |
| | | |
| Shareholders' equity: | | |
| Preferred stock, $.01 par value; authorized: 2,497,500 shares; none issued and outstanding | - | - |
| Series C Convertible Preferred Stock, net, $.01 par value; authorized: 1,500 shares; | | |

| | | |
|---|---|---|
| issued and outstanding: 48.2 shares; liquidation value: $482,314 | 1 | 1 |
| Series D Convertible Preferred Stock, net, $.01 par value; authorized: 2,500,000 shares; issued and outstanding: 907,144 shares; liquidation value: $907,144 | 9,072 | 9,072 |
| Common stock, $.01 par value; authorized: 200,000,000 shares; issued and outstanding: 63,538,029 shares | 635,380 | 635,380 |
| Additional paid-in capital | 77,147,012 | 77,096,177 |
| Accumulated deficit | (72,808,137) | (72,786,994) |
| | | |
| Total shareholders' equity | 4,983,328 | 4,953,636 |
| | | |
| Total liabilities and shareholders' equity | $5,672,459 | $5,827,041 |

See Notes to Condensed Consolidated Financial Statements.

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

| | For the Three Months Ended | |
|---|---|---|
| | March 31, 2010 | March 31, 2009 |
| Revenues | | |
| Net Product revenues | $808,988 | $622,739 |
| License revenues | 433,252 | 198,841 |
| Revenues | 1,242,240 | 821,580 |
| Cost of revenues | 446,984 | 322,745 |
| Gross margin | 795,256 | 498,835 |
| Research and development expenses | 171,655 | 149,513 |
| General, administrative and selling expenses | 638,265 | 634,421 |
| Loss from operations | (14,664) | (285,099) |
| Interest income, net | 1,806 | 2,492 |
| Loss before provision for income taxes | (12,858) | (282,607) |
| Provision for income taxes | 8,285 | 1,257 |
| Net loss | $(21,143) | $(283,864) |
| Basic and diluted weighted average shares | 63,538,029 | 60,978,373 |
| Basic and diluted net loss per share | $(0.00) | $(0.00) |

See Notes to Condensed Consolidated Financial Statements.

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
FOR THE THREE MONTHS ENDED MARCH 31, 2010
(UNAUDITED)

| | Series C Convertible Preferred Stock Outstanding | Series C Convertible Preferred Stock | Series D Convertible Preferred Stock Outstanding | Series D Convertible Preferred Stock | Common Stock Shares Outstanding | Common Stock | Additional Paid-In Capital | Accumulated Deficit | Total Shareholders' Equity |
|---|---|---|---|---|---|---|---|---|---|
| Balance, January 1, 2010 | 48.231432 | $1 | 907,144 | $9,072 | 63,538,029 | $635,380 | $77,096,177 | $(72,786,994) | $4,953,636 |
| Stock-based Compensation Expense related to Stock Option Grants | - | - | - | - | - | - | 50,835 | - | 50,835 |
| Net loss | - | - | - | - | - | - | - | (21,143) | (21,143) |
| Balance, March 31, 2010 | 48.231432 | $1 | 907,144 | $9,072 | 63,538,029 | $635,380 | $77,147,012 | $(72,808,137) | $4,983,328 |

See Notes to Condensed Consolidated Financial Statements.

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

| | For the Three Months Ended | |
|---|---|---|
| | March 31, 2010 | March 31, 2009 |
| Cash flows from operating activities: | | |
| Net loss | $(21,143) | $(283,864) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization | 136,054 | 127,641 |
| Stock based compensation expense | 50,835 | 59,890 |
| Bad debt expense | 2,153 | - |
| Inventory reserve | (3,548) | (1,379) |
| Deferred income taxes | 8,229 | - |
| Change in: | | |
| Accounts receivable | (1,301) | 571,461 |
| Inventories | 167,698 | 168,859 |
| Short term customer deposit | 13,536 | (150,000) |
| Prepaid expenses and other current assets | (54,037) | 40,081 |
| Trade accounts payable | (201,839) | 8,443 |
| Short-term deferred revenue | (13,536) | 150,000 |
| Other current liabilities | 36,386 | 18,333 |
| Net cash provided by operating activities | 119,487 | 709,465 |
| | | |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (26,246) | (21,619) |
| Purchases of patents and trademarks | (151) | (13,577) |
| Net cash used in investing activities | (26,397) | (35,196) |
| | | |
| Cash flows from financing activities: | | |
| Principal repayments of long term debt | (5,285) | - |
| Net cash used in financing activities | (5,285) | - |
| | | |
| Net increase in cash | 87,805 | 674,269 |
| | | |
| Cash, beginning of year | 1,805,091 | 1,006,951 |
| Cash, end of period | $1,892,896 | $1,681,220 |
| | | |
| Supplemental disclosures of cash flow information: | | |
| | | |
| Cash paid for: | | |
| Income Taxes | $2,656 | $5,613 |
| Interest | $1,800 | $- |

See Notes to Condensed Consolidated Financial Statements.

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

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

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

These unaudited, condensed consolidated interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In addition, the December 31, 2009 balance sheet data was derived from the audited consolidated financial statements, but does not include all disclosures required by GAAP. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for any other interim period or for the fiscal year.

These unaudited condensed consolidated interim financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2009 included in the Company's Form 10-K for the fiscal year ended December 31, 2009, filed on March 16, 2010. The accounting policies used in preparing these unaudited condensed consolidated interim financial statements are consistent with those described in the December 31, 2009 audited consolidated financial statements.

Management's Liquidity Plans - As of March 31, 2010, Andrea had working capital of $2,851,793 and cash on hand of $1,892,896. Andrea's loss from operations was $14,664 for the three months ended March 31, 2010. Andrea plans to continue to improve its cash flows during 2010 by aggressively pursuing additional licensing opportunities related to Andrea DSP Audio Software and increasing its Andrea Anti-Noise Headset Products sales through new products that are currently being offered and that are under development, as well as the increased efforts of the Company to its sales and marketing efforts. However, there can be no assurance that Andrea will be able to successfully execute the aforementioned plans.

As of May 4, 2010, Andrea had approximately $1,900,000 of cash. Management projects that Andrea has sufficient liquidity available to operate through at least March 2011. While Andrea explores opportunities to increase revenues in new business areas, the Company also continues to examine additional opportunities for cost reduction and further diversification of its business. Since the third quarter of 2006, Andrea has generated cash flows from operations. If Andrea fails to develop additional revenues from sales of its products and licensing of its technology 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

(Loss) earnings Per Share - Basic (loss) earnings per share is computed by dividing the net (loss) income by the weighted average number of common shares outstanding during the period. Diluted (loss) earnings adjusts basic (loss) earnings per share for the effects of convertible securities, stock options and other potentially dilutive financial instruments, only in the periods in which such effect is dilutive. Securities that could potentially dilute basic earnings per share ("EPS") in the future that were not included in the computation of the diluted EPS because to do so would have been anti-dilutive for the periods presented, consist of the following:

| Total potential common shares as of: | March 31, 2010 | March 31, 2009 |
|---|---|---|
| Options to purchase common stock (Note 8) | 16,116,821 | 14,536,820 |
| Series C Convertible Preferred Stock and related accrued dividends (Note 3) | 2,206,664 | 4,103,984 |
| Series D Convertible Preferred Stock (Note 4) | 3,628,576 | 6,481,254 |
| Total potential common shares | 21,952,061 | 25,122,058 |

Cash - Cash includes cash and highly liquid investments with original maturities of three months or less. At times during the periods ended March 31, 2010 and December 31, 2009, the Company had cash deposits in excess of the maximum amounts insured by the Federal Deposit Insurance Corporation insurance limits. At March 31, 2010, the Company's cash is held at three financial institutions.

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

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

| | For the Three Months Ended | | | |
|---|---|---|---|---|
| | March 31, 2010 | | March 31, 2009 | |
| Customer A | 31 | % | 19 | % |
| Customer B | 11 | % | * | |

* Amounts are less than 10%

As of March 31, 2010, Customer A and Customer B accounted for approximately 15% and 26% of account receivable, respectively. As of December 31, 2009, there was no account receivable outstanding for Customer A or Customer B.

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

| | For the Three Months Ended | | | |
|---|---|---|---|---|
| | March 31, 2010 | | March 31, 2009 | |
| Supplier A | 95 | % | 25 | % |
| Supplier B | * | | 75 | % |

At March 31, 2010, Supplier A accounted for approximately 12% of accounts payable. At December 31, 2009, Supplier A accounted for approximately 63% of accounts payable.

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

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

| | March 31, 2010 | December 31, 2009 |
|---|---|---|
| Raw materials | $47,916 | $54,351 |
| Finished goods | 1,279,822 | 1,441,085 |
| | 1,327,738 | 1,495,436 |
| Less: reserve for obsolescence | (649,460 ) | (653,008 ) |
| | $678,278 | $842,428 |

Intangible and Lived Assets - Andrea accounts for its long-lived assets in accordance with Statement of Financial Accounting Standards Board (“FASB”) Accounting Standard Codification (“ASC”) 360 “Plant, Property and Equipment, ” for purposes of determining and measuring impairment of its long-lived assets (primarily intangible assets) other than goodwill. Andrea’s policy is to review the value assigned to its long lived assets to determine if they have been permanently impaired by adverse conditions which may affect Andrea whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If Andrea identifies a permanent impairment such that the carrying amount of Andrea’s long lived assets is not recoverable using the sum of an undiscounted cash flow projection (gross margin dollars from product sales), the impaired asset is adjusted to its estimated fair value, based on an estimate of future discounted cash flows which becomes the new cost basis for the impaired asset. Considerable management judgment is necessary to estimate undiscounted future operating cash flows and fair values and, accordingly, actual results could vary significantly from such estimates. No impairment charges were recognized during the three month period ended March 31, 2010 and 2009.

Revenue Recognition - Non software-related revenue, which is generally comprised of microphones and microphone connectivity product revenues, is recognized when title and risk of loss pass to the customer, which is generally upon shipment. With respect to licensing revenues, Andrea recognizes revenue in accordance with ASC 985, “Software” and ASC 605 “Revenue Recognition.” License revenue is recognized based on the terms and conditions of individual contracts. In addition, fee based services, which are short-term in nature, are generally performed on a time-and-material basis under separate service arrangements and the corresponding revenue is generally recognized as the services are performed.

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

Income Taxes - The provision for income taxes 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. For all other income taxes, Andrea accounts for income taxes in accordance with ASC 740, “Income Taxes” (“ASC 740”). ASC 740 requires an asset and liability approach for financial accounting and reporting for income taxes and establishes for all entities a minimum threshold for financial statement recognition of the benefit of tax positions, and requires certain expanded disclosures. The provision for income taxes is based upon income or loss after adjustment for those permanent items that are not considered in the determination of taxable income. Deferred income taxes represent the tax effects of differences between the financial reporting and tax bases of the Company’s assets and liabilities at the enacted tax rates in effect for the years in which the differences are expected to reverse. The Company evaluates the recoverability of deferred tax assets and establishes a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. Accordingly, and after considering changes in previously existing positive evidence, the Company reduced its valuation allowance to recognize a deferred tax asset of approximately $143,000 for the year ending December 31, 2009. In addition, Andrea expects it will reduce its valuation in future periods to the extent that it can demonstrate its ability to utilize the assets. Management makes judgments as to the interpretation of the tax laws that might be challenged upon an audit and cause changes to previous estimates of tax liability. In management’s opinion, adequate provisions for income taxes have been made for all years. If actual taxable income by tax jurisdiction varies from estimates, additional allowances or reversals of reserves may be necessary. Income tax expense consists of the tax payable for the period and the change during the period in deferred tax assets and liabilities. The Company has identified its federal tax return and its state tax return in New York as "major" tax jurisdictions. Based on the Company's evaluation, it has been concluded that there are no significant uncertain tax positions requiring recognition in the Company's condensed consolidated financial statements. The Company's evaluation was performed for tax years ended 2006 through 2009. The Company believes that its income tax positions and deductions will be sustained on audit and does not anticipate any adjustments that will result in a material change to its financial position.

Stock-Based Compensation -At March 31, 2010, Andrea had three stock-based employee compensation plans, which are described more fully in Note 8. Andrea accounts for stock-based compensation in accordance with ASC 718, “Compensation – Stock Compensation” (“ASC 718”). ASC 718 establishes accounting for stock-based awards exchanged for employee services. Under the provisions of ASC 718, stock-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as expense over the employee’s requisite service period (generally the vesting period of the equity grant). The fair value of the Company’s common stock options are estimated using the Black Scholes option-pricing model with the following assumptions: expected volatility, dividend rate, risk free interest rate and the expected life. The Company expenses stock-based compensation by using the straight-line method. In accordance with ASC 718, excess tax benefits realized from the exercise of stock-based awards are classified in cash flows from financing activities. The future realization of the reserved deferred tax assets related to these tax benefits associated with the exercise of stock options will result in a credit to additional paid in capital if the related tax deduction reduces taxes payable. The Company has elected the “with and without approach” regarding ordering of windfall tax benefits to determine whether the windfall tax benefit did reduce taxes payable in the current year. Under this approach, the windfall tax benefit would be recognized in additional paid-in-capital only if an incremental tax benefit is realized after considering all other benefits presently available.

Recently Issued Accounting Pronouncements

In October 2009, the FASB issued new accounting guidance, under FASB Accounting Standard Update (“ASU”) No. 2009-13 “Revenue Recognition,” which amends revenue recognition policies for arrangements with multiple deliverables. This guidance eliminates the residual method of revenue recognition and allows the use of management's best estimate of selling price for individual elements of an arrangement when vendor specific objective evidence, vendor objective evidence or third-party evidence is unavailable. This guidance is effective for all new or materially modified arrangements entered into on or after January 1, 2011 with earlier application permitted as of the beginning of a fiscal year. Full retrospective application of the new guidance is optional. The Company has not completed their assessment of this new guidance on their financial condition, results of operations or cash flows.

In October 2009, the FASB issued new accounting guidance, under ASU No. 2009-14 "Software", which amends the scope of existing software revenue recognition accounting. Tangible products containing software components and non-software components that function together to deliver the product's essential functionality would be scoped out of the accounting guidance on software and accounted for based on other appropriate revenue recognition guidance. For the Company, this guidance is effective for all new or materially modified arrangements entered into on or after January 1, 2011 with earlier application permitted as of the beginning of a fiscal year. Full retrospective application of this new guidance is optional. This guidance must be adopted in the same period that the Company adopts the amended accounting for arrangements with multiple deliverables described in the preceding paragraph. The Company has not completed their assessment of this new guidance on their financial condition, results of operations or cash flows.

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 the Company's convertible preferred stock. Estimates and assumptions are periodically reviewed and the effects of any material revisions are reflected in the consolidated financial statements in the period that they are determined to be necessary. Actual results could differ from those estimates and assumptions.

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

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

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 a $1,671 increase in the stated value, which sum is convertible into Common Stock at a conversion price of $0.2551. On February 17, 2004, Andrea announced that it had entered into an Exchange and Termination Agreement and an Acknowledgment and Waiver Agreement, which eliminated the dividend of 5% per annum on the stated value. The additional amount of $1,671 represents the 5% per annum from October 10, 2000 through February 17, 2004. The shares of Series C Preferred Stock are subject to antidilution provisions, which are triggered in the event of certain stock splits, recapitalizations, or other dilutive transactions. In addition, issuances of common stock at a price below the conversion price then in effect (currently $0.2551), or the issuance of warrants, options, rights, or convertible securities which have an exercise price or conversion price less than that conversion price, other than for certain previously outstanding securities and certain "excluded securities" (as defined in the certificate of amendment), require the adjustment of the conversion price to that lower price at which shares of common stock have been issued or may be acquired. In the event that Andrea issues securities in the future which have a conversion price or exercise price which varies with the market price and the terms of such variable price are more favorable than the conversion price in the Series C Preferred Stock, the purchasers may elect to substitute the more favorable variable price when making conversions of the Series C Preferred Stock.

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

As of March 31, 2010, there were 48.231432 shares of Series C Preferred Stock outstanding, which were convertible into 2,206,664 shares of Common Stock and remaining accrued dividends of $80,606.

Note 4. Series D Redeemable Convertible Preferred Stock

On February 17, 2004, Andrea entered into a Securities Purchase Agreement (including a Registration Rights Agreement) with certain holders of the Series C Preferred Stock and other investors (collectively, the "Buyers") pursuant to which the Buyers agreed to invest a total of $2,500,000. In connection with this agreement, on February 23, 2004, the Buyers purchased, for a purchase price of $1,250,000, an aggregate of 1,250,000 shares of a new class of preferred stock, the Series D Preferred Stock, convertible into 5,000,000 shares of Common Stock (an effective conversion price of $0.25 per share) and Common Stock warrants exercisable for an aggregate of 2,500,000 shares of Common Stock. These warrants were exercisable at any time after August 17, 2004, at an exercise price of $0.38 per share. On February 23, 2009, these warrants expired without being exercised.

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

In addition, on June 4, 2004, the Buyers purchased for an additional $1,250,000, an additional 1,250,000 shares of Series D Preferred Stock convertible into 5,000,000 shares of Common Stock (an effective conversion price of $0.25 per share) and Common Stock warrants exercisable for an aggregate of 2,500,000 shares of Common Stock. The warrants were exercisable at any time after December 4, 2004 and before June 4, 2009 at an exercise price of $0.17 per share. On June 4, 2009, these warrants expired without being exercised.

The shares of Series D Preferred Stock are also subject to antidilution provisions, which are triggered in the event of certain stock splits, recapitalizations, or other dilutive transactions. In addition, issuances of common stock at a price below the conversion price then in effect (currently $0.25), or the issuance of warrants, options, rights, or convertible securities which have an exercise price or conversion price less than that conversion price, other than for certain previously outstanding securities and certain “excluded securities” (as defined in the certificate of amendment), require the adjustment of the conversion price to that lower price at which shares of common stock have been issued or may be acquired. In the event that Andrea issues securities in the future which have a conversion price or exercise price which varies with the market price and the terms of such variable price are more favorable than the conversion price in the Series D Preferred Stock, the purchasers may elect to substitute the more favorable variable price when making conversions of the Series D Preferred Stock. The Company is required to maintain an effective registration statement from the time of issuance until the earlier of (i) the date as of which the investors may sell all of the securities for the common stock issuable under the Series D Preferred Stock covered by the registration statement without restriction under SEC rules or (ii) the date on which the investors shall have sold all the securities covered by the registration statement. In addition, the Company is required to use its best efforts to secure the inclusion for quotation on the Over the Counter Bulletin Board for the common stock issuable under the Series D Preferred Stock and to arrange for at least two market makers to register with the Financial Industry Regulatory Authority. In the event that the holder of the Series D Preferred Stock and related warrants is unable to convert these securities into Andrea Common Stock, the Company shall pay to each such holder of such registrable securities a Registration Delay Payment. This payment is to be paid in cash and is equal to the product of (i) the stated value of such Preferred Shares multiplied by (ii) the product of (1) .0005 multiplied by (2) the number of days that sales cannot be made pursuant to the Registration Statement (excluding any days during that may be considered grace periods as defined by the Registration Rights Agreement).

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

Additionally, Andrea reviewed the Series D Preferred Stock warrants and concluded that they are considered to be indexed to the Company’s stock within the provisions of ASC 815-40 and were properly classified.

Prior to December 31, 2009, 281,250 shares of common stock have been issued as a result of exercises of the Series D Preferred Stock Warrants.

As of March 31, 2010, there were 907,144 shares of Series D Preferred Stock outstanding which were convertible into 3,628,576 shares of Common Stock.

Note 5. Licensing Agreements

The Company has entered into various licensing, production and distribution agreements with manufacturers of PC and related components. These agreements provide for revenues based on the terms of each individual agreement. The Company's two largest licensing customers accounted for $383,199 and $40,528 of revenues for the three months ended March 31, 2010 and $156,053 and $20,816 of revenues for the three months ended March 31, 2009.

Note 6. Long Term Debt

Long-term debt consists of the following:

| | March 31, 2010 | December 31, 2009 |
|---|---|---|
| Long-term debt | $115,715 | $121,000 |
| Less: Current Maturities of Long-Term Debt | 21,562 | 21,214 |
| Long-Term Debt, net of Current Maturities | $94,153 | $99,786 |

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HSBC unsecured bank loan, dated December 9, 2009, is due in 60 monthly installments of $2,362 including principal and interest at 6.4%.

As of March 31, 2010, maturities of long term debt are as follows:

| | |
|---|---|
| Apri1, 2010 – March 31, 2011 | $21,562 |
| Apri1, 2011 – March 31, 2012 | 22,983 |
| Apri1, 2012 – March 31, 2013 | 24,498 |
| Apri1, 2013 – March 31, 2014 | 26,112 |
| Apri1, 2014 – March 31, 2015 | 20,560 |
| Total | $115,715 |

Note 7. Commitments And Contingencies

Leases

Andrea leases its corporate headquarters located in Bohemia, New York. The lease from an unrelated party, which currently expires in April 2015, is for approximately 11,000 square feet and houses Andrea's warehousing, sales and executive offices. Rent expense under this operating lease was approximately $21,715 and $21,083 for the three months ended March 31, 2010 and 2009, respectively.

As of March 31, 2010, the minimum annual future lease payments, under this lease and all other noncancellable operating leases, are as follows:

| | |
|---|---|
| 2010 (April 1 – December 31) | $80,389 |
| 2011 | 108,974 |
| 2012 | 105,728 |
| 2013 | 96,814 |
| 2014 | 99,718 |
| Thereafter | 33,565 |
| Total | $525,188 |

Employment Agreements

In November 2008, the Company entered into an employment agreement with the Chairman of the Board, Douglas J Andrea. The effective date of the employment agreement is August 1, 2008 and expires July 31, 2010 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 $312,500 through July 31, 2009 and for the period of August 1, 2009 through July 31, 2010 Mr. Andrea will receive an annual base salary of $325,000. 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 August 8, 2008, the Board granted Mr. Andrea 2,000,000 stock options and 1,000,000 stock options with an aggregate fair value of $120,000 (fair value was estimated using the

Black-Scholes option-pricing model). The 2,000,000 grant vests in three equal annual installments over a three year period commencing August 1, 2009. The 1,000,000 grant vests in three equal annual installments over a three year period commencing August 1, 2010. These 3,000,000 stock options have an exercise price of $0.04 per share, which was the fair market value of the Company's common stock at the date of grant, and a term of 10 years. Pursuant to the employment agreement, on July 24, 2009, the Board of Directors granted Mr. Andrea 1,000,000 stock options with an aggregate fair value of $110,000 (fair value was estimated using the Black-Scholes option-pricing model). The 1,000,000 grant vests in three equal annual installments over a three year period commencing August 1, 2010. These 1,000,000 stock options have an exercise price of $0.11 per share, which was the fair market value of the Company's common stock 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, as defined in the agreement. At March 31, 2010, the future minimum cash commitments under this agreement aggregate $108,333.

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

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Legal Proceedings

Andrea is not currently involved in any pending legal proceedings.

Note 8. 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. No further awards will be granted under the 1998 Plan.

In October 2006, the Board adopted the Andrea Electronics Corporation 2006 Equity Compensation Plan ("2006 Plan"), which was subsequently approved by the shareholders. The 2006 Plan 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. On July 24, 2009, shareholders approved an amendment to the 2006 Plan to increase the number of shares issuable under the 2006 Plan to 18,000,000. 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, 2010, there were 6,267,936 shares available for further issuance under the 2006 Plan.

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

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

There were no options granted during the three months ended March 31, 2010 and 2009.

Option activity during 2010 is summarized as follows:

| Options Outstanding | | | | Options Exercisable | | | |
|---|---|---|---|---|---|---|---|
| Options Outstanding | Weighted Average | Weighted Average | Weighted Average | Options Exercisable | Weighted Average | Weighted Average | Weighted Average |

| | | Exercise Price | Fair Value | Remaining Contractual Life | | Exercise Price | Fair Value | Remaining Contractual Life |
|---|---|---|---|---|---|---|---|---|
| At January 1, 2010 | 16,141,821 | $ 0.20 | $ 0.16 | 7.32 years | 9,891,470 | $ 0.29 | $ 0.22 | 6.37 years |
| Expired | (25,000 ) | $ 7.88 | $ 5.33 | | | | | |
| At March 31, 2010 | 16,116,821 | $ 0.19 | $ 0.16 | 7.08 years | 9,974,922 | $ 0.27 | $ 0.21 | 6.17 years |

During the three months ended March 31, 2010, 108,452 options vested with a weighted average exercise price and a weighted average fair value of $0.06 per option.  Based on the March 31, 2010 fair market value of the Company's common stock of $0.07, the aggregate intrinsic value for the 16,116,821 options outstanding and 9,974,922 shares exercisable is $198,450 and $93,879, respectively.

Total compensation expense recognized related to stock option awards was $50,835 and $54,889 for the three months ended March 31, 2010 and 2009, respectively.  In the accompanying consolidated statement of operations for the three months ended March 31, 2010, $37,920 of expense is included in general, administrative and selling expenses, $8,805 is included in research and development expenses and $4,110 is included in cost of revenues.  In the accompanying consolidated statement of operations for the three months ending March 31, 2009, $44,278 of expense is included in general, administrative and selling expenses, $10,389 is included in research and development expenses and $222 is included in cost of revenues.

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As of March 31, 2010, there was $170,826 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 ($103,476 in 2010, $54,097 in 2011 and $13,253 in 2012).

Pursuant to Andrea's compensation policy for outside directors, on July 24, 2009 and August 8, 2008, Andrea granted 90,908 shares of Common Stock with a fair market value of $0.11 and 500,000 shares of Common Stock with a fair market value of $0.04, respectively. These stock grants were fully vested on the date of grant. Compensation expense related to these awards was $0 and $5,001 for the three months ended March 31, 2010 and 2009, respectively.

Note 9. Segment Information

Andrea follows the provisions of ASC 280 "Segment Reporting" ("ASC 280"). Reportable operating segments are determined based on Andrea's management approach. The management approach, as defined by ASC 280, is based on the way that the chief operating decision-maker organizes the segments within an enterprise for making operating decisions and assessing performance. While Andrea's results of operations are primarily reviewed on a consolidated basis, the chief operating decision-maker also manages the enterprise in two segments: (i) Andrea DSP Microphone and Audio Software Products and (ii) Andrea Anti-Noise Products. Andrea DSP Microphone and Audio Software Products primarily include products based on the use of some, or all, of the following technologies: Andrea Digital Super Directional Array microphone technology (DSDA), Andrea Direction Finding and Tracking Array microphone technology (DFTA), Andrea PureAudio noise filtering technology, and Andrea EchoStop, an advanced acoustic echo cancellation technology. Andrea Anti-Noise Products include noise cancellation and active noise cancellation computer headset products and related computer peripheral products.

The following represents selected condensed consolidated financial information for Andrea's segments for the three-month periods ended March 31, 2010 and 2009.

| 2010 Three Month Segment Data | Andrea DSP Microphone and Audio Software Products | Andrea Anti-Noise Products | 2010 Three Month Segment Data |
|---|---|---|---|
| Net revenues from external customers | $ 204,434 | $ 604,554 | $ 808,988 |
| License Revenues | 433,252 | - | 433,252 |
| Income (loss) from operations | 152,854 | (167,518) | (14,664) |
| Depreciation and amortization | 117,486 | 18,568 | 136,054 |
| Purchases of property and equipments | 9,019 | 17,227 | 26,246 |
| Purchases of patents and trademarks | - | 151 | 151 |
| Assets | 3,424,876 | 2,247,583 | 5,672,459 |
| Total long lived assets | 1,914,886 | 310,802 | 2,225,688 |

| 2009 Three Month Segment Data | Andrea DSP Microphone and Audio Software | Andrea Anti-Noise Products | 2009 Three Month Segment Data |
|---|---|---|---|

| | | Products | | | | |
|---|---|---|---|---|---|---|
| Net revenues from external customers | $ | 75,411 | $ | 547,328 | $ | 622,739 |
| License Revenues | | 198,841 | | - | | 198,841 |
| Loss from operations | | 192,149 | | 92,950 | | 285,099 |
| Depreciation and amortization | | 117,654 | | 9,987 | | 127,641 |
| Capital expenditures | | 2,560 | | 19,059 | | 21,619 |
| Purchases of patents and trademarks | | 7,032 | | 6,545 | | 13,577 |

| December 31, 2009 Year End Segment Data | Andrea DSP Microphone and Audio Software Products | Andrea Anti-Noise Products | 2009 Year End Segment Data |
|---|---|---|---|
| Assets | 3,555,990 | 2,271,051 | 5,827,041 |
| Total long lived assets | 2,023,353 | 311,992 | 2,335,345 |

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Management assesses non-operating income statement data on a consolidated basis only. International revenues are based on the country in which the end-user is located. For the three-month periods ended March 31, 2010 and 2009, and as of each respective period-end, net revenues and accounts receivable by geographic area are as follows:

| Geographic Data | March 31, 2010 | March 31, 2009 |
|---|---|---|
| Net revenues: | | |
| United States | $ 1,096,698 | $ 735,839 |
| Foreign(1) | 145,542 | 85,741 |
| | $ 1,242,240 | $ 821,580 |

(1) Net revenues to any one foreign country did not exceed 10% of total net revenues for the three months ended March 31, 2010 and March 31, 2009.

As of March 31, 2010 and December 31, 2009, accounts receivable by geographic area is as follows:

| Geographic Data | March 31, 2010 | December 31, 2009 |
|---|---|---|
| Accounts receivable: | | |
| United States | $ 433,796 | $ 453,777 |
| Foreign(1) | 79,679 | 60,550 |
| | $ 513,475 | $ 514,327 |

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

Overview

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

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

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

Our Critical Accounting Policies

Our unaudited condensed consolidated financial statements and the notes to our unaudited condensed consolidated financial statements contain information that is pertinent to management's discussion and analysis. The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. On a continual basis, management reviews its estimates utilizing currently available information, changes in facts and circumstances, historical experience and reasonable assumptions. After such reviews, and if deemed appropriate, those estimates are adjusted accordingly. Actual results may vary from these estimates and assumptions under different and/or future circumstances. Our significant accounting policies are described in Note 2 of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2009. A discussion of our critical accounting policies and estimates are included in Management's Discussion and Analysis or Plan of Operation in our Annual Report on Form 10-K for the year ended December 31, 2009. Management has discussed the development and selection of these policies with the Audit Committee of the Company's Board of Directors, and the Audit Committee of the Board of Directors has reviewed the Company's disclosures of these policies. There have been no material changes to the critical accounting policies or estimates reported in the Management's Discussion and Analysis section of the Annual Report on Form 10-K for the year ended December 31, 2009.

Cautionary Statement Regarding Forward-Looking Statements

This report contains forward-looking statements that are based on assumptions and may describe future plans, strategies and expectations of the Company. These forward-looking statements are generally identified by use of the words "believe", "expect", "intend", "anticipate", "estimate", "project" or similar expressions. The Company's ability to predi results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in economic, competitive, governmental, technological and other factors that may affect our business and prospects. Additional factors are discussed below under "Risk Factors" and in Part I, "Item 1A – Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2009. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Except as required by applicable law or regulation, the Company does not undertake, and specifically disclaims any obligation, to release publicly the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

Risk Factors

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

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

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

– the cost of development of our products;

– the mix of products we sell;

– the mix of distribution channels we use;

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

– fluctuations in the computer and communications hardware and software marketplace; and

– general economic conditions.

We cannot assure that the level of revenues and gross profit, if any, that we achieve in any particular fiscal period will not be significantly lower than in other fiscal periods. Our net revenues for the three months ended March 31, 2010 were $1,242,240 compared to $821,580 for the three months ended March 31, 2009. Net loss for the three months ended March 31, 2010 was $21,143, or $0.00 per share on a basic and diluted basis, and $283,864, or $0.00 per share on a basic and diluted basis for the three months ended March 31, 2009. We continue to explore opportunities to grow sales in other business areas; we are also examining additional opportunities for cost reduction, production efficiencies and further diversification of our business. Although we have improved cash flows by reducing overall expenses, if our revenues continue to decline we may not continue to generate positive cash flows and our net income or loss may be affected.

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

In order to be a viable entity we need to maintain and increase profitable operations. To continue to achieve profitable operations we need to maintain or increase current net revenues and continue to look for ways to control expenses. We might also need to sell additional assets or raise capital as a means of funding continued operations. In recent years, we have sustained significant operating losses. We may have to raise additional capital from external sources. These sources may include private or public financings through the issuance of debt, convertible debt or equity, or collaborative arrangements. Such additional capital and funding may not be available on favorable terms, if at all. Additionally, we may only be able to obtain additional capital or funds through arrangements that require us to relinquish rights to our products, technologies or potential markets, in whole or in part, or result in our sale. As a result of the past few years of performance, we believe that we have sufficient liquidity to continue our operations at least through March 2011, provided our net revenues do not materially decline and our operating expenses do not materially increase. Although we have revised our business strategies to reduce our expenses and capital expenditures, we cannot assure you that we will be successful in generating positive cash flows or obtaining access to additional sources of funding in amounts necessary to continue our operations. Failure to maintain sufficient access to funding may also result in our inability to continue operations.

Shares Eligible For Future Sale May Have An Adverse Effect On Market Price and Andrea Shareholders May Experience Substantial Dilution.

Sales of a substantial number of shares of our common stock in the public market could have the effect of depressing the prevailing market price of our common stock. Of the 200,000,000 shares of common stock presently authorized, 63,538,029 were outstanding as of May 4, 2010. The number of shares outstanding does not include an aggregate of 28,209,997 shares of common stock that are issuable. This number of issuable common shares is equal to approximately 44% of the 63,538,029 outstanding shares. These issuable common shares are comprised of: a) 16,106,821 shares of our common stock reserved for issuance upon exercise of outstanding awards granted under our 1991 Performance Equity Plan, 1998 Stock Plan and 2006 Stock Plan; b) 6,267,936 shares reserved for future grants under our 2006 Stock Plan; c) 2,206,664 shares of common stock that are issuable upon conversion of the Series C Preferred Stock; and d) 3,628,576 shares of common stock issuable upon conversion of the Series D Preferred Stock.

In addition to the risk factors set forth above and the other information set forth in this report, you should carefully consider the factors discussed in Part I, “Item 1A – Risk Factors” in the Company’s Annual Report on Form 10-K for the year ended December 31, 2009, which could materially affect our business, financial condition or future results. The risks described in this report and in our Annual Report on Form 10-K are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Results Of Operations

Three Months ended March 31, 2010 compared to Three Months ended March 31, 2009

Net Revenues

| | For the Three Months Ended March 31, 2010 | For the Three Months Ended March 31, 2009 | % Change | |
|---|---|---|---|---|
| Andrea Anti-Noise Products net Product revenues | | | | |
| Sales of products to OEM customers for use with educational software | $ 44,817 | $ 149,379 | (70) | (a) |
| All other Andrea Anti-Noise net product revenues | 559,737 | 397,949 | 41 | (b) |
| Total Andrea Anti-Noise Products net Product revenues | $ 604,554 | $ 547,328 | 10 | |
| | | | | |
| Andrea DSP Microphone and Audio Software Products revenues | | | | |
| Sales of automotive array microphone products | 167,742 | 12,118 | 1,284 | (c) |
| All other Andrea DSP Microphone and Audio product revenues | 36,692 | 63,293 | (42) | |
| License revenues | 433,252 | 198,841 | 118 | (d) |
| Total Andrea DSP Microphone and Audio Software Products revenues | 637,686 | 274,252 | 133 | |
| | | | | |
| Total Revenues | $ 1,242,240 | $ 821,580 | 51 | |

(a) This decrease of approximately $105,000 represents decreased product sales to our educational customers for use with their distance learning products as compared to the three months ending March 31, 2009. We believe that this decrease in product sales relates to the timing of the customers purchases rather than decreased demand.

(b) The increase of approximately $162,000 in all other Andrea Anti-noise product revenues is related to increased demand from our distance learning customers as well as distributor and reseller customers who sell both to distance learning customers and speech recognition end users.

(c) The approximate $155,000 increase in sales of automotive array microphone products is primarily the result of increased product sales to integrators of public safety vehicle solutions.

(d) The increase in license revenues is a result of increased royalties reported for the three months ending March 31, 2010 as compared to the same period last year. We believe this increase is related to an increase of PC models which feature our technology.

Cost of Revenues

Cost of revenues as a percentage of net revenues for the three months ended March 31, 2010 decreased to 36% from 39% for the three months ended March 31, 2009. The cost of revenues as a percentage of net revenues for the three months ended March 31, 2010 for Andrea Anti-Noise Products is 56% compared to 51% for the three months ended March 31, 2009. The cost of revenues as a percentage of net revenues for the three months ended March 31, 2010 for the Andrea DSP Microphone and Audio Software Products is 17% compared to 16% for the three months ended

March 31, 2009. The decrease in cost of revenues as a percentage of sales for the Andrea Anti-Noise Products for the three months ending March 31, 2010 is a result of an increase in revenues related to this segment. The decrease in cost of revenues as a percentage of sales for Andrea DSP Microphone and Audio Software Products for the three months ending March 31, 2010 is a result of the increased revenues of automotive array products.

Research and Development

Research and development expenses for the three months ended March 31, 2010 increased 15% to $171,655 from $149,513 for the three months ended March 31, 2009. For the three months ended March 31, 2010, the increase in research and development expenses reflects a 15% increase in our Andrea DSP Microphone and Audio Software Technology efforts to $94,924, or 55% of total research and development expenses and a 14% increase in our Andrea Anti-Noise Headset Product efforts to $76,731, or 45% of total research and development expenses. With respect to DSP Microphone and Audio Software technologies, research efforts are primarily focused on the pursuit of commercializing a natural language-driven human/machine interface by developing optimal far-field microphone solutions for various voice-driven interfaces, incorporating Andrea's digital super directional array microphone technology, and certain other related technologies such as noise suppression and stereo acoustic echo cancellation. We believe that continued research and development spending should provide Andrea with a competitive advantage.

General, Administrative and Selling Expenses

General, administrative and selling expenses increased approximately 1% to $638,265 for the three months ended March 31, 2010 from $634,421 for the three months ended March 31, 2009. For the three months ended March 31, 2010, the increase reflects an 18% decrease in our Andrea DSP Microphone and Audio Software Technology efforts to $280,155, or 44% of total general, administrative and selling expenses and a 22% increase in our Andrea Anti-Noise Headset Product efforts to $358,110, or 56% of total general, administrative and selling expenses.

Interest Income, net

Interest income, net for the three months ended March 31, 2010 was $1,806 compared to $2,492 for the three months ended March 31, 2009. The year to date decrease in interest income, net is the result of interest expense from our long term debt.

Provision for Income Taxes

The provision for income taxes for the three months ended March 31, 2010 was $8,285 compared to a provision for income taxes of $1,257 for the three months ended March 31, 2009. The increase is a result of an increased estimated taxable income.

Net loss

Net loss for the three months ended March 31, 2010 was $21,143 compared to net loss of $283,864 for the three months ended March 31, 2009. The net loss for the three months ended March 31, 2010 and March 31, 2009 principally reflects the factors described above.

Off-Balance Sheet Arrangements

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

Liquidity And Capital Resources

Andrea’s principal sources of funds are and are expected to continue to be gross cash flows from operations. At March 31, 2010, we had cash of $1,892,896 compared with $1,805,091 at December 31, 2009. The cash balance at March 31, 2010 is primarily a result of our cash provided from operations.

Our working capital balance at March 31, 2010 was $2,851,793 compared to a working capital of 2,718,077 at December 31, 2009. The increase in working capital reflects a decrease in total current assets of $44,925 and a decrease in total current liabilities of $178,641. The decrease in total current assets reflects an increase in cash of $87,805, a decrease in accounts receivable of $852, a decrease in inventory of $164,150, a decrease in short term customer deposits of $13,536, a decrease in deferred income tax assets of $8,229, and an increase in prepaid expenses of $54,037. The decrease in total current liabilities reflects a decrease in trade accounts payable of $201,839, an increase in the current portion in long-term debt of $348, a decrease in short-term deferred revenue of $13,536 and an increase of $36,386 in other current liabilities.

The increase in cash of $87,805 reflects $119,487 of net cash provided by operating activities, $26,397 of net cash used in investing activities and $5,258 of cash used in financing activities.

The cash provided by operating activities of $119,487, excluding non-cash charges for the three months ended March 31, 2010, is attributable to a $1,301 increase in accounts receivable, a $167,698 decrease in inventories, a $13,536 decrease in short term customer deposits, a $54,037 increase in prepaid expenses and other current assets, a $201,839 decrease in accounts payable, a $13,536 decrease in short-term deferred revenue and a $36,386 increase in other current liabilities. The changes in receivables, inventory, prepaid expenses and accounts payable primarily reflect differences in the timing related to both the payments for and the acquisition of inventory as well as for other services in connection with ongoing efforts related to Andrea’s various product lines.

The cash used in investing activities of $26,397 reflects purchases of property and equipment of $26,246 and an increase in patents and trademarks of $151. The significant increase in property and equipment reflects capital expenditures associated with information technology purchases including and, to a lesser extent, molds associated with our Andrea Anti-Noise Headset Products. The increase in patents and trademarks reflects capital expenditures associated with our intellectual property.

The cash used in financing activities of $5,285, reflects repayments on our loan from HSBC. We obtained this loan to finance a significant upgrade to our information technologies systems.

We plan to continue to improve our cash flows in 2010 by aggressively pursuing additional licensing opportunities related to our Andrea DSP Audio Software and increasing the sales of our Andrea Anti-Noise Headset Products through the introduction of new products as well as the increased efforts we are putting into our sales and marketing efforts. However, there can be no assurance that we will be able to successfully execute the aforementioned plans. As of May 4, 2010, Andrea has approximately $1,900,000 of cash deposits. We believe that we have sufficient liquidity available to continue in operation through at least March 2011. To the extent that we do not generate sufficient cash flows from our operations in the next twelve months, additional financing might be required. Although we have improved cash flows by reducing overall expenses, if our revenues decline, these reductions may impede our ability to be cash flow positive and our net income or loss may be disproportionately affected. We have no commitment for additional financing and may experience difficulty in obtaining additional financing on favorable terms, if at all. Any financing we obtain may contain covenants that restrict our freedom to operate our business or may have rights, preferences or privileges senior to our common stock and may dilute our current shareholders' ownership interest in Andrea. We cannot assure that demand will continue for any of our products, including future products related to our Andrea DSP Microphone and Audio Software technologies, or, that if such demand does exist, that we will be able to obtain the necessary working capital to increase production and provide marketing resources to meet such demand on favorable terms, or at all.

Recently Issued Accounting Pronouncements

For a discussion of the impact of recent accounting pronouncements, see Note 2 of the accompanying condensed consolidated financial statements.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

## ITEM 4. CONTROLS AND PROCEDURES

Andrea's management, including its principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, Andrea's disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that it files or submits under the Exchange Act with the Securities and Exchange Commission (the "SEC") (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to Andrea's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

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

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

# PART II OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS

None.

## ITEM 1A. RISK FACTORS

Not applicable.

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

None.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

## ITEM 4. (REMOVED AND RESERVED)

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

a) Exhibits

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

Exhibit 32 – Section 1350 Certifications*

* Filed herewith

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

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

Date: May 6, 2010

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|---|---|---|
| /s/ DOUGLAS J. ANDREA<br>Douglas J. Andrea | Chairman of the Board, President, Chief Executive Officer and Corporate Secretary | May 6, 2010 |
| /s/ CORISA L. GUIFFRE<br>Corisa L. Guiffre | Vice President, Chief Financial Officer and Assistant Corporate Secretary | May 6, 2010 |