ANDREA ELECTRONICS CORP
Form 10-Q
November 15, 2010

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2010

OR

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

For the transition period from ____________ to ____________

Commission file number 1-4324

ANDREA ELECTRONICS CORPORATION

(Exact name of registrant as specified in its charter)

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: As of November 11, 2010, there were 63,721,035 common shares outstanding.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2010 (unaudited)	December 31, 2009
ASSETS		
Current assets:		
Cash	$2,248,918	$1,805,091
Accounts receivable, net of allowance for doubtful accounts of $10,266 and $6,262, respectively	888,866	514,327
Inventories, net	690,818	842,428
Short term customer deposits	79,632	93,168
Deferred income taxes, net	35,392	143,130
Prepaid expenses and other current assets	83,177	93,552
Total current assets	4,026,803	3,491,696
Property and equipment, net	224,813	215,974
Intangible assets, net	1,758,222	2,106,507
Other assets, net	12,864	12,864
Total assets	$6,022,702	$5,827,041
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Trade accounts payable	$379,256	$392,128
Current portion of long-term debt	22,261	21,214
Accrued Series C Preferred Stock dividends	73,921	80,606
Short-term deferred revenue	109,632	123,168
Other current liabilities	196,976	156,503
Total current liabilities	782,046	773,619
Long term debt, net of current portion	82,845	99,786
Series B Redeemable Convertible Preferred Stock, $.01 par value; authorized: 1,000 shares; issued and outstanding: 0 shares	-	-
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, $.01 par value; authorized: 2,497,500 shares; none issued and outstanding	-	-
Series C Convertible Preferred Stock, net, $.01 par value; authorized: 1,500 shares; issued and outstanding: 44.2 and 48.2 shares, respectively; liquidation value:	1	1

$442,314 and $482,314, respectively		
Series D Convertible Preferred Stock, net, $.01 par value; authorized: 2,500,000 shares; issued and outstanding: 907,144 shares; liquidation value: $907,144	9,072	9,072
Common stock, $.01 par value; authorized: 200,000,000 shares; issued and outstanding: 63,721,035 and 63,538,029 shares, respectively	637,210	635,380
Additional paid-in capital	77,252,821	77,096,177
Accumulated deficit	(72,741,293)	(72,786,994)
Total shareholders' equity	5,157,811	4,953,636
Total liabilities and shareholders' equity	$6,022,702	$5,827,041

See Notes to Condensed Consolidated Financial Statements.

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

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
Revenues				
Net product revenues	$ 1,080,096	$ 1,039,711	$ 2,724,563	$ 2,578,004
License revenues	424,461	358,256	1,245,731	839,104
Revenues	1,504,557	1,397,967	3,970,294	3,417,108
Cost of revenues	570,153	646,368	1,477,526	1,505,011
Gross margin	934,404	751,599	2,492,768	1,912,097
Research and development expenses	170,219	148,913	524,252	441,279
General, administrative and selling expenses	642,767	578,165	1,819,325	1,751,244
Income (loss) from operations	121,418	24,521	149,191	(280,426)
Interest income, net	1,145	4,782	4,304	9,718
Income (loss) before provision for income taxes	122,563	29,303	153,495	(270,708)
Provision for income taxes	58,637	355	107,794	1,920
Net income (loss)	$ 63,926	$ 28,948	$ 45,701	$ (272,628)
Basic weighted average shares	63,689,208	62,952,705	63,588,976	61,643,716
Diluted weighted average shares	73,296,287	72,608,050	72,273,719	61,643,716
Basic and diluted net income (loss) per share	$ .00	$ .00	$ .00	$ (.00)

See Notes to Condensed Consolidated Financial Statements.

ANDREA ELECTRONICS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
FOR NINE MONTHS ENDED SEPTEMBER 30, 2010
(UNAUDITED)

	Series C Convertible Preferred Stock Outstanding	Series C Convertible Preferred Stock	Series D Convertible Preferred Stock Outstanding	Series D Convertible Preferred Stock	Common Stock Shares Outstanding	Common Stock	Additional Paid-In Capital	Accumulated Deficit	Total Shareholders' Equity
Balance, January 1, 2010	48.231432	$1	907,144	$9,072	63,538,029	$635,380	$77,096,177	$(72,786,994)	$4,953,636
Conversion of Series C Convertible Preferred Stock	(4.000000)	-	-	-	183,006	1,830	4,855	-	6,685
Stock-based Compensation Expense related to Stock Option Grants	-	-	-	-	-	-	151,789	-	151,789
Net Income	-	-	-	-	-	-	-	45,701	45,701
Balance, September 30, 2010	44.231432	$1	907,144	$9,072	63,721,035	$637,210	$77,252,821	$(72,741,293)	$5,157,811

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, 2010	September 30, 2009
Cash flows from operating activities:		
Net income (loss)	$ 45,701	$ (272,628)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	409,103	387,710
Stock based compensation expense	151,789	190,803
Bad debt expense	4,004	(46,172)
Inventory reserve	15,111	-
Deferred income taxes	107,738	-
Change in:		
Accounts receivable	(378,543)	420,505
Inventories	136,499	133,258
Short term customer deposits	13,536	(93,168)
Prepaid expenses and other current assets	10,375	22,501
Trade accounts payable	(12,872)	460,561
Short-term deferred revenue	(13,536)	83,168
Other current liabilities	40,473	26,189
Net cash provided by operating activities	529,378	1,312,727
Cash flows from investing activities:		
Purchases of property and equipment	(59,948)	(33,032)
Purchases of patents and trademarks	(9,709)	(33,851)
Net cash used in investing activities	(69,657)	(66,883)
Cash flows from financing activities:		
Principal repayments of long term debt	(15,894)	-
Net cash used in financing activities	(15,894)	-
Net increase in cash	443,827	1,245,844
Cash, beginning of year	1,805,091	1,006,951
Cash, end of period	$ 2,248,918	$ 2,252,795
Supplemental disclosures of cash flow information:		
Non-cash investing and financing activities:		
Conversion of Series C Convertible Preferred Stock and related dividends into common stock	$ 6,685	$ 69,306
Cash paid for:		
Income Taxes	$ 2,656	$ 7,040
Interest	$ 1,739	$ -

See Notes to Condensed Consolidated Financial Statements.

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

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

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

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

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

Management's Liquidity Plans - As of September 30, 2010, Andrea had working capital of $3,244,757 and cash on hand of $2,248,918. Andrea’s income from operations was $121,418 and $149,191 for the three and nine months ended September 30, 2010, respectively. Andrea plans to continue to improve its cash flows during 2010 and 2011 by aggressively pursuing additional licensing opportunities related to Andrea DSP Audio Software and increasing its Andrea Anti-Noise Headset Products sales through new products that are currently being offered and that are under development, as well as the increased efforts of the Company to its sales and marketing efforts. However, there can be no assurance that Andrea will be able to successfully execute the aforementioned plans.

As of November 11, 2010, Andrea had approximately $2,100,000 of cash. Management projects that Andrea has sufficient liquidity available to operate through at least September 2011. While Andrea explores opportunities to increase revenues in new business areas, the Company also continues to examine additional opportunities for cost reduction and further diversification of its business. Since the third quarter of 2006, Andrea has generated cash flows from operations. If Andrea fails to develop additional revenues from sales of its products and licensing of its technology or to generate adequate funding from operations, or if Andrea fails to obtain additional financing through a capital transaction or other type of financing, Andrea will be required to continue to significantly reduce its operating expenses and/or operations or Andrea may have to relinquish its products, technologies or markets which could have a materially adverse effect on revenue and operations. Andrea has no commitment for additional financing and may experience difficulty in obtaining additional financing on favorable terms, if at all.

Note 2. Summary of Significant Accounting Policies

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

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
Total potential common shares as of:				
Options to purchase common stock (Note 8)	9,306,821	8,384,321	9,223,488	16,174,321
Series C Convertible Preferred Stock and related accrued dividends (Note 3)	-	-	-	2,206,664
Series D Convertible Preferred Stock and related warrants (Note 4)	-	-	-	3,628,576
Total potential common shares	9,306,821	8,384,321	9,223,488	22,009,561

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

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

	For the Three Months Ended September 30, 2010	For the Three Months Ended September 30, 2009	For the Nine Months Ended September 30, 2010	For the Nine Months Ended September 30, 2009
Numerator:				
Net income (loss)	$ 63,926	$ 28,948	$ 45,701	$ (272,628)
Denominator:				
Basic Weighted average shares	63,689,208	62,952,705	63,588,976	61,643,716
Effect of dilutive securities:				
Series C Convertible Preferred Stock	2,023,658	2,206,664	2,145,662	-
Series D Convertible Preferred Stock	3,628,576	3,628,576	3,628,576	-
Employee stock options	3,954,845	3,820,105	2,910,505	-
Denominator for diluted income (loss) per share-adjusted weighted average shares after assumed conversions	73,296,287	72,608,050	72,273,719	61,643,716

Cash - Cash includes cash and highly liquid investments with original maturities of three months or less. At times during the periods ended September 30, 2010 and December 31, 2009, the Company had cash deposits in excess of the maximum amounts insured by the Federal Deposit Insurance Corporation insurance limits. At September 30, 2010, the Company's cash is held at three financial institutions.

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

	For the Three Months Ended September 30, 2010	For the Three Months Ended September 30, 2009	For the Nine Months Ended September 30, 2010	For the Nine Months Ended September 30, 2009
Customer A	17 %	22 %	25 %	20 %
Customer B	11 %	*	*	*
Customer C	11 %	*	*	*
Customer D	12 %	*	*	*
Customer E	*	*	10 %	*
Customer F	*	11 %	*	*
Customer G	*	13 %	*	*

* Amounts are less than 10%

Customer A, B, C, and D accounted for approximately 25%, 10%, 18% and 20%, respectively of total accounts receivable at September 30, 2010.

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

	For the Three Months Ended				For the Nine Months Ended			
	September 30, 2010		September 30, 2009		September 30, 2010		September 30, 2009	
Supplier A	71	%	100	%	80	%	94	%
Supplier B	29	%	*		16	%	*	

* Amounts are less than 10%

At September 30, 2010 and December 31, 2009, Supplier A accounted for approximately 30% and 63% of accounts payable, respectively.

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

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

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

	September 30, 2010	December 31, 2009
Raw materials	$ 35,121	$ 54,351
Finished goods	1,323,816	1,441,085
	1,358,937	1,495,436
Less: reserve for obsolescence	(668,119)	(653,008)
	$ 690,818	$ 842,428

Intangible and Lived Assets - Andrea accounts for its long-lived assets in accordance with Statement of Financial Accounting Standards Board ("FASB") Accounting Standard Codification ("ASC") 360 "Plant, Property and Equipment, " for purposes of determining and measuring impairment of its long-lived assets (primarily intangible assets) other than goodwill. Andrea's policy is to review the value assigned to its long lived assets to determine if they have been permanently impaired by adverse conditions which may affect Andrea whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If Andrea identifies a permanent impairment such that the carrying amount of Andrea's long lived assets is not recoverable using the sum of an undiscounted cash flow projection (gross margin dollars from product sales), the impaired asset is adjusted to its estimated fair value, based on an estimate of future discounted cash flows which becomes the new cost basis for the impaired asset. Considerable management judgment is necessary to estimate undiscounted future operating cash flows and fair values and, accordingly, actual results could vary significantly from such estimates. No impairment charges were recognized during the three and nine month periods ended September 30, 2010 and 2009.

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

Income Taxes - The provision for income taxes is a result of certain licensing revenues that are subject to withholding of income tax as mandated by the foreign jurisdiction in which the revenues are earned. For all other income taxes, Andrea accounts for income taxes in accordance with ASC 270, “Interim Reporting” (ASC 240”) and ASC 740, “Income Taxes” (“ASC 740”), whereby the Company utilizes the expected annual effective tax rate in determining its income tax provisions for the interim period’s income or loss. ASC 740 requires an asset and liability approach for financial accounting and reporting for income taxes and establishes for all entities a minimum threshold for financial statement recognition of the benefit of tax positions, and requires certain expanded disclosures. The provision for income taxes is based upon income or loss after adjustment for those permanent items that are not considered in the determination of taxable income, which includes amortization expense, stock based compensation and other permanent differences. These permanent items result in a difference between income taxes at the statutory Federal income tax rate and income taxes reported in the condensed consolidated income statement. Deferred income taxes represent the tax effects of differences between the financial reporting and tax bases of the Company’s assets and liabilities at the enacted tax rates in effect for the years in which the differences are expected to reverse. The Company evaluates the recoverability of deferred tax assets and establishes a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. Accordingly, and after considering changes in existing positive evidence, the Company reduced its valuation allowance to recognize a deferred tax asset of approximately $143,000 for the year ended December 31, 2009. In addition, Andrea expects it will reduce its valuation in future periods to the extent that it can demonstrate its ability to utilize the assets. Management makes judgments as to the interpretation of the tax laws that might be challenged upon an audit and cause changes to previous estimates of tax liability. In management’s opinion, adequate provisions for income taxes have been made for all years. If actual taxable income by tax jurisdiction varies from estimates, additional allowances or reversals of reserves may be necessary. Income tax expense consists of the tax payable for the period and the change during the period in deferred tax assets and liabilities. The Company has identified its federal tax return and its state tax return in New York as "major" tax jurisdictions. Based on the Company's evaluation, it has been concluded that there are no significant uncertain tax positions requiring recognition in the Company's condensed consolidated financial statements. The Company's evaluation was performed for tax years ended 2006 through 2009. The Company believes that its income tax positions and deductions will be sustained on audit and does not anticipate any adjustments that will result in a material change to its financial position.

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

Stock-Based Compensation -At September 30, 2010, Andrea had two stock-based employee compensation plans, which are described more fully in Note 8. Andrea accounts for stock-based compensation in accordance with ASC 718, "Compensation – Stock Compensation" ("ASC 718"). ASC 718 establishes accounting for stock-based awards exchanged for employee services. Under the provisions of ASC 718, stock-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as expense over the employee's requisite service period (generally the vesting period of the equity grant). The fair value of the Company's common stock options are estimated using the Black Scholes option-pricing model with the following assumptions: expected volatility, dividend rate, risk free interest rate and the expected life. The Company expenses stock-based compensation by using the straight-line method. In accordance with ASC 718, excess tax benefits realized from the exercise of stock-based awards are classified in cash flows from financing activities. The future realization of the reserved deferred tax assets related to these tax benefits associated with the exercise of stock options will result in a credit to additional paid in capital if the related tax deduction reduces taxes payable. The Company has elected the "with and without approach" regarding ordering of windfall tax benefits to determine whether the windfall tax benefit did reduce taxes payable in the current year. Under this approach, the windfall tax benefit would be recognized in additional paid-in-capital only if an incremental tax benefit is realized after considering all other benefits presently available.

Recently Issued Accounting Pronouncements

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

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

Use of Estimates

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

Management bases its estimates on historical experience and on various assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. The most significant estimates, among other things, are used in accounting for allowances for bad debts, inventory valuation and obsolescence, product warranty, depreciation, deferred income taxes, expected realizable values for assets (primarily intangible assets), contingencies, revenue recognition as well as the recording and presentation of the Company’s convertible preferred stock. Estimates and assumptions are periodically reviewed and the effects of any material revisions are reflected in the consolidated financial statements in the period that they are determined to be necessary. Actual results could differ from those estimates and assumptions.

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

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

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

Note 3. Series C Redeemable Convertible Preferred Stock

On October 10, 2000, Andrea issued and sold in a private placement $7,500,000 of Series C Redeemable Convertible Preferred Stock (the "Series C Preferred Stock"). Each of these shares of Series C Preferred Stock had a stated value of $10,000 plus a $1,671 increase in the stated value, which sum is convertible into Common Stock at a conversion price of $0.2551. On February 17, 2004, Andrea announced that it had entered into an Exchange and Termination Agreement and an Acknowledgment and Waiver Agreement, which eliminated the dividend of 5% per annum on the stated value. The additional amount of $1,671 represents the 5% per annum from October 10, 2000 through February 17, 2004. The shares of Series C Preferred Stock are subject to antidilution provisions, which are triggered in the event of certain stock splits, recapitalizations, or other dilutive transactions. In addition, issuances of common stock at a price below the conversion price then in effect (currently $0.2551), or the issuance of warrants, options, rights, or convertible securities which have an exercise price or conversion price less than that conversion price, other than for certain previously outstanding securities and certain "excluded securities" (as defined in the certificate of amendment), require the adjustment of the conversion price to that lower price at which shares of common stock have been issued or may be acquired. In the event that Andrea issues securities in the future which have a conversion price or exercise price which varies with the market price and the terms of such variable price are more favorable than the conversion price in the Series C Preferred Stock, the purchasers may elect to substitute the more favorable variable price when making conversions of the Series C Preferred Stock.

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

On July 16, 2010, 4.0 shares of Series C Preferred Stock, together with related accrued dividends, were converted into 183,006 shares of Common Stock at a conversion price of $0.2551.

As of September 30, 2010, there were 44.231432 shares of Series C Preferred Stock outstanding, which were convertible into 2,023,658 shares of Common Stock and remaining accrued dividends of $73,921.

Note 4. Series D Redeemable Convertible Preferred Stock

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

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

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

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

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

As of September 30, 2010, there were 907,144 shares of Series D Preferred Stock outstanding which were convertible into 3,628,576 shares of Common Stock.

Note 5. Licensing Agreements

The Company has entered into various licensing, production and distribution agreements with manufacturers of PC and related components. These agreements provide for revenues based on the terms of each individual agreement. The Company's two largest licensing customers accounted for $254,576 and $160,782 of license revenues for the three months ended September 30, 2010 and $306,476 and $39,750 of license revenues for the three months ended September 30, 2009. The Company's two largest licensing customers accounted for $981,413 and $184,826 of license revenues for the nine months ended September 30, 2010 and $692,905 and $88,160 of license revenues for the nine months ended September 30, 2009.

Note 6. Long Term Debt

Long-term debt consists of the following:

	September 30, 2010	December 31, 2009
Long-term debt	$ 105,106	$ 121,000
Less: Current Maturities of Long-Term Debt	22,261	21,214
Long-Term Debt, net of Current Maturities	$ 82,845	$ 99,786

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

As of September 30, 2010, maturities of long term debt are as follows:

October, 2010 – September 30, 2011	$22,261
October, 2011 – September 30, 2012	23,728
October, 2012 – September 30, 2013	25,292
October, 2013 – September 30, 2014	26,959
October, 2014 – September 30, 2015	6,866
Total	$105,106

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Note 7. Commitments And Contingencies

Leases

Andrea leases its corporate headquarters located in Bohemia, New York. The lease from an unrelated party, which currently expires in April 2015, is for approximately 11,000 square feet and houses Andrea’s warehousing, sales and executive offices. Rent expense under this operating lease was $22,367 and $68,547 for the three and nine-month periods ended September 30, 2010, respectively. Rent expense under this operating lease was $21,715 and $64,513 for the three and nine-month periods ended September 30, 2009, respectively.

As of September 30, 2010, the minimum annual future lease payments, under this lease and all other noncancellable operating leases, are as follows:

2010 (October 1 – December 31)	$26,796
2011	108,974
2012	105,728
2013	96,814
2014	99,718
Thereafter	33,565
Total	$471,595

Employment Agreements

In July 2010, the Company entered into an employment agreement with the President, Chief Executive Officer and Chairman of the Board, Douglas J Andrea. The effective date of the employment agreement was August 1, 2010. The employment agreement expires July 31, 2012 and is subject to renewal as approved by the Compensation Committee of the Board of Directors. Pursuant to his employment agreement, Mr. Andrea will receive an annual base salary of $337,500 for the period of August 1, 2010 through July 31, 2011 and for the period of August 1, 2011 through July 31, 2012 Mr. Andrea will receive an annual base salary of $350,000. The employment agreement provides for quarterly bonuses equal to 25% of the Company’s pre-bonus net after tax quarterly earnings in excess of $25,000 for a total quarterly bonus amount not to exceed $12,500; and annual bonuses equal to 10% of the Company’s annual pre-bonus net after tax earnings in excess of $300,000. All bonuses shall be payable as soon as the Company's cash flow permits. All bonus determinations or any additional bonus in excess of the above will be made in the sole discretion of the Compensation Committee. On August 1, 2010, the Board granted Mr. Andrea 1,000,000 stock options with an aggregate fair value of $130,000 (fair value was estimated using the Black-Scholes option-pricing model). The 1,000,000 grant vests in three equal annual installments over a three year period commencing August 1, 2011. These 1,000,000 stock options have an exercise price of $0.13 per share, which was the fair market value of the Company’s common stock at the date of grant, and a term of 10 years. Pursuant to the employment agreement and subject to the approval of the Board of Directors, the Compensation Committee will recommend a second grant of 1,000,000 stock options as soon as practical after August 1, 2011, with an exercise price equal to the per share fair market value of the Company’s common stock on the date of grant. Mr. Andrea is also entitled to a change in control payment equal to two times his salary with continuation of health and medical benefits for two years in the event of a change in control, as defined in the agreement. At September 30, 2010, the future minimum cash commitments under this agreement aggregate $644,119.

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

Legal Proceedings

Andrea is not currently involved in any pending legal proceedings.

Note 8. Stock Plans and Stock Based Compensation

In 1998, the Board adopted the 1998 Stock Option Plan ("1998 Plan"), which was subsequently approved by the shareholders. The 1998 Plan, as amended, authorizes the granting of awards, the exercise of which would allow up to an aggregate of 6,375,000 shares of Andrea's Common Stock to be acquired by the holders of those awards. The awards can take the form of stock options, stock appreciation rights, restricted stock, deferred stock, stock reload options or other stock-based awards. Awards may be granted to key employees, officers, directors and consultants. No further awards will be granted under the 1998 Plan.

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In October 2006, the Board adopted the Andrea Electronics Corporation 2006 Equity Compensation Plan (“2006 Plan”), which was subsequently approved by the shareholders. As originally adopted the 2006 Plan authorized the granting of awards, the exercise of which would allow up to an aggregate of 10,000,000 shares of Andrea’s Common Stock to be acquired by the holders of those awards. On July 24, 2009, shareholders approved an amendment to the 2006 Plan to increase the number of shares issuable under the 2006 Plan to 18,000,000. The awards can take the form of stock options, stock appreciation rights, restricted stock or other stock-based awards. Awards may be granted to key employees, officers, directors and consultants. At September 30, 2010, there were 4,213,936 shares available for further issuance under the 2006 Plan.

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

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

On August 1, 2010, the Board granted Mr. Andrea 1,000,000 stock options with an aggregate fair value of $130,000 (fair value was estimated using the Black-Scholes option-pricing model). The 1,000,000 grant vests in three equal annual installments over a three year period commencing August 1, 2011. These 1,000,000 stock options have an exercise price of $0.13 per share, which was the fair market value of the Company’s common stock on the date of grant, and a term of 10 years.

On September 22, 2010, the Board granted 916,500 stock options to employees of the Company. Each option grant provides for vesting periods of up to three years, an exercise price of $0.08 per share, which was the fair market value of the Company’s common stock on the date of grant, and a term of 10 years. The fair value of these 916,500 stock options was $73,320 (fair value was estimated on the date of grant using the Black-Scholes option-pricing model).

On September 22, 2010, pursuant to Andrea’s compensation policy for outside directors, Andrea granted 62,500 stock options to the chairperson of the Audit Committee and 25,000 stock options to each of the other three outside directors. The stock option grants provide for an 18-month vesting period, an exercise price of $0.08 per share, which was the fair market value of the Company’s common stock on the date of grant, and a term of 10 years. The fair value of these 137,500 stock options was $11,000 (fair value was estimated on the date of grant using the Black-Scholes option-pricing model).

The fair values of the stock options granted for the three and nine-month periods ended September 30, 2010 were estimated on the date of grant using the Black-Scholes option-pricing model using the following weighted-average assumptions:

	Three months ended September 30, 2010	Nine months ended September 30, 2010
Expected life in years	6	6
Risk-free interest rates	1.84%	1.84%

Volatility	168.22%	168.22%
Dividend yield	0%	0%

The fair values of the stock options granted for the three and nine-month periods ended September 30, 2009 were estimated on the date of grant using the Black-Scholes option-pricing model using the following weighted-average assumptions:

	Three months ended September 30, 2009	Nine months ended September 30, 2009
Expected life in years	6	6
Risk-free interest rates	2.90%	2.90%
Volatility	163.21%	163.21%
Dividend yield	0%	0%

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Option activity during 2010 is summarized as follows:

	Options Outstanding				Options Exercisable			
	Options Outstanding	Weighted Average Exercise Price	Weighted Average Fair Value	Weighted Average Remaining Contractual Life	Options Exercisable	Weighted Average Exercise Price	Weighted Average Fair Value	Weighted Average Remaining Contractual Life
At January 1, 2010	16,141,821	$ 0.20	$ 0.16	7.32 years	9,891,470	$ 0.29	$ 0.22	6.37 years
Granted	2,054,000	$ 0.10	$ 0.10					
Expired	(245,000)	$ 6.49	$ 4.53					
At September 30, 2010	17,950,821	$ 0.11	$ 0.10	7.05 years	12,628,391	$ 0.12	$ 0.10	6.26 years

During the three months ended September 30, 2010, 2,840,169 options vested with a weighted average exercise price and a weighted average fair value of $0.07 per option. During the nine months ended September 30, 2010, 2,981,921 options vested with a weighted average exercise price and a weighted average fair value of $0.07 per option. Based on the September 30, 2010 fair market value of the Company's common stock of $0.10, the aggregate intrinsic value for the 17,950,821 options outstanding and 12,628,391 shares exercisable is 444,580 and $303,464, respectively.

Total compensation expense recognized related to stock option awards was $50,953 and $60,476 for the three months ended September 30, 2010 and 2009, respectively. In the accompanying condensed consolidated statement of operations for the three months ended September 30, 2010, $39,875 of expense is included in general, administrative and selling expenses, $7,035 is included in research and development expenses and $4,043 is included in cost of revenues. In the accompanying condensed consolidated statement of operations for the three months ended September 30, 2009, $48,060 of expense is included in general, administrative and selling expenses, $11,399 is included in research and development expenses and $1,017 is included in cost of revenues. Total compensation expense recognized related to all stock option awards was $151,789 and $169,138 for the nine months ended September 30, 2010 and 2009, respectively. In the accompanying condensed consolidated statement of operations for the nine months ended September 30, 2010, $114,881 of expense is included in general, administrative and selling expenses, $24,645 is included in research and development expenses and $12,263 is included in cost of revenues. In the accompanying condensed consolidated statement of operations for the nine months ended September 30, 2009, $134,894 of expense is included in general, administrative and selling expenses, $32,177 is included in research and development expenses and $2,067 is included in cost of revenues.

As of September 30, 2010, there was $284,192 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the 1998 and 2006 Plans. This unrecognized compensation cost is expected to be recognized over the next four years ($52,767 in 2010, $157,606 in 2011, $59,117 in 2012 and $14,702 in 2013).

Note 9. Segment Information

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

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The following represents selected condensed consolidated financial information for Andrea's segments for the three-month periods ended September 30, 2010 and 2009.

2010 Three Month Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti-Noise Products	2010 Three Month Total
Net revenues from external customers	$ 240,567	$ 839,529	$ 1,080,096
License revenues	424,461	-	424,461
Income (loss) from operations	191,176	(69,758)	121,418
Depreciation and amortization	117,720	19,433	137,153
Purchases of property and equipments	3,454	6,418	9,872
Purchases of patents and trademarks	3,757	5,502	9,259
Assets	3,660,782	2,361,920	6,022,702
Total long lived assets	1,694,614	301,285	1,995,899

2009 Three Month Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti-Noise Products	2009 Three Month Total
Net revenues from external customers	$ 91,437	$ 948,274	$ 1,039,711
License revenues	358,256	-	358,256
Income (loss) from operations	34,441	(9,920)	24,521
Depreciation and amortization	117,902	12,504	130,406
Purchases of property and equipments	2,153	3,229	5,382
Purchases of patents and trademarks	1,245	4,484	5,729

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

The following represents selected condensed consolidated financial information for Andrea's segments for the nine-month periods ended September 30, 2010 and 2009:

2010 Nine Month Segment Data	Andrea DSP Microphone and Audio Software Products	Andrea Anti-Noise Products	2010 Nine Month Total

Net revenues from external customers	$	695,972	$	2,028,591		$	2,724,563
License revenues		1,245,731		-			1,245,731
Income (loss) from operations		474,659		(325,468	)		149,191
Depreciation and amortization		352,641		56,462			409,103
Purchases of property and equipments		20,145		39,803			59,948
Purchases of patents and trademarks							