ANDREA ELECTRONICS CORP
Form 10QSB
November 14, 2003

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

(Mark One)

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

For the quarterly period ended September 30, 2003

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	**11-0482020**
(State or other jurisdiction of	**(I.R.S. employer**
incorporation or organization)	**identification no.)**
45 Melville Park Road, Melville, New York	**11747**
(Address of principal executive offices)	**(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 report(s), and (2) has been subject to such filing requirements for the past 90 days (check one) Yes x No ¨

Indicate the number of shares outstanding of each of the issuer s classes of common equity, as of the latest practicable date: As of November 11, 2003, there are 26,607,713 common shares outstanding.

Transitional Small Business Disclosure format (check one) Yes ¨ No x

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2003 (unaudited)	December 31, 2002 (audited)
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 2,352,532	$ 3,307,437
Accounts receivable, net of allowance for doubtful accounts of $59,465 and $70,831	465,971	412,849
Notes receivable	709,970	
Inventories, net	1,505,629	2,222,450
Prepaid expenses and other current assets	173,635	309,705
Assets from discontinued operations		1,487,482
Total current assets	5,207,737	7,739,923
PROPERTY AND EQUIPMENT, net	277,439	543,572
INTANGIBLE ASSETS, net	7,720,365	8,208,638
OTHER ASSETS, net	271,318	282,582
Total assets	$ 13,476,859	$ 16,774,715
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Trade accounts payable	$ 609,196	$ 1,023,353
Current portion of long-term debt	20,488	21,056
Accrued restructuring charges	360,565	364,577
Deferred revenue	1,666,680	1,666,680
Other current liabilities	1,787,706	2,409,526
Liabilities from discontinued operations		122,903
Total current liabilities	4,444,635	5,608,095
LONG-TERM DEBT	1,161	16,572
DEFERRED REVENUE	1,129,954	2,379,964
OTHER LIABILITIES	236,754	249,677
Total liabilities	5,812,504	8,254,308
SERIES B REDEEMABLE CONVERTIBLE PREFERRED STOCK, net, $.01 par value; authorized: 1,000 shares; issued and outstanding: 0 and 66 shares, respectively; liquidation value: $0 and $660,000, respectively		645,091
SERIES C REDEEMABLE CONVERTIBLE PREFERRED STOCK, net, $.01 par value; authorized: 1,500 shares; issued and outstanding: 730 and 749 shares, respectively; liquidation value: $7,301,876 and $7,491,876, respectively	7,210,257	7,381,508

COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS EQUITY:		
Preferred stock, $.01 par value; authorized: 4,997,500 shares; none issued and outstanding		
Common stock, $.01 par value and $.50 par value, respectively; authorized: 200,000,000 shares; issued and outstanding: 25,149,166 and 21,127,918 shares, respectively	251,492	10,563,959
Additional paid-in capital	65,033,999	54,074,247
Deferred stock compensation	(5,700)	(23,099)
Accumulated deficit	(64,825,693)	(64,121,299)
Total shareholders equity	454,098	493,808
Total liabilities and shareholders equity	$ 13,476,859	$ 16,774,715

See Notes to Condensed Consolidated Financial Statements

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	For the Three Months Ended September 30		For the Nine Months Ended September 30	
	2003	**2002**	**2003**	**2002**
REVENUES		(restated)*		(restated)*
Net Product Revenues	$ 749,888	$ 662,560	$ 2,440,802	$ 2,231,543
License Revenues	416,670	360,353	1,250,010	536,686
Revenues	1,166,558	1,022,913	3,690,812	2,768,229
COST OF REVENUES	653,251	458,326	1,941,979	1,702,545
Gross margin	513,307	564,587	1,748,833	1,065,684
RESEARCH AND DEVELOPMENT EXPENSES	667,207	780,006	2,177,978	2,370,278
GENERAL, ADMINISTRATIVE AND SELLING EXPENSES	949,938	1,308,236	2,959,623	4,052,469
Loss from operations	(1,103,838)	(1,523,655)	(3,388,768)	(5,357,063)
OTHER INCOME (EXPENSE)				
Interest income (expense), net	508	(30,756)	41,039	(13,538)
Rent and miscellaneous income, net	30,873	14,809	108,511	34,372
Other income (expense)	31,381	(15,947)	149,550	20,834
LOSS FROM CONTINUING OPERATIONS	(1,072,457)	(1,539,602)	(3,239,218)	(5,336,229)
INCOME (LOSS) FROM DISCONTINUED OPERATIONS		(54,685)	2,534,824	320,698
PROVISION FOR INCOME TAXES		(1,806,615)		(1,806,615)
CUMULATIVE EFFECT OF A CHANGE IN ACCOUNTING PRINCIPLE FOR GOODWILL, NET OF $0 TAX				(12,458,872)
Net loss	(1,072,457)	(3,400,902)	(704,394)	(19,281,018)
PREFERRED STOCK DIVIDENDS	113,892	115,328	334,182	357,854
Net loss attributable to common shareholders	$ (1,186,349)	$ (3,516,230)	$ (1,038,576)	$ (19,638,872)
PER SHARE INFORMATION				
Loss from continuing operations Basic and Diluted	$ (.04)	$ (.17)	$ (.14)	$ (.39)
Income from discontinued operations Basic and Diluted			.11	.02
Cumulative effect of a change in accounting principle for goodwill Basic and Diluted				(.68)
Net loss Basic and Diluted	(.04)	(.17)	(.03)	(1.05)
Preferred stock dividends Basic and Diluted	(.01)	(.01)	(.02)	(.02)

Net loss per share attributable to common shareholders Basic and Diluted	$ (.05)	$ (.18)	$ (.05)	$ (1.07)
Shares used in computing net loss per share Basic and Diluted	24,310,003	19,216,925	22,785,111	18,356,233

See Notes to Condensed Consolidated Financial Statements.

* Restated to reflect cumulative effect of a change in accounting principle (Note 2) and to reflect discontinued operations relating to the Aircraft Communications Products Division (Note 9).

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2003

(UNAUDITED)

	Shares Outstanding	Common Stock	Additional Paid-In Capital	Deferred Stock Compensation	Accumulated Deficit	Total Shareholders Equity
BALANCE, January 1, 2003	21,127,918	$ 10,563,959	$ 54,074,247	$ (23,099)	$ (64,121,299)	$ 493,808
Change in Par Value		(10,352,680)	10,352,680			
Adjustment for Previously Issued Shares	38,352	384	(384)			
Conversions of Series B Redeemable Convertible Preferred Stock	3,256,695	32,567	730,948			763,515
Conversions of Series C Redeemable Convertible Preferred Stock	726,201	7,262	210,690			217,952
Amortization of option grant to consultant				17,399		17,399
Preferred stock dividends			(334,182)			(334,182)
Net loss					(704,394)	(704,394)
BALANCE, SEPTEMBER 30, 2003	25,149,166	$ 251,492	$ 65,033,999	$ (5,700)	$ (64,825,693)	$ 454,098

See Notes to Condensed Consolidated Financial Statements.

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	For the Nine Months Ended September 30,	
	2003	**2002**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss from continuing operations	$ (3,239,218)	$ (19,601,716)
Adjustments to reconcile net loss to net cash (used in)/provided by continuing operations:		
Cumulative effect of a change in accounting principle		12,458,872
Depreciation and amortization	855,096	936,081
Deferred income taxes		1,806,615
Non-cash stock compensation expense	17,399	228,177
Provision for bad debt	11,366	105,444
Loss on disposal of fixed assets	47,560	
Change in:		
Accounts receivable	(64,488)	771,621
Inventories, net	716,821	51,815
Prepaid expenses and other current assets	136,070	149,155
Other assets, net	11,264	72,151
Trade accounts payable	(414,157)	(95,592)
Accrued restructuring charges	(4,012)	(111,131)
Deferred revenue	(1,250,010)	3,463,314
Other current and long term liabilities	(803,801)	567,476
Net cash (used in)/provided by continuing operations	(3,980,110)	802,282
Income from discontinued operations	2,534,824	320,698
Gain on sale of discontinued operations	(2,242,573)	
Change in:		
Assets from discontinued operations	(188,192)	298,063
Liabilities from discontinued operations	(6,265)	(10,859)
Net cash provided by discontinued operations	97,794	607,902
Net cash (used in)/provided by operating activities	(3,882,316)	1,410,184
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from the sale of Aircraft Communications Products Division	2,500,000	
Principle payments received on note receivable from sales of Aircraft Communications Products Division	591,640	
Purchases of property and equipment	(52,156)	(132,686)
Patents and trademarks	(96,094)	(146,882)
Net cash provided by/(used in) investing activities	2,943,390	(279,568)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payment of debt obligations	(15,979)	(143,376)

Net cash used in financing activities	(15,979)	(143,376)
NET (DECREASE) /INCREASE IN CASH AND CASH EQUIVALENTS	(954,905)	987,240
CASH AND CASH EQUIVALENTS, beginning of period	3,307,437	3,724,130
CASH AND CASH EQUIVALENTS, end of period	$ 2,352,532	$ 4,711,370
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Non-cash investing and financing activities:		
Conversion of Series B Redeemable Convertible Preferred Stock into common stock	$ 763,515	$ 1,774,190
Conversion of Series C Redeemable Convertible Preferred Stock into common stock	$ 217,952	$
Stock grant to employee and officers	$	$ 229,500
Option grant to consultant	$	$ 42,200

See Notes to Condensed Consolidated Financial Statements.

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

NOTEES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

Note 1. Basis of Presentation and Management Liquidity Plans

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

These unaudited, condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-QSB. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for the fiscal year. For further information, refer to the consolidated financial statements and accompanying footnotes included in Andrea s annual report on Form 10-K for the year ended December 31, 2002.

Management s Liquidity Plans As of September 30, 2003, Andrea had working capital of $763,102 and cash on hand of $2,352,532. On April 11, 2003, Andrea sold its Aircraft Communications Products segment for approximately $3.8 million. The Aircraft Communications Products division is engaged in the manufacture and sale of intercommunications systems and amplifiers primarily used on legacy military aircraft. For the three-month period ended March 31, 2003, this business segment generated approximately $1.1 million in revenue, and total operating profit of approximately $292 thousand. Pursuant to the terms of the purchase agreement, Andrea received $2.5 million in cash, and the balance of the purchase price is being paid in equal installments over the eleven month period commencing May 2003 (Note 9).

In addition to the proceeds resulting from the sale of the Aircraft Communications Products segment, Andrea plans to continue to improve its cash flows during 2003 by continuing to implement reductions of administrative overhead expenses where necessary and feasible as well as aggressively pursuing 1) existing and prospective opportunities to sell its Superbeam Array Microphone generated through its co-marketing efforts with Analog Devices in the personal computing market, 2) existing opportunities in the automotive (in-vehicle computing) market, 3) opportunities in the video and audio conferencing market and 4) opportunities in the call center market. In addition, Andrea engaged an investment banker to explore a variety of strategic alternatives relative to its digital audio technology business. However, there can be no assurance that Andrea will be able to successfully execute the aforementioned plans.

As of November 11, 2003, Andrea had approximately $2.2 million of cash. Although Andrea has implemented several measures in an effort to reduce its expenses and to help preserve cash and it continues to pursue additional sources of capital, there can be no assurance that Andrea will be successful in its attempts to raise sufficient capital essential to its survival. To the extent Andrea fails to develop additional revenues from sales of its products to generate adequate funding from operations, or if Andrea fails to obtain additional financing through a capital transaction or other type of funding, 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 and will not be able to develop and implement a business plan. Additionally, even if Andrea does raise sufficient operating capital, there can be no assurance that the net proceeds will be sufficient to enable it to develop its business to a level where it will generate profits and cash flows from operations. Andrea has no commitment for additional financing, and may experience difficulty in obtaining additional financing on favorable terms, if at all. Furthermore, if the redemption rights of the Series C Preferred Stock are triggered and Andrea has insufficient funds to satisfy the redemption, Andrea would be required to obtain a waiver from the holders of the Preferred Stock. If no such waiver can be obtained, Andrea s ability to continue its current operations will be materially adversely affected and it could result in Andrea s inability to meet its operating obligations. These matters raise substantial doubt about Andrea s ability to continue as a going concern. As such, the third quarter condensed consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and satisfaction of liabilities in the normal course of business. The financial statements do not include any adjustments relating to the recoverability of the recorded assets or the classification of the liabilities that might be necessary should Andrea be unable to continue as a going concern.

Note 2. Summary of Significant Accounting Policies

Management Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and 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.

Among other things, estimates are used in accounting for allowances for bad debts, inventory obsolescence, restructuring reserves, product warranty, depreciation, deferred income taxes, expected realizable values for assets (primarily goodwill and 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.

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

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. License revenue is recognized based on the terms and conditions of individual contracts (see Note 6). 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.

Loss Per Share Andrea follows the provisions of Statement of Financial Accounting Standards (SFAS) No. 128, Earnings Per Share. In accordance with this statement, basic net loss per common share is computed by dividing net loss applicable to common shareholders by the weighted-average number of common shares outstanding during the period. Diluted net loss per common share is computed by dividing net loss by the weighted-average number of common shares and dilutive common share equivalents and convertible securities then outstanding.

Securities that could potentially dilute basic earnings per share (EPS), in the future, which were not in the computation of the diluted EPS because to do so would have been anti-dilutive for the periods presented (as a result of the losses from continuing operations), consist of the following:

Warrants to purchase common stock	75,000
Options to purchase common stock	4,287,000
Redeemable Convertible Preferred Stock	27,957,182
Total potential common shares upon conversion as of September 30, 2003	32,319,182

Stock-Based Compensation At September 30, 2003, Andrea had two stock-based employee compensation plans. As permitted under SFAS No. 148 , Accounting for Stock-Based Compensation Transition and Disclosure, which amended SFAS No. 123, Accounting for Stock-Based Compensation, Andrea has elected to continue to follow the intrinsic value method in accounting for its stock-based employee compensation arrangements as defined by Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 44, Accounting for Certain Transactions Involving Stock Compensation. No compensation expense has been recognized for options granted to employees, as all options granted under those plans have an exercise price equal to the market value of the underlying common stock on the date of grant.

The following table illustrates the effect on net loss and net loss per share if Andrea had applied the fair value recognition provisions of SFAS No. 123 to options granted to employees:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2003	2002	2003	2002
Net loss attributable to common shareholders as reported:	$ (1,186,349)	$ (3,516,230)	$ (1,038,576)	$ (19,638,872)
Deduct: Total stock-based employee compensation expense determined under fair value-based method	15,010	769,937	495,100	2,343,447
Pro forma net loss attributable to common shareholders:	$ (1,201,359)	$ (4,286,167)	$ (1,533,676)	$ (21,982,319)
Basic and diluted net loss attributable to common shareholders per share as reported:	$ (0.05)	$ (0.18)	$ (0.05)	$ (1.07)
Basic and diluted pro forma net loss attributable to common shareholders per share:	$ (0.05)	$ (0.22)	$ (0.07)	$ (1.20)

The fair values of the stock options granted were estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions; for the periods ended September 30, 2003 and 2002:

	For the Nine Months Ended September 30,	
	2003	2002
Expected life in years	4	4
Risk-free interest rates	2.67%	4.09%
Volatility	200%	190%
Dividend yield	0%	0%

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 the bank in excess of the maximum amount insured by the FDIC at September 30, 2003 and December 31, 2002.

Concentration of Credit Risk Deferred revenue relates to licensing agreements with one customer at September 30, 2003 (Note 6). Revenues related to the recognition of the deferred revenue as well as other service related revenues to this customer were approximately 44% and 35% of the total revenues for the three months ended September 30, 2003 and 2002, respectively and approximately 40% and 19% of the total revenues for the nine months ended September 30, 2003 and 2002, respectively.

Inventories Inventories are stated at the lower of cost (on a first-in, first-out) or market basis.

	September 30, 2003	December 31, 2002
Raw materials	$ 837,671	$ 1,281,655
Work-in-process	17,124	79,120
Finished goods	1,246,512	1,385,447
	2,101,307	2,746,222
Less: reserve for obsolescence	(595,678)	(523,772)
	$ 1,505,629	$ 2,222,450

Goodwill And Other Intangible Assets

In June 2001, the FASB issued SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets and supercedes APB Opinion No. 17, Intangible Assets. It addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. SFAS No. 142 also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements. SFAS No. 142 requires that an impairment test for goodwill be performed in two steps, (i) determine impairment based upon fair value of a reporting unit as compared to its carrying value, and (ii) if there is an impairment, measure the impairment loss by comparing the implied fair value of goodwill with the carrying amount of that goodwill.

In accordance with SFAS No. 142, Andrea performed initial transition impairment testing of goodwill during 2002, which resulted in the determination that the carrying amount of the Andrea DSP Microphone and Audio Software business unit exceeded its fair value. The impairment loss resulted primarily from a change in the criteria for the measurement of an impairment loss. Under the previous methodology required by SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of, impairment was measured, if events or changes in circumstances indicated potential impairment, using an undiscounted cash flow methodology. No goodwill impairment would have been recorded on January 1, 2002, under the prior SFAS No. 121 methodology. Under SFAS No. 142, the Company utilized the discounted cash flow methodology, which resulted in an impairment charge of approximately $12.5 million as a cumulative effect of a change in accounting principle and reduced goodwill to zero, shown in the consolidated statement of operations. Andrea restated the first quarter of 2002 to reflect the impairment charge effective January 1, 2002, as required by SFAS No. 3 Reporting Accounting Changes in Interim Financial Statements.

Andrea amortizes its core technology, patents and trademarks on a straight-line basis over the estimated useful lives of its intangible assets that range from 15 to 17 years. For the three-month periods ended September 30, 2003 and 2002, amortization expense was $195,144 and $193,562, respectively. For the nine-month periods ended September 30, 2003 and 2002 amortization expense was $584,367 and $578,155, respectively.

Recently Issued Accounting Pronouncements

In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections. SFAS No. 145 requires that gains and losses from extinguishment of debt be classified as extraordinary items only if they meet the criteria in APB No. 30 Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary Unusual and Infrequently Occurring Events and Transactions. Applying the provisions of APB No. 30 will distinguish transactions that are part of an entity s recurring operations from those that are unusual and infrequent that meet the criteria for classification as an extraordinary item. Andrea adopted SFAS No. 145 during the first quarter of 2003. The adoption of this statement did not have a material impact on Andrea s condensed consolidated financial position or results of operations.

In June 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 addresses accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring). SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized and measured initially at fair value when the liability is incurred. SFAS No. 146 is effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. The adoption of this statement did not have a material effect on Andrea s condensed consolidated financial position or results of operations.

In November 2002, the FASB issued interpretation No. 45 Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN 45 requires a company, at the time it issues a guarantee, to recognize an initial liability for the fair value of obligations assumed under the guarantee and elaborates on existing disclosure requirements related to guarantees and warranties. The initial recognition requirements of FIN 45 are effective for guarantees issued or modified after December 31, 2002. Adoption of the disclosure requirements were effective for interim and annual periods ending after December 15, 2002, and did not have a material impact on Andrea s condensed consolidated financial position or results of operations.

In January 2003, the FASB issued interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after December 15, 2003. The adoption of FIN 46 is not expected to have a material effect on Andrea s condensed consolidated financial position or results of operations.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. This statement amends and clarifies SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities. The statement clarifies the accounting guidance on (1) derivative instruments (including certain derivative instruments embedded in other contracts) and (2) hedging activities that fall within the scope of SFAS No. 133. SFAS No. 149 also amends certain other existing pronouncements, which will result in more consistent reporting of contracts that are derivatives in their entirety or that contain embedded derivatives that warrant separate accounting. SFAS No. 149 is effective (1) for contracts entered into or modified after June 30, 2003, with certain exceptions, and (2) for hedging relationships designated after June 30, 2003. The guidance is to be applied prospectively. The adoption of SFAS No. 149 did not have a material impact on its condensed consolidated financial position or results of operations.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 addresses certain financial instruments that, under previous guidance could be accounted for as equity, but now must be classified as liabilities in statements of financial position. These financial instruments include: 1) mandatory redeemable financial instruments, 2) obligation to repurchase the issuer s equity shares by transferring assets, and 3) obligation to issue a variable number of shares. SFAS No. 150 is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS No. 150 did not have a material effect on Andrea s condensed consolidated financial position or results of operations.

Note 3. Series B Redeemable Convertible Preferred Stock

On June 22, 1999, Andrea issued and sold in a private placement $7,500,000 of Series B Redeemable Convertible Preferred Stock (the Series B Preferred Stock), and a warrant covering 75,000 shares of Andrea s Common Stock. Each of the 750 shares of Series B Preferred Stock, (all shares have been converted, see below) had a stated value of $10,000 plus dividends of 4% per annum, which sum was convertible into Common Stock at a conversion price equal to the lower of $8.775 (the Maximum Conversion Price) or the average of the two lowest trade prices of the Common Stock during the 15 consecutive trading days immediately preceding a conversion date (the Market Price), subject to certain adjustments, including anti-dilution. The 4% dividends may, at the option of Andrea, be paid in cash. The warrant has an exercise price of $8.775 per share and expires on June 18, 2004. Andrea has reserved 75,000 shares of Common Stock for exercise of these warrants.

During 2003, the following shares of the Series B Preferred Stock, together with related accrued dividends, were converted into shares of Common Stock:

Date of Conversion	Number of Series B Preferred Stock Converted	Conversion Price	Number of Common Shares

March 14, 2003	20	$0.225	1,021,857
May 15, 2003	19	$0.205	1,071,770
July 15, 2003	27	$0.270	1,163,068
Total	66		3,256,695

As of September 30, 2003, all of the Series B Preferred Stock have been converted into Common Stock.

Note 4. 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 the 750 shares of Series C Preferred Stock has a stated value of $10,000 plus dividends of 5% per annum, which sum is convertible into Common Stock at a conversion price which was initially equal to $7.0565 or 110% of the average of the two lowest closing bid prices of the Common Stock during the 5 consecutive trading days immediately preceding the issuance date, for the first nine months. The conversion price was reset every six months thereafter to the lesser of the then existing conversion price or the average of the two lowest closing bid prices of the Common Stock during the 5 consecutive trading days immediately preceding the six-month reset dates or, for the period beginning on the day two years after the initial issuance and ending on the maturity of the Series C Preferred Stock, the least of: (i) the then existing conversion price, (ii) the average of the two lowest closing bid prices of the Common Stock during the 15 consecutive trading days immediately preceding such two year date or (iii) the closing bid price on the day of conversion, subject in each case to certain adjustments. The 5% dividend amount may, at the option of Andrea, be paid in cash or in shares of Andrea s Common Stock. The Series C Preferred Stock is convertible or redeemable at maturity by Andrea, based upon certain circumstances at that time, and is redeemable by the holder upon certain events.

During the nine months ended September 30, 2003, the following shares of Series C Preferred Stock, together with related accrued dividends, were converted into shares of Common Stock:

Date of Conversion	Number of Series C Preferred Stock Converted	Conversion Price	Number of Common Shares
September 4, 2003	5	$0.30	190,845
September 15, 2003	7	$0.30	267,534
September 24, 2003	7	$0.30	267,822
Total	19		726,201

As of September 30, 2003, all 730.19 of the Series C Preferred Stock are currently convertible into Andrea s Common Stock at a maximum conversion price of $0.30.

In accordance with EITF Issue 00-27, Application of EITF Issue No. 98-5 to Certain Convertible Instruments, in the third quarter of 2001, Andrea recorded a non-cash charge of $7,500,000 to shareholder s equity. This pronouncement values the economic benefit of the contingent beneficial conversion feature that the holders of the Series C Preferred Stock received when the conversion price of the Series C Preferred Stock was reset from $7.0565 to $1.44 in July 2001. This charge represented the maximum charge under this standard.

The original value of the transaction costs upon issuance was $175,000. As of September 30, 2003, the Series C Preferred Stock is recorded net of the unaccreted present value of the transaction costs of $91,619. The Series C Preferred Stock is presented outside of shareholders equity in the accompanying condensed consolidated balance sheets because of certain redemption features.

Upon the announcement of a major transaction or upon certain triggering events, as defined, the investors have the right to require Andrea to redeem all or a portion of the investors Series C Preferred Stock at a redemption price equal to the greater of (i) 120% of the Liquidation Value, as defined, or (ii) the product of the applicable conversion rate in effect on the date of the major transaction or the triggering event and the closing bid price of the Common Stock of Andrea on the trading day immediately preceding the major transaction or triggering event or the closing bid price of Andrea s Common Stock on the date of the holder s delivery of redemption notice to Andrea. In addition, if Andrea is unable to effect such redemption (i) interest will accumulate on the value of the Series C Preferred Stock that Andrea is unable to redeem at the rate of 2% per month and (ii) the holders of the Series C Preferred Stock are entitled to void their redemption notices and receive a reset of their applicable conversion price.

On March 15, 2002, Andrea announced that a triggering event had occurred and that as a result of the trigger, the investor had the right to require Andrea to redeem all of the Series C Preferred Stock. The investor has agreed, in a Waiver Agreement, to waive its right to receive the aggregate Triggering Event Redemption Price (as defined in the Certificate of Amendment) (together with any interest and related cash payments or penalties thereon) the investor was otherwise entitled to as a result of the existing triggering event until April 7, 2007. In addition, the investor agreed to waive, until April 7, 2007, its right to receive the aggregate Triggering Event Redemption Price, as defined, (together with any interest and related cash payments or penalties thereon) with respect to (1) any future triggering event relating to additional registration failures, provided that the existing registration statements remain effective and available to the investor for the number of shares covered by such registration statements as of the date of the waiver (less any future sales made pursuant to such registration statements), and (2) any future triggering event relating to the delisting of Andrea s Common Stock, provided that the Common Stock is thereafter authorized for trading on the OTC Bulletin Board. In addition, the investor agreed to waive, until April 7, 2007, Andrea s obligation to register any additional shares and Andrea s obligation to make certain cash payments, if any, for its failure to register any additional shares. Finally, the investor acknowledged that no Maturity Date Redemption Price (as defined) was due on October 10, 2002. The investor s waivers described above shall be null and void immediately, however, upon the earlier of April 7, 2007, if such Triggering Event Redemption Price is not paid on April 7, 2007, the first date on which Andrea fails to comply in any material respect with the terms of the Waiver Agreement, and related agreements entered into between Andrea and the investor and the first date on which Andrea is insolvent.

As consideration for the Waiver Agreement, Andrea agreed to grant the investor a security interest in all of Andrea s assets; however, the investor agreed to have its lien on Andrea s assets subordinated to (1) any lien granted in the future to a non-affiliated third party in connection with a strategic transaction with a financing component, provided that such third-party lien relates only to the amount of the financing component of such transactions, and (2) any lien granted in the future to a bank or other similar institution pursuant to any asset-based financing transaction. In addition, the investor agreed to release its lien in connection with any sale of any assets subject to the investor s lien, provided the investor receives a lien on the proceeds of the sale. The investor acknowledged that its lien in any portion of Andrea s intellectual property is effectively subordinate to the interest of any current or future licensee of such intellectual property, as any interest the investor may have in such intellectual property cannot be greater than Andrea s interest therein.

Given that the waiver granted by the investor does not cover all triggering events set forth in the Certificate of Amendment and that the Waiver Agreement will be null and void in the event Andrea fails to comply in any material respect with the terms of the Agreements, among other things, there is a risk that the investor could declare a triggering event that would trigger the redemption rights.

If such redemption rights are triggered and Andrea has insufficient funds to satisfy the redemption, Andrea will be required to obtain a new waiver from the holders of the Series C Preferred Stock. If the Series C Preferred Stockholders do not consent to such a waiver, Andrea s efforts to obtain additional funding and capital, and its ability to continue its current operations, will be materially adversely affected.

Subsequent to September 30, 2003, the following shares of Series C Preferred Stock, together with related accrued dividends, were converted into shares of Common Stock:

Date of Conversion	**Number of Series C Preferred Stock Converted**	**Conversion Price**	**Number of Common Shares**
October 1, 2003	5	$0.30	191,461
October 8, 2003	7	$0.30	268,269
October 16, 2003	6	$0.30	230,164
October 22, 2003	5	$0.30	191,941
November 4, 2003	15	$0.30	576,712
Total	38		1,458,547

As of November 11, 2003, there are 692.19 shares of the Series C Preferred Stock outstanding. Andrea has currently reserved 58,244,936 shares of Common Stock for issuance upon conversion of the shares of the Series C Preferred Stock.

Note 5. Restructuring Accrual

During the fourth quarter of 2001, Andrea recorded restructuring charges in connection with exiting a PC headset channel, or customer-type, within the Anti-Noise Product segment. During the three months ended September 30, 2002, Andrea made payments of $9,476, which reduced the restructuring liability. During the nine months ended September 30, 2003 and 2002, Andrea made payments of $4,012 and $111,131 respectively, which reduced the restructuring liability.

Note 6. Licensing Agreements

In December 2001 and March 2002, Andrea entered into two agreements with Analog Devices. These license agreements relate to Andrea s high performance noise canceling technologies that enable clear voice communications and high-performance audio in small home-office and regular office environments. Under these agreements, Analog Devices paid Andrea a total of $5 million in license fees during 2002. The unamortized portion of the license agreements, as amended, is recorded as deferred revenue ($1,666,680 of which is classified as current and $1,129,954 is classified as long-term as of September 30, 2003) in the accompanying condensed consolidated balance sheets. All license revenues are being recognized on a straight-line basis over three-years, $3 million of which started to be recognized during the first quarter of 2002, and $2 million of which started in the third quarter of 2002. During the three months ended September 30, 2003 and September 30, 2002, $416,670 and $360,353, respectively, of license revenues were recognized in the accompanying condensed consolidated statements of operations. During the nine months ended September 30, 2003 and September 30, 2002, $1,250,010 and $536,686, respectively, of license revenues were recognized in the accompanying condensed consolidated statements of operations.

Note 7. Commitments And Contingencies

Leases

Andrea s corporate headquarters is located in Melville, New York, where Andrea leases space for manufacturing, research and development, sales and executive offices from an unrelated party. The lease is for approximately 40,000 square feet and expires in January 2009. Rent expense under this operating lease was approximately $153,500 for the three-month periods ended September 30, 2003 and 2002 and $460,000 for the nine month periods ended September 30, 2003 and 2002. As a result of the sale of the discontinued operations, Andrea is subletting approximately 15,000 square feet to Andrea Systems LLC for a twelve month period ending March 31, 2004. $76,731 and $153,462 of rental income was recognized under this agreement for the three month and nine month periods ended September 30, 2003, respectively. As of September 30, 2003, the minimum future lease commitments, under this lease and all other noncancellable operating leases, net of the rental income are as follows:

	Leases	Sublease	Net
October 1, 2003 to December 31, 2003	$ 190,358	$ (76,731)	$ 113,627
2004	737,802	(76,731)	661,071
2005	651,063		651,063

2006	677,106		677,106
2007	704,190		704,190
Thereafter	521,067		521,067
Total	$ 3,481,586	$ (153,462)	$ 3,328,124

Employment Agreements

The Board of Directors of Andrea is currently in the process of negotiating employment contracts with the officers of the Company. At September 30, 2003, the future minimum cash commitments for 2003 aggregate $221,166 for these same individuals.

In August 2003, Paul E. Donofrio, President and Chief Executive Officer, and the Company entered into a Memorandum of Understanding regarding the terms of Mr. Donofrio s employment. Pursuant to the Memorandum of Understanding, Mr. Donofrio will receive an initial annual base salary of $175,000, an initial stock grant of 350,000 options and a minimum annual bonus of $50,000. Mr. Donofrio would also be entitled to a change in control payment equal to one times 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. The term of this agreement can be extended for two additional one year terms and, if so, Mr. Donofrio s base salary would be $200,000 and $225,000 in years two and three, respectively, with additional grants of stock options each year. The Company is currently in the process of drafting an employment agreement for Paul E. Donofrio, that incorporates all of the terms and conditions of the Memorandum of Understanding.

Legal Proceedings

On August 6, 2003, Christopher P. Sauvigne, director and former President and Chief Executive Officer of Andrea filed a lawsuit in the Supreme Court of the State of New York, County of Nassau, against the Company titled Christopher P. Sauvigne v. Andrea Electronics Corporation, Index No. 03-012098 (the Action). The Action alleges that Mr. Sauvigne and Andrea were parties to an employment contract and that Andrea breached the contract in connection with the termination of Mr. Sauvigne as President and Chief Executive Officer of Andrea on August 1, 2003. The Action seeks (i) a sum of not less than $131,250, plus interest, (ii) a mandate that Andrea grant stock options to Mr. Sauvigne and (iii) reasonable counsel fees and costs. Andrea intends to defend the Action vigorously. While the outcome of the Action cannot be predicted with certainty, Andrea believes the Action is without merit. On September 25, 2003, Andrea filed a response to the Action with the Court denying these claims. In addition, Andrea filed a counterclaim which seeks (i) reimbursement of any compensation paid to Mr. Sauvigne for any personal and/or undocumented expenses incurred by him (ii) forfeiture and repayment to Andrea of all salary, bonuses, and benefits that Mr. Sauvigne received from Andrea after the breach of his fiduciary duty in an amount to be determined at trial and (iii) attorneys fees and costs.

Additionally, Andrea is involved in routine litigation incidental to the normal course of business. While it is not feasible to predict or determine the final outcome of the claims, Andrea believes the resolution of these matters will not have a material adverse effect on Andrea s financial position, results of operations or liquidity.

Note 8. Segment Information

Andrea follows the provisions of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. Reportable operating segments are determined based on Andrea s management approach. The management approach, as defined by SFAS No. 131, is based on the way that the chief operating decision-maker organizes the segments within an enterprise for making operating decisions and assessing performance. While Andrea s results of operations are primarily reviewed on a consolidated basis, the chief operating decision-maker also manages the enterprise in segments. With the sale of the Aircraft Communications Products division on April 11, 2003 (Note 9), Andrea operates in two segments: (i) Andrea Anti-Noise Products and (ii) Andrea DSP Microphone and Audio Software Products. Our Andrea Anti-Noise Products include our noise cancellation and active noise cancellation computer headset products and related computer peripheral products. Our 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. All of Andrea s revenues are from external customers.

The following represents selected condensed consolidated financial information for Andrea s segments for the three-month periods ended September 30, 2003 and 2002:

Segment Data	Andrea Anti-Noise Products	Andrea DSP Microphone and Audio Software Products	Total 2003
Net revenues	$ 580,912	$ 585,646	$ 1,166,558
Loss from operations	(391,811)	(712,027)	(1,103,838)
Depreciation	44,469	51,266	95,735

	Andrea Anti-Noise Products	Andrea DSP Microphone and Audio Software Products	Total 2002
Net revenues	$ 519,254	$ 503,659	$ 1,022,913
Income/(Loss) from operations	25,077	(1,548,732)	(1,523,655)
Depreciation	41,175	43,631	84,806

The following represents selected condensed consolidated financial information for Andrea s segments for the nine months ended September 30, 2003, and 2002:

Segment Data	Andrea Anti-Noise Products	Andrea DSP Microphone and Audio Software Products	Total 2003
Net revenues	$ 1,907,151	$ 1,783,661	$ 3,690,812
Loss from operations	(674,149)	(2,714,619)	(3,388,768)
Depreciation	110,351	137,349	247,700

	Andrea Anti-Noise Products	Andrea DSP Microphone and Audio Software Products	Total 2002
Net revenues	$ 1,772,156	$ 996,073	$ 2,768,229
Loss from operations	(350,312)	(5,006,751)	(5,357,063)
Depreciation	132,172	153,651	285,823

Andrea assesses assets and non-operating income statement data on a consolidated basis only. International revenues are based on the country in which the end-user is located. For the three-month periods ended September 30, 2003 and 2002, and as of each respective period-end, revenues and accounts receivable by geographic area are as follows:

Geographic Data	September 30, 2003	September 30, 2002
Revenues:		
United States	$ 1,095,601	$ 923,860
Europe	53,062	45,926
Other foreign	17,895	53,127
	$ 1,166,558	$ 1,022,913
Accounts receivable:		
United States	$ 408,909	$ 182,122
Europe	1,765	60,871
Other foreign	55,297	61,030
	$ 465,971	$ 304,023

For the nine months ended September 30, 2003 and 2002, revenues by geographic area are as follows:

Geographic Data	September 30, 2003	September 30, 2002
Revenues:		
United States	$ 3,387,395	$ 2,182,282
Europe	123,577	224,820
Other foreign	179,840	361,127
	$ 3,690,812	$ 2,768,229

Note 9. Discontinued Operations

Sale of Aircraft Communication Products Division

On April 11, 2003, Andrea completed the sale of substantially all of the assets and liabilities of the Andrea Aircraft Communications Products division for approximately $3.8 million. Andrea received $2.5 million in cash, and approximately $1.3 million in notes which are payable in equal installments over the succeeding eleven month period. The sale resulted in a gain recorded in the quarter ended June 30, 2003, of approximately $2.24 million which reflects the difference between the purchase price of $3.8 million and the net assets sold (accounts receivable of $693,861, net inventories of $981,813, and accounts payable and accrued liabilities of $124,064). The Aircraft Communications Products division is engaged in the manufacture and sale of intercommunications systems and amplifiers primarily used on legacy military aircraft. The consideration for the sale was determined through arms-length negotiations between Andrea and Andrea Systems, LLC. Andrea Systems, LLC is a new entity that was established by a group of private investors. As part of the sale, Andrea entered into a one-year transition services agreement with Andrea Systems, LLC pursuant to which the Company expects to receive approximately $307,000.

During the quarter ended March 31, 2003, Andrea committed to a plan to sell its Aircraft Communications Products division. Accordingly, the results of operations and the assets and liabilities of this division are presented as discontinued operations for both current and prior periods.

The following table reflects the results of the discontinued operations of the Aircraft Communication Products business segment for the three-month periods ended September 30, 2003 and 2002, respectively:

	September 30, 2003	September 30, 2002
Net sales	$	$ 347,116
Cost Of Sales		213,305
Gross margin		133,811
Research And Development Expenses		104,766
General, Administrative And Selling Expenses		83,730
Operating Loss from Discontinued Operations		(54,685)
Gain on Sale of Discontinued Operations		
Loss from Discontinued Operations	$	$ (54,685)

The following table reflects the results of the discontinued operations of the Aircraft Communication Products business segment for the nine-month periods ended September 30, 2003 and 2002, respectively:

	September 30, 2003	September 30, 2002
Net sales	$ 1,068,976	$ 2,171,450
Cost Of Sales	569,128	1,281,955
Gross margin	499,848	889,495
Research And Development Expenses	119,871	306,850
General, Administrative And Selling Expenses	87,726	261,947
Operating Income from Discontinued Operations	292,251	320,698
Gain on Sale of Discontinued Operations	2,242,573	
Income from Discontinued Operations	$ 2,534,824	$ 320,698

Sales to the federal government and related subcontractors aggregated $525,068 and $881,583 for the nine months ended September 30, 2003 and 2002, respectively.

Note 10. Increase in Authorized Shares and Change in the Par Value of the Common Stock

Increase in Authorized Shares

On January 31, 2003, Andrea s shareholders approved an increase in the authorized shares of common stock from 70,000,000 shares to 200,000,000 shares.

Change in the Par Value of the Common Stock

On January 31, 2003, Andrea s shareholders approved a reduction in the par value of Andrea s common stock from $0.50 per share to $0.01 per share.

Note 11. Stock Option Grant to Director and President and Chief Executive Officer

In May 2003, the Board of Directors granted 35,000 stock options to a newly appointed director. The grant provides for a vesting period of one year, an exercise price of $0.34, which was fair market value at the date of grant, and a term of 10 years.

In August 2003, the Board of Directors granted 350,000 stock options to the President and Chief Executive Officer. The grant provides for a six month vesting period, an exercise price of $0.31, which was fair market value at the date of grant, and a term of 10 years.

In October 2003, the Board of Directors granted 35,000 stock options to a newly appointed director. The grant provides for a vesting period of one year, an exercise price of $0.52, which was fair market value at the date of grant, and a term of 10 years.

Note 12. American Stock Exchange 18 Month Notice

Andrea received a non-compliance notice from the American Stock Exchange (AMEX or the Exchange) indicating that it is below certain of the Exchange s continued listing standards. Specifically, Andrea is not in compliance with Section 1003(a)(i) with shareholders equity of less than $2,000,000 and losses from continuing operations and/or net losses in two of its three most recent fiscal years; Section 1003(a)(ii) shareholders equity of less than $4,000,000 and losses from continuing operations and/or net losses in three out of its four most recent fiscal years and Section 1003(a)(iii) shareholders equity of less than $6,000,000 and losses from continuing operations and/or net losses in its five most recent fiscal years.

In accordance with Section 1009 of the Amex Company Guide, Andrea was afforded the opportunity to submit a plan of compliance to the Exchange. The plan is to outline what action the Company will take, or has taken to bring the Company into compliance with the continued listed standards within an 18-month period. On June 25, 2003, Andrea presented its plan to the Exchange. On August 13, 2003 the Exchange notified Andrea that it has accepted the Company s plan of compliance and granted an extension of time to November 23, 2004 to regain compliance with the continued listing standards. Andrea will be subject to periodic review by the Exchange staff during the extension period. Failure to make progress consistent with the plan or to regain compliance with the continued listing standards by the end of the extension period could result in the Company being delisted from the American Stock Exchange.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

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 high volume assembly of most of our Andrea Anti-Noise ® Products from purchased components, and we are assembling low volume Andrea DSP Microphone and Audio Software Products from purchased components primarily at our Israeli facility. 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 condensed consolidated financial statements and the notes to our 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 of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities. In addition to the recording and presentation of our convertible preferred stock, we believe that the following are some of the more critical judgment areas in the application of our accounting policies that affect our financial condition and results of operations. We have discussed the application of these critical accounting policies with our Audit Committee.

Revenue Recognition Non license-related revenue is recognized upon shipment. Andrea reports such revenues levels on a net revenues basis, with net revenues being computed by deducting from gross revenues the amount of actual revenues returns and the amount of reserves established for anticipated returns. With respect to license revenues, Andrea recognizes revenue in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended, and we refer to Staff Accounting Bulletin (SAB) No. 101 Revenue Recognition in Financial Statement for interpretive guidance. We recognize license-related revenues primarily based on an evaluation of the terms of individual contracts (see Note 6 of our condensed consolidated financial statements, for example) considering, specifically, whether 1) significant obligations remain, 2) evidence of an arrangement exists, 3) the fees are fixed or determinable, and 4) collectibility is reasonably assured. In addition, fee-based services are performed on a time-and material basis or on a fixed-fee basis, under separate service arrangements.

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Accounts Receivable We are required to estimate the collectibility of our trade receivables. Judgment is required in assessing the realization of these receivables, including the current creditworthiness of each customer and related aging of the past due balances. We evaluate specific accounts when we become aware of a situation where a customer may not be able to meet its financial obligations due to a deterioration of its financial viability, credit ratings or bankruptcy. The reserve requirements are based on the best facts available to us and reevaluated and adjusted as additional information is received. Our reserves also are determined by using percentages applied to certain aged receivable categories. At September 30, 2003 and December 31, 2002, our allowance for doubtful accounts from continuing operations was approximately $59 thousand and $71 thousand, respectively.

Inventory We are required to state our inventories at the lower of cost or market. In assessing the ultimate realization of inventories, we are required to make considerable judgments as to future demand requirements and compare that with our current inventory levels. Our reserve requirements generally increase as our projected demand requirements decrease due to market conditions, technological and product life cycle changes as well as longer than previously expected usage periods. Inventories from continuing operations of approximately $1.5 million and $2.2 million at September 30, 2003 and December 31, 2002 are net of reserves of approximately $596 thousand and $524 thousand, respectively. It is possible that additional charges to inventory may occur in the future if there is further declines in market conditions, or if additional restructuring actions are taken.

SFAS No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets supersedes SFAS No. 121 Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of and Accounting Principles Board (APB) Opinion No. 30 Reporting Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions . SFAS No. 144 retains the fundamental provisions of SFAS No. 121 for recognition and measurement of impairment, but amends the accounting and reporting standards for segments of a business to be disposed of. The provisions of this statement require management judgments regarding the future operating and disposition plans for marginally performing assets, and estimates of expected realizable values for assets to be sold. The impact of adopting this standard was not material to the financial statements.

SFAS No. 141, Business Combinations , and SFAS No. 142, Goodwill and Other Intangible Assets requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. Under SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment. Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives (but with no maximum life). Andrea adopted this standard effective January 1, 2002. Other intangible assets, which do not have indefinite lives, continue to be amortized.

We performed initial transitional impairment testing for goodwill during the first six months of fiscal 2002. The impairment testing is performed in two steps: (step one) the determination of impairment, based upon the fair value of a reporting unit as compared to its carrying value, and (step two) if there is an impairment, this step measures the amount of impairment loss by comparing the implied fair value of goodwill with the carrying amount of that goodwill. SFAS No. 142 required that an entity complete step one of the transitional goodwill impairment test within six months of adoption, and that if there is an indication that the carrying amount of the net assets of a reporting unit exceeds its fair value, step two must be completed by the end of the fiscal year. Andrea completed its step two impairment testing during the fourth quarter of 2002 in accordance with SFAS No. 142 with the assistance of an independent appraisal firm, relying primarily on discounted net cash flows for the respective business segment, and determined that the carrying amount of the Andrea DSP Microphone and Audio Software business segment exceeded its fair value. Accordingly, the Company recorded an impairment charge in 2002 of approximately $12.5 million as a cumulative effect of a change in accounting principle in accordance with this new pronouncement and reduced goodwill to zero. The Company restated the first quarter of 2002 to reflect the impairment charge effective January 1, 2002 as required under SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements.

Deferred Tax Assets We currently have significant deferred tax assets. SFAS No. 109, Accounting for Income Taxes requires a valuation allowance be established when it is more likely than not that all or a portion of deferred tax assets will not be realized. Furthermore, SFAS No. 109 provides that it is difficult to conclude that a valuation allowance is not needed when there is negative evidence such as cumulative losses in recent years. Therefore, cumulative losses weigh heavily in the overall assessment. During 2002, we recorded a full valuation allowance, representing a charge of $1.8 million, against our deferred tax assets. In addition, we expect to provide a full valuation allowance on future tax benefits until we can sustain a level of profitability that demonstrates our ability to utilize the assets, or other significant positive evidence arises that suggests our ability to utilize such assets. The future realization of a portion of our reserved deferred tax assets related to tax benefits associated with the exercise of stock options, if and when realized, will not result in a tax benefit in the condensed consolidated statement of operations, but rather will result in an increase in additional paid in capital. We will continue to re-assess our reserves on deferred income tax assets in future periods on a quarterly basis.

During 2001, we recorded significant charges in connection with a restructuring program. The related reserves established in that restructuring reflect various estimates, primarily those pertaining to inventory and settlements of contractual obligations. We reassess the reserve requirements under our restructuring program at the end of each reporting period. Actual experience may be different from our estimates used and, accordingly, additional charges related to our restructuring may be incurred.

We are subject to proceedings, lawsuits and other claims, including proceedings under laws and government regulations related to securities, environmental, labor, product and other matters. We are required to assess the likelihood of any adverse judgments or outcomes to these matters, as well as potential ranges of probable losses. A determination of the amount of reserves required, if any, for these contingencies is based on an analysis of each individual issue with the assistance of legal counsel. The amount of any reserves may change in the future due to new developments in each matter.

The impact of changes in the estimates and judgments pertaining to revenue recognition, receivables and inventories is directly reflected in our segments income (loss) from operations. Although any charges related to our deferred tax assets are not reflected in our segment results, the long-term forecasts supporting the realization of those assets and changes in them are significantly affected by the actual and expected results of each segment.

Cautionary Statement Regarding Forward-Looking Statements

Certain information contained in this Management s Discussion and Analysis of Financial Condition and Results of Operations for the three months ended September 30, 2003 (the 2003 Third Quarter) compared to the three months ended September 30, 2002 (the 2002 Third Quarter) and for the nine months ended September 30, 2003 (the 2003 First Nine Months) compared to the nine months ended September 30, 2002 (the 2002 First Nine Months) are forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words anticipates, believes, estimates, expects, intends, plans, se variations of such words, and similar expressions are intended to identify forward-looking statements. We have based these forward-looking statements on our current expectations, estimates and projections about our business and industry, our beliefs and certain assumptions made by our management. Investors are cautioned that matters subject to forward-looking statements involve risks and uncertainties including economic, competitive, governmental, technological and other factors that may affect our business and prospects. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. In order to obtain the benefits of these safe harbor provisions for any such forward-looking statements, we wish to caution investors and prospective investors about the following significant factors, which, among others, have in some cases affected our actual results and are in the future likely to affect our actual results and could cause them to differ materially from those expressed in any such forward-looking statements. These factors include the following:

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;
- general economic conditions.

We cannot assure that the level of sales and gross profit, if any, that we achieve in any particular fiscal period will not be significantly lower than in other fiscal periods. Our revenues for the 2003 Third Quarter were approximately $1.2 million versus $1.0 million for the 2002 Third Quarter. Net loss applicable to common shareholders for the 2003 Third Quarter was approximately $1.2 million, or a loss per share of $0.05 on a basic and diluted basis, versus net loss applicable to common shareholders of approximately $3.5 million, or a loss per share of $0.18 on a basic and diluted basis for the 2002 Third Quarter. Our revenues for the 2003 First Nine Months were approximately $3.7 million versus $2.8 million for the 2002 First Nine Months. Net loss applicable to common shareholders for the 2003 First Nine Months was approximately $1.0 million, or a loss per share of $0.05 on a diluted basis, compared to a net loss of approximately $19.6 million, or a loss per share of $1.07 on a diluted basis, for the 2002 First Nine Months. During 2003, we continued to experience cash flow constraints and, in response, on April 11, 2003, we sold our

Aircraft Communications Products segment. Although we believe this sale will provide the Company with necessary working capital, the Aircraft Communications Products division generated approximately $1.1 million and $2.2 million in revenue and total operating profit of approximately $292 thousand and $321 thousand, for the nine-month periods ended September 30, 2003 and 2002, respectively. The Aircraft Communication Products division generated approximately $347 thousand in revenue and total operating loss of approximately $55 thousand, for the three-month period ended September 30, 2002. While we continue to explore opportunities to grow sales, we are also examining additional opportunities for cost-reduction, production efficiencies and further diversification of our business. Although we intend to continue improving cash flows by reducing overall expenses, we may not be able to easily and quickly implement such initiatives and, if our revenues continue to decline, our net loss may be disproportionately affected. Furthermore, our acquisition in 1998 of Lamar Signal Processing, Ltd. (Lamar) resulted in a substantial amount of goodwill and other identifiable intangible assets. The amortization of these intangible assets has had, and will continue to have, a negative, non-cash impact on our results of operations (other than goodwill). In addition, at December 31, 2002 we recorded an impairment charge of approximately $12.5 million as a cumulative effect of a change in accounting principle to write off the goodwill associated with the Lamar acquisition. Although the strategic intent of the business has not changed, the realization of the economic benefits from the business has been limited by the overall poor economic conditions affecting the computing and communications industries. As a result of all the above factors, we expect to continue to accumulate losses and the market price of our common stock could decline.

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, and could result in our delisting on the American Stock Exchange or inability to continue operations.

In recent years, we have sustained significant operating losses. Since 1997, we have been unable to generate sufficient cash flow from operations to meet our operating needs and, correspondingly, from time to time during the past several years, we have raised additional capital from external sources. We expect to continue to 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 the sale of Andrea. On April 11, 2003, we sold our Aircraft Communications Products segment for $3.8 million. In addition, we have engaged an investment banker to explore a variety of strategic alternatives relative to our digital audio technology business. Given our current financial condition and market conditions, it may be difficult to attract additional financings on favorable terms, or at all, as compared to prior periods. We have revised our business strategies to reduce our expenses and capital expenditures, but we still do not generate sufficient cash flow from operations to meet our operating needs and we cannot assure you that we will be successful in obtaining financings or access to additional sources of funding in amounts necessary to continue our operations (See Note 1). Failure to maintain sufficient access to funding may also result in our delisting from the American Stock Exchange. (See Note 12)

We face the risk that Andrea could be required to redeem the 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). The Series C Preferred Stock is convertible or redeemable at maturity by Andrea, based upon certain circumstances at that time, and is redeemable by the holder upon certain events, including the announcement of a major transaction, as defined in the Certificate of Amendment, or upon certain other triggering events. In the first quarter of 2002, a triggering event occurred and we obtained a waiver from the Series C Preferred Stock holders of their redemption right. A final agreement regarding the waiver arrangement was reached on March 28, 2002. The waiver related to the existing triggering event, as well as certain possible future triggering events, however, the waiver will be null and void upon the earlier of April 7, 2007, the first date on which Andrea fails to comply in any material respect with the terms of the waiver and related documents, and the first date on which Andrea is insolvent.

As consideration for the Series C Preferred Stock holder s agreement to waive its current and, in certain circumstances, any future right to receive the aggregate Triggering Event Redemption Price for the Series C Preferred Stock, Andrea agreed to grant a security interest in all of Andrea s assets. However, the Series C Preferred Stock holder agreed to have its lien on Andrea s assets subordinated to (1) any lien granted in the future to a non-affiliated third party in connection with a strategic transaction with a financing component, provided that such third-party lien relates only to the amount of the financing component of such transactions, and (2) any lien granted in the future to a bank or other similar institution pursuant to any asset based financing transaction. In addition, the Series C Preferred Stock holder agreed to release its lien in connection with any sale of any assets subject to its lien, provided they receive a lien on the proceeds of the sale. The Series C Preferred Stock holder acknowledged that its lien in any portion of Andrea s intellectual property is effectively subordinate to the interest of any current or future licensee of such intellectual property, as any interest the investor may have in such intellectual property cannot be greater than Andrea s interest therein.

Given that the waiver granted by the Series C Preferred Stock holder does not cover all triggering events that could require the redemption of the Series C Preferred Stock, and that the waiver will be null and void in the event Andrea fails to comply in any material respect with the terms of the agreements relating to the waiver, among other things, there is a risk that the Series C Preferred Stock holder could declare a triggering event that would trigger the redemption rights. If such redemption rights are triggered and Andrea has insufficient funds to satisfy the redemption, which would be the case if a redemption occurred at this time, Andrea will be required to obtain a new waiver from the holder of the Series C Preferred Stock. If no such waiver can be obtained, Andrea s ability to continue its current operations will be materially adversely affected and if Andrea has insufficient funds to redeem the Series C Preferred Stock, it could result in Andrea s inability to meet its operating obligations and, consequently, delisting from the American Stock Exchange.

Shares Eligible For Future Sale May Have An Adverse Effect On Market Price; You 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, 26,607,713 were outstanding as of November 11, 2003. The number of shares outstanding does not include 6,123,125 shares of our common stock reserved for issuance upon exercise of outstanding awards granted under our 1991 Performance Equity Plan and 1998 Stock Plan, and shares of our common stock reserved for further awards under the 1998 Stock Plan; nor does it include 58,319,936 shares of common stock reserved for issuance upon conversion of Series C convertible preferred stock and exercise of warrants related to the Series B convertible preferred stock.

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

As of November 11, 2003, we had 692.19 shares of Series C Preferred Stock outstanding. The Series C Preferred Stock is convertible into shares of common stock, subject to ownership limitations that prohibit the holders of the preferred stock from owning more than 4.99% of the outstanding shares of common stock at the time of conversion or 9.99% over the sixty day period prior to the conversion. These restrictions do not prevent purchasers from converting and selling some of their holdings and then later converting the rest of their holdings.

As the price of our common stock decreases, the number of shares of common stock issuable upon conversion of our Series C Preferred Stock increases.

The variable conversion price of the Series C Preferred Stock is a function of the market price of our common stock. If the price of our common stock decreases over time, the number of shares of common stock issuable upon conversion of each series will increase.

The following table illustrates, as of any reset date and assuming the conversion price indicated is lower than the then applicable conversion price on that date, the varying amounts of shares of common stock that would be issuable upon conversion of all outstanding 692.19 shares of Series C Preferred Stock at the indicated conversion prices (without regard to any limitations on conversion) and assuming that the 5% dividend amount is paid in cash:

Conversion Price	Number of Shares of Common Stock Issuable Upon Conversion(1)	Percentage of Outstanding Common Stock(2)
$0.15	46,145,840	63%
$0.20	34,609,380	57%
$0.25	27,687,504	51%
$0.30	23,072,920	46%

(1) The holder of Series C Preferred Stock is prohibited from converting its holdings of the Series C Preferred Stock if after giving effect to such conversion it would beneficially own in excess of 4.99% or, over the sixty day period prior to the conversion, 9.99% of the outstanding shares of our common stock following such conversion. The numbers in this column do not reflect these limitations.

(2) Based on 26,607,713 shares of common stock outstanding as of November 11, 2003.

The maximum conversion price of the Series C Preferred Stock is permanently set at $0.30 pursuant to the terms of the agreement. The conversion rate at November 11, 2003 of the Series C Preferred Stock was $0.30. If all of the outstanding shares of the Series C Preferred Stock were converted on November 11, 2003, assuming that the 5% dividend amount is paid in cash, we would have issued a total of 23,072,920 shares of common stock (irrespective of the 4.99% and 9.99% limitations). If the market price of our common stock declines below the $0.30 maximum conversion price, the conversion rates would increase, resulting in our issuing a greater number of shares upon conversion of the Series C Preferred Stock.

Sales of an increased number of shares of common stock issued upon conversion of the Series C Preferred Stock resulting from a declining market price for our common stock can cause the market price of our common stock to decline further.

Disregarding the manner in which the shares of common stock issued upon conversion of the Series C Preferred Stock are sold as well as any other factors such as reactions to our operating results and general market conditions which may be operative in the market at such time, an increase in the number of shares of common stock eligible for sale can cause a decrease in the market price of our common stock. This decrease could reduce the conversion prices of the Series C Preferred Stock, leading to a further increase in the number of shares of common stock issuable upon future conversions and a further decline in our stock price.

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

Short sales of our common stock may be attracted by or accompany the sale of converted common stock, which in the aggregate could cause downward pressure upon the price of the common stock, regardless of our operating results, thereby attracting additional short sales of the common stock. The result of conversions of the Series C Preferred Stock at declining conversion prices would be increasing and substantial dilution of the interests of the other holders of common stock.

If we fail to market and commercialize our Andrea DSP Microphone and Audio Software products, or continue the further development of Andrea Anti-Noise Headset products, our revenues may not increase at a high enough rate to improve our results of operations or may not increase at all.

Our business, results of operations and financial condition depend on the successful commercialization of our Andrea DSP Microphone and Audio Software products and technologies. We introduced our first Andrea DSP Microphone products in 1998 and we continued to introduce complementary products and technologies over the last several years. We are primarily targeting these products at the desktop computer market, the market for in-vehicle computing and the audio and video conferencing markets, among others. The success of these products is subject to the risks frequently encountered by companies in an early stage of product commercialization, particularly companies in the computing and communications industries. Since we began sales of our initial Andrea Anti-Noise Headset products in 1995, we have continued to develop and introduce new products in this line. In addition, in the fourth quarter of 2001, we also restructured this business segment which resulted in a significant reduction in revenues.

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

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

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

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

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

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

If our marketing collaborators do not effectively market their products with which our products are included or incorporated, our sales growth will be adversely affected.

We have entered into collaborative and distribution arrangements with software publishers and computer hardware manufacturers relating to the marketing and sale of Andrea DSP Microphone and Audio Software products through inclusion or incorporation with the products of our collaborators. Our success will therefore be dependent to a substantial degree on the efforts of these collaborators to market their products with which our products are included or incorporated. Our collaborators may not successfully market these products. In addition, our collaborators generally are not contractually obligated to any minimum level of sales of our products or technologies, and we have no control over their marketing efforts. Furthermore, our collaborators may develop their own microphone, earphone or headset products that may replace our products or technologies or to which they may give higher priority.

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

We conduct low volume assembly operations at our facilities in New York and Israel. As sales of any particular product increases, assembly operations are transferred to subcontractors (primarily in the Far East) using purchased components. Some specialized components for the Andrea Anti-Noise Headset and Andrea DSP Microphone products, such as microphones and digital signal processing boards are available from a limited number of suppliers (in some cases foreign) and subject to long lead times. We may not be able to continue to obtain sufficient supplies of these more specialized components, particularly if the sales of our products increase substantially or market demand for these components otherwise increases. If our subcontracts fail to meet our production and shipment schedules, our business, results of operations and financial condition would be materially and adversely affected.

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

We rely on a combination of patents, patent applications, trade secrets, copyrights, trademarks, nondisclosure agreements with our employees, licensees and potential licensees, limited access to and dissemination of our proprietary information, and other measures to protect our intellectual property and proprietary rights. However, the steps that we have taken to protect our intellectual property may not prevent its misappropriation or circumvention. In addition, numerous patents have been granted to other parties in the fields of noise cancellation, noise reduction, computer voice recognition, digital signal processing and related subject matter. We expect that products in these fields will increasingly be subject to claims under these patents as the numbers of products and competitors in these fields grow and the functionality of products overlap. Claims of this type could have an adverse effect on our ability to manufacture and market our products or to develop new products and technologies, because the parties holding these patents may refuse to grant licenses or only grant licenses with onerous royalty requirements. Moreover, the laws of other countries do not protect our proprietary rights to our technologies to the same extent as the laws of the United States.

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

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

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

We generate sales to regions outside the United States, particularly in Europe and areas in the Americas and Asia. For the three-month period ended September 30, 2003, and 2002, sales to customers outside the United States accounted for approximately 6% and 10%, respectively, of our net sales from continuing operations. For the nine-month period ended September 30, 2003, and 2002, sales to customers outside the United States accounted for approximately 8% and 21%, respectively, of our net sales from continuing operations. International sales and operations are subject to a number of risks, including:

- trade restrictions in the form of license requirements;
- restrictions on exports and imports and other government controls;
- changes in tariffs and taxes;
- difficulties in staffing and managing international operations;
- problems in establishing and managing distributor relationships;

general economic conditions; and

political and economic instability or conflict.

To date, we have invoiced our international sales in U.S. dollars, and have not engaged in any foreign exchange or hedging transactions. We may not be able to continue to invoice all of our sales in U.S. dollars or be able to avoid engaging in foreign exchange or hedging transactions. If we are required to invoice any material amount of international sales in non-U.S. currencies, fluctuations in the value of non-U.S. currencies relative to the U.S. dollar may adversely affect our business, results of operations and financial condition or require us to incur hedging costs to counter such fluctuations.

We face risk from operating in Israel.

Our principal research and development facility is located in the State of Israel and, as a result, certain of our key research and development employees are located in Israel. Although substantially all of our sales currently are being made to customers outside Israel, we are nonetheless directly influenced by the political, economic and military conditions affecting Israel. Since the establishment of the State of Israel in 1948, a state of hostility has existed, varying in degree and intensity, between Israel and Arab countries. Although Israel has entered into various agreements with certain Arab countries and the Palestinian Authority, and various declarations have been signed in connection with efforts to resolve some of the economic and political problems in the Middle East, we cannot predict whether or in what manner these problems will be resolved.

If we are unable to attract and retain the necessary managerial, technical and other personnel necessary for our business, then our business, results of operations and financial condition will be harmed.

Our performance is substantially dependent on the performance of our executive officers and key employees. The loss of the services of any of these executive officers or key employees could have a material adverse effect on our business, results of operations and financial condition. Our future success depends on our continuing ability to attract and retain highly qualified managers and technical personnel. As of the date of this filing, the Board of Directors of Andrea Electronics is in the process of negotiating employment contracts with the officers of the Company. Competition for qualified personnel is intense and we may not be able to attract, assimilate or retain qualified personnel in the future.

Results Of Operations

Quarter ended September 30, 2003 compared to Quarter ended September 30, 2002 and Nine Months Ended September 30, 2003 Compared to the Nine Months Ended September 30, 2002.

Revenues

Revenues 2003 Third Quarter were $1,166,558, an increase of 14% from revenues of $1,022,913 for the 2002 Third Quarter. Revenues for the 2003 First Nine Months were $3,690,812, an increase of 33% from the 2002 First Nine Months revenues of $2,768,229. The increase in revenues for the 2003 Third Quarter reflects an increase of 16% in revenues of Andrea DSP Microphone and Software Products to $585,646, or 50% of revenues and a 12% increase in revenues of Andrea Anti-Noise Products to $580,912, or 50% of total revenues. The increase in revenues for the 2003 First Nine Months reflects an increase of 79% in revenues of Andrea DSP Microphone and Software Products to $1,783,661, or 48% of revenues, and a 8% increase in revenues of Andrea Anti-Noise Products to $1,907,151, or 52% of total revenues. The increase in revenues of Andrea DSP Microphone and Audio Software Products is primarily due to licensing revenue recognized relating to our agreements with Analog Devices. The increase in revenues of Andrea Anti-Noise Headset Products is primarily due to an increasing number of businesses utilizing distance learning and on-line collaboration software utilizing our noise canceling headset products. The unamortized portion of the Analog license agreements is recorded as deferred revenue ($1,666,680 of which is classified as current and $1,129,954 is classified as long-term as of September 30, 2003). All license revenues are being recognized on a straight-line basis over three-years, $3 million of which started to be recognized during the first quarter of 2002, and $2 million of which started in the third quarter of 2002.

Cost of Revenues

Cost of revenues as a percentage of revenues for the 2003 Third Quarter increased to 56% from 45% for the 2002 Third Quarter. Cost of Revenues as a percentage of sales for the 2003 First Nine Months decreased to 53% from 62% for the 2002 First Nine Months. This decrease for the 2003 First Nine Months primarily reflects the impact of the significant changes in the composition of our revenues as described under Revenues above, in particular, the significant increase in high-margin license revenues associated with our agreements with Analog Devices.

Research and Development

Research and development expenses for the 2003 Third Quarter decreased 14% to $667,207 from $780,006 for the 2002 Third Quarter. Research and development expenses for the 2003 First Nine Months were $2,177,978, a decrease of 8% from the 2002 First Nine Months research and development expenses of $2,370,278. The substantial amount of research and development is primarily a reflection of our efforts to develop and commercialize DSP microphone and audio technologies. For the first nine months ended September 30, 2003, the Andrea DSP Microphone and Audio Software Technology efforts were $1,936,826, or 89% of total research and development expenses and Andrea Anti-Noise Headset Product efforts were $241,152, or 11% 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 optimal far-field microphone solutions for various voice-driven interfaces, incorporating Andrea s digital super directional array microphone technology (DSDA), 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, however, as part of our overall effort to conserve cash, we intend to reduce where possible the relatively high levels of such expenses during fiscal 2003 and the early part of 2004.

General, Administrative and Selling Expenses

General, administrative and selling expenses decreased approximately 27% to $949,938 for the 2003 Third Quarter from $1,308,236 for the 2002 Third Quarter. General, administrative and selling expenses for the 2003 First Nine Months were $2,959,623 a decrease of 27% from the 2002 First Nine Months general, administrative and selling expenses of $4,052,469. These decreases are primarily due to our cost reduction efforts primarily related to employee compensation and other general corporate overhead. As part of our overall effort to conserve cash, we intend to reduce where possible the relatively high levels of such expenses during the remaining fiscal 2003 and the early part of 2004.

Other Income / Expense

Other income for the 2003 Third Quarter was $31,381 compared to other expense of $15,947 for the 2002 Third Quarter. Other income for the 2003 First Nine Months was $149,550 compared to other income of $20,834 for the 2002 First Nine Months. These increases in other income are primarily the result of rental income received as a result of the transition agreement involved with the discontinued operations partially offset by a $47 thousand loss recognized on the disposal of fixed assets.

Provision for Income Taxes

We provide a full valuation allowance on future tax benefits until we can sustain a level of profitability that demonstrates our ability to utilize the assets, or other significant positive evidence arises that suggests our ability to utilize such assets. The future realization of a portion of our reserved deferred tax assets related to tax benefits associated with the exercise of stock options, if and when realized, will not result in a tax benefit in the condensed consolidated statement of operations, but rather will result in an increase in additional paid in capital. We will continue to re-assess our reserves on deferred income tax assets in future periods on a quarterly basis.

Discontinued Operations

We sold our Aircraft Communications Products division on April 11, 2003. The purchase price was comprised of $2.5 million in cash, and approximately $1.3 million in notes payable in equal installments over the succeeding 11-month period. The gain on the sale, recorded in the second quarter of 2003, was approximately $2.24 million. The results of the Aircraft Communication Products division for both the 2003 First Nine Months and 2002 First Nine Months have been classified as discontinued operations in the accompanying condensed consolidated financial statements. Operating income from discontinued operations was approximately $292 thousand and $321 thousand, respectively, for the 2003 First Nine Months and 2002 First Nine Months, respectively. Aircraft Communications Products revenues, included within the discontinued operations line item, during 2003 First Nine Months and 2002 First Nine Months were $1.1 million and $2.2 million, respectively.

Net Loss

Net loss for 2003 Third Quarter was $1,072,457 compared to a net loss of $3,400,902 for the 2002 Third Quarter. Net loss for the 2003 First Nine Months was $704,394, compared to a net loss of $19,281,018 for the 2003 First Nine Months. The net loss for 2003 Third Quarter and 2003 First Nine Months principally reflects the factors described above. The net loss for 2002 Third Quarter included a non-cash charge to provision for income taxes of approximately $1.8 million relating to a potential non-realization of the associated deferred tax asset. In addition to the $1.8 million non-cash charge to provision for income taxes, the net loss for 2002 First Nine Months included an impairment charge of approximately $12.5 million relating to the determination that the carrying value of the Andrea DSP Microphone and Audio Software business unit exceeded its fair market value.

Liquidity And Capital Resources

Andrea s principal sources of funds have historically been, and are expected to continue to be, gross cash flows from operations and proceeds from the sale of convertible notes, preferred stock or other securities to certain financial institutions and potential industry partners. At September 30, 2003, we had cash and cash equivalents of $2,352,532 compared with $3,307,437 at December 31, 2002. The balance of cash and cash equivalents at September 30, 2003 is primarily a result of the sale of our Aircraft Communication Products division, together with gross cash flows from operations.

Working capital at September 30, 2003, was $763,102 compared to $2,131,828 at December 31, 2002. The decrease in working capital reflects a decrease in total current assets of $2,532,186 and a decrease in total current liabilities of $1,163,460. The decrease in total current assets reflects decreases in cash and cash equivalents of $954,905, an increase in accounts receivable of $53,122, an increase in note receivables of $709,970, a decrease in inventory of $716,821 , a decrease in assets from discontinued operations of $1,487,482, a decrease in prepaid expenses and other current assets of $136,070. The decrease in total current liabilities reflects a decrease in trade accounts payable of $414,157, a decrease in current portion of long-term debt of $568, a decrease of $4,012 in accrued restructuring charges, a decrease of $621,820 in other current liabilities, and a decrease of $122,903 in liabilities from discontinued operations.

The decrease in cash at September 30, 2003 of $954,905 reflects $97,794 of net cash provided by discontinued operating activities, $3,980,110 of net cash used in continuing operating activities, $2,943,390 of net cash provided by investing activities and $15,979 of net cash used in financing activities.

The cash used in operating activities of $3,980,110, excluding non-cash charges, is primarily attributable to the $3,239,218 net loss from continuing operations for 2003 First Nine Months, a $64,488 increase in accounts receivable, a $716,821 decrease in inventory, a $136,070 decrease in prepaid expenses and other current assets, a $11,264 decrease in other assets, a $414,157 decrease in accounts payable, a $803,801 decrease in other current and long-term liabilities, a $4,012 decrease in accrued restructuring charges and a $1,250,010 decrease in deferred revenue. The change in deferred revenue reflects licensing revenue that was recognized during the 2003 First Nine Months as a result of our license agreements with Analog Devices, Inc. The changes in inventory, accounts payable and other current and long term liabilities 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 provided by discontinued operating activities at September 30, 2003 of $97,794 is a result of net income from discontinued operations of $2,534,824, the gain on the sale of discontinued operations of $2,242,573, the increase in assets from discontinued operations of $188,192 and the decrease in liabilities from discontinued operations of $6,265.

The cash provided by investing activities at September 30, 2003 of $2,943,390 reflects the proceeds from the sale of the Aircraft Communications Products Division of $2,500,000 and principal payments received on the note receivable related to the sale of the Aircraft Communications Products Division of $591,640 partially offset by an increase in property and equipment of $52,156 and an increase in patents and trademarks of $96,094. The increase in property and equipment primarily relates to capital expenditures related to manufacturing dies for our Andrea Anti Noise Headset business line and our Andrea DSP Microphone and Audio Software business line. The increase in patents and trademarks reflects capital expenditures associated with intellectual property related to our Andrea DSP Microphone and Audio Software business line.

The net cash used in financing activities of $15,979 reflects payments made related to the debt we assumed in connection with the acquisition of Lamar.

We believe that it will be necessary to raise additional working capital to support operations. In recent years, we have sustained significant operating losses and we have been unable to generate sufficient cash flow from operations to meet our operating needs. Consequently, from time to time during the past several years, we raised capital from external sources. In December 1995, April 1996, August 1996 and June 1998, Andrea raised working capital through the issuance of convertible subordinated debentures. In June 1999, Andrea raised $7.5 million through the issuance and sale of Series B Preferred Stock. In October 2000, Andrea raised $7.5 million through the issuance and sale of Series C Preferred Stock. During 2002, we continued to explore different sources of external funding in amounts necessary to continue our operations, while pursuing opportunities in our Andrea DSP Microphone and Audio Software Products segment and our Andrea Anti-Noise Products segment. As a result of our efforts, on April 11, 2003, we sold our Aircraft Communications Products division for approximately $3.8 million. Pursuant to the terms of the purchase agreement, we received $2.5 million in cash with the balance of the purchase price payable in equal installments over the succeeding eleven-month period. In addition to the proceeds resulting from the sale of the Aircraft Communications Products segment, we plan to continue to improve our cash flows during 2003, and the early part of 2004, by continuing to implement reductions of administrative overhead expenses where necessary and feasible as well as aggressively pursue 1) existing and prospective opportunities to sell our Superbeam Array Microphone generated through our co-marketing efforts with Analog Devices in the personal computing market, 2) existing opportunities in the automotive (in-vehicle computing) market, 3) opportunities in the video and audio conferencing market and 4) opportunities in the call center market. In addition, we have engaged an investment banker to explore a variety of strategic alternatives relative to our digital audio technology business. However, there can be no assurance that we will be able to successfully execute the aforementioned plans.

As of November 11, 2003, we had approximately $2.2 million of cash. During the year ended 2002, we utilized $4.6 million in cash, excluding the $5 million in cash generated from the license agreements with Analog Devices. We expect our cash utilization to continue to decrease as a result of the reductions of certain administrative, overhead and research and development expenses that have started in the second quarter of 2003, partially offset by the elimination of positive net cash flows from the Aircraft Communications Products division. Although we have implemented several measures in an effort to reduce our expenses to help preserve cash and we continue to pursue additional sources of capital, there can be no assurance that we will be successful in our attempts to raise sufficient capital essential to our survival. To the extent that we fail to develop additional revenues from sales of our products to generate adequate funding from operations, or if we fail to obtain additional financing through a capital transaction or other type of funding, we will be required to significantly reduce our operating expenses and/or operations or we may have to relinquish our products, technologies or markets and will not be able to develop and implement a business plan. Additionally, even if we do raise sufficient operating capital, there can be no assurance that the net proceeds will be sufficient to enable us to develop our business to a level where it will generate profits and cash flows from operations. 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. Furthermore, if the redemption rights of the Series C Preferred Stock are triggered and we have insufficient funds to satisfy the redemption, we would be required to obtain a waiver from the holders of the Preferred Stock. If no such waiver can be obtained, our ability to continue our current operations will be materially adversely affected and it could result in our inability to meet its operating obligations. These matters raise substantial doubt about our ability to continue as a going concern. As such, the third quarter condensed consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and satisfaction of liabilities in the normal course of business. The financial statements do not include any adjustments relating to the recoverability of the recorded assets or the classification of the liabilities that might be necessary should we be unable to continue as a going concern.

ITEM 3. 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 the Andrea s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. In addition, based on that evaluation, no change in Andrea s internal control over financial reporting occurred during the quarter ended September 30, 2003 that has materially affected, or is reasonably likely to materially affect, its internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On August 6, 2003, Christopher P. Sauvigne, director and former President and Chief Executive Officer of Andrea filed a lawsuit in the Supreme Court of the State of New York, County of Nassau, against the Company styled Christopher P. Sauvigne v. Andrea Electronics Corporation, Index No. 03-012098 (the Action). The Action alleges that Mr. Sauvigne and Andrea were parties to an employment contract and that Andrea breached the contract in connection with the termination of Mr. Sauvigne as President and Chief Executive Officer of Andrea on August 1, 2003. The Action seeks (i) a sum of not less than $131,250, plus interest, (ii) a mandate that Andrea grant stock options to Mr. Sauvigne and (iii) reasonable counsel fees and costs. Andrea intends to defend the Action vigorously. While the outcome of the Action cannot be predicted with certainty, Andrea believes the Action is without merit. On September 25, 2003, Andrea filed a response to the Action with the Court denying these claims. In addition, Andrea filed a counterclaim against Mr. Sauvigne alleging that (i) Mr. Sauvigne misused his corporate credit card and (ii) breached his fiduciary duty to Andrea by omitting material facts concerning his involvement with the group of private investors that purchased the Andrea Aircraft Communications Products division and/or failing to disclose to Andrea that the private investor group included various members of Mr. Sauvigne s family. The counterclaim seeks (i) reimbursement of any compensation paid to Mr. Sauvigne for any personal and/or undocumented expenses incurred by him (ii) forfeiture and repayment to Andrea of all salary, bonuses, and benefits that Mr. Sauvigne received from Andrea after the breach of his fiduciary duty in an amount to be determined at trial and (iii) attorneys fees and costs.

See Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations Cautionary Statement Regarding Forward-Looking Statements An unfavorable ruling in any current litigation proceeding or future proceeding may adversely affect our business, results of operations and financial condition and Note 7 to the unaudited condensed consolidated financial statements in this quarterly report for a discussion of the legal proceedings of Andrea.

ITEM 2. CHANGES IN SECURITIES

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITIES HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

a) Exhibits

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

Exhibit 32 Section 1350 Certifications

b) Reports on Form 8-K

On August 11, 2003, Andrea filed a Current Report on Form 8-K reporting that it had issued a press release announcing that Paul E. Donofrio has been appointed President and Chief Executive Officer of the Company, effective August 4, 2003.

On August 15, 2003, Andrea filed a Current Report of Form 8-K reporting that it had issued a press release announcing that it had received notice from the American Stock Exchange informing Andrea that the American Stock Exchange had accepted Andrea s plan of compliance and granted an extension of time to November 23, 2004 to regain compliance with the continued listing standards of the American Stock Exchange.

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ANDREA ELECTRONICS CORPORATION

By: /s/ Paul E. Donofrio

Name: Paul E. Donofrio

Date: November 13,2003

Title: President and Chief Executive Officer

/s/ Paul E. Donofrio Paul E. Donofrio	President and Chief Executive Officer	November 13, 2003
/s/ Corisa L. Guiffre Corisa L. Guiffre	Vice President, Chief Financial Officer and Assistant Corporate Secretary	November 13, 2003